

An Overview of LIBOR Transition Efforts¹

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¹The opinions expressed in this presentation do not necessarily reflect the views of FSF or U.S. GSIBs.

- ▶ The LIBOR reform started in 2012 with the Wheatley Review, which focused on the governance and oversight of LIBOR. In April 2013, the production of LIBOR became formally regulated by the UK Financial Conduct Authority (FCA).
- ▶ In 2013, the Financial Stability Board (FSB) initiated work to develop reform proposals for major interest rate benchmarks, including LIBOR. In 2014, the FSB released its reform proposal; recommended a multiple-rate approach to: (i) strengthen LIBOR by underpinning it to the greatest extent possible with transactions data; and (ii) to develop alternative, nearly risk-free reference rates.

- ▶ In 2013, the International Organization of Securities Commissions (IOSCO) released its Principles for Financial Benchmarks, which are benchmark quality, methodological quality, accountability, and governance. In February 2014, ICE Benchmark Administration (IBA) took over as the administrator of LIBOR and has strengthened the governance and oversight of LIBOR.
- ▶ In 2014, the Federal Reserve convened the Alternative Reference Rates Committee (ARRC) to identify robust alternatives to USD LIBOR and identify an adoption plan to facilitate the voluntary acceptance and use of these alternative reference rates.

- ▶ The ARRC narrowed its selection of potential alternatives to two rates: (i) an overnight Treasury repo rate - the Secured Overnight Financing Rate (SOFR); and (ii) a rate reflecting bank borrowing in overnight wholesale unsecured markets - the Overnight Bank Funding Rate (OBFR). In July 2017, the ARRC selected SOFR as its preferred alternative to USD LIBOR.
- ▶ Volumes underlying SOFR have been consistently above \$1 trillion in 2020, volumes underlying OBFR averaged \$200 billion in 2020.
- ▶ The second report of the ARRC estimated that, around the end of 2016, total exposure to USD LIBOR was around \$200 trillion: Derivatives 190; Business Loans 3.4; Consumer Loans 1.3; Bonds 1.8; and Securitizations 1.8.

- ▶ In September 2019, a group of bank representatives wrote to the regulators that “SOFR, on a stand-alone basis, is not well suited to be a benchmark for lending products” and expressed their concerns that “this transition will adversely affect credit availability.”
- ▶ During periods of economic stress, credit spreads on bank debt and other wholesale bank borrowings tend to increase, raising banks cost of funds. During times of economic stress, SOFR (unlike LIBOR) will likely decrease disproportionately relative to other market rates as investors seek the safe haven of U.S. Treasury securities.
- ▶ In that event, the return on banks SOFR-linked loans would decline, while banks unhedged cost of funds would increase, thus creating a significant mismatch between bank assets (loans) and liabilities (borrowings).

- ▶ In 2020, the Federal Reserve convened the Credit Sensitivity Group (CSG). The CSG held four workshops between June and August 2020. The CSG's initial plan was to recommend a specific credit sensitive rate/spread as a supplement to SOFR.
- ▶ In October and November 2020, the U.S. banking regulators stated that they would not endorse a specific replacement rate for LIBOR for loans: "A bank may use any reference rate for its loans that the bank determines to be appropriate for its funding model and customer needs. However, the bank should include fallback language in its lending contracts that provides the use of a robust fallback rate if the initial reference rate is discontinued."

- ▶ After selecting SOFR and setting out a Paced Transition Plan with respect to derivatives, the ARRC was reconstituted in 2018 to help ensure the successful implementation of the Paced Transition Plan and to serve as a forum for cash and derivatives market participants to address the risks of severe market disruption that could result from the cessation of LIBOR.
- ▶ The Paced Transition Plan called for central counterparties (CCPs) not to accept new swap contracts for clearing with Effective Federal Funds Rate (EFFR) as Price Alignment Interest (PAI) and discounting except for the purpose of closing out or reducing outstanding risk in legacy contracts that use EFFR as PAI and discount rate.

- ▶ In 2019, LCH and CME announced plans to take the following actions on October 16, 2020: (i) use SOFR for PAI/discounting of new swap contracts going forward; and (ii) modify outstanding swap contracts to replace EFR with SOFR for PAI/discounting.
- ▶ Both CCPs highlighted the implications of the discounting and PAI switch on bilateral contracts which can result in either the physical delivery of a cleared interest rate swap or in a cash settlement computed using the discount curve prevailing at a CCP.
- ▶ As the discounting rate changes: (i) the value of a swap changes; and (ii) it will have sensitivities to the new discounting rate and not the old one. CCPs often address the first one via a cash payment, and the second, where required, via an exchange of basis swaps.

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STATEMENT

- ▶ The administrator of LIBOR may cease the publication of the one week and two month USD LIBOR settings immediately following the LIBOR publication on December 31, 2021, and the remaining USD LIBOR settings immediately following the LIBOR publication on June 30, 2023.
- ▶ There may be circumstances where a bank can enter into new USD LIBOR contracts after December 31, 2021, such as: (i) transactions executed to participate in a CCP auction in the case of a member default; (ii) market making in support of client activity related to USD LIBOR transactions executed before January 1, 2022; and (iii) transactions that reduce or hedge the bank's or any client of the bank's USD LIBOR exposure on contracts entered into before January 1, 2022.