LIBOR Transition

EXPERT VIEWS

Insights and tips for managing the process, from industry leaders and global regulators.

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With clear timelines now established for the cessation of the London Inter-bank Offered Rate (LIBOR), all firms should actively prepare. As part of our support for firms during this transition, we've interviewed industry leaders and global regulators to hear their views on the latest developments, gleaning advice that can help you manage the process and actively transition your portfolio.

Featured interviews

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Arif Merali

SENIOR ADVISER, MARKETS DIRECTORATE,
BANK OF ENGLAND

Arif Merali has been actively involved in the LIBOR transition since 2015, representing his firms on the Working Group on Sterling Risk-Free Reference Rates (RFRWG) before joining the Bank of England in 2020.

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"Progress has been good, with effective cooperation between public and private sectors."

Maria Daniels

SENIOR LDI CORE PM & LDI LIBOR TRANSITION PROGRAMME LEAD,
BLACKROCK

Maria Daniels is a Senior Portfolio Manager within the EMEA Liability Driven Investment (LDI) business at BlackRock and has been with the company for 10 years. She's been responsible for the management and execution of the LDI LIBOR transition program across all LDI clients.

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"Our objective was and remains to ensure smooth and efficient execution, limiting market impact and ensuring readiness to take advantage of market opportunities as they arose."

Kari Hallgrimsson

MANAGING DIRECTOR AND CO-HEAD
OF EMEA RATES TRADING,J.P. MORGAN

Kari Hallgrimsson's responsibilities at J.P. Morgan include government bond trading, linear and non-linear interest-rate derivatives, inflation-linked products and FX forwards across G10.

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"The cessation statement provides much-needed clarity on the path of benchmark reform and, as a result, the market simply cannot delay transitioning away from LIBOR."

Philip Whitehurst

HEAD OF SERVICE DEVELOPMENT,
RATES DERIVATIVES, LCH

Philip Whitehurst has 30 years' experience in the over-the-counter (OTC) derivatives markets, in a range of functions and firms. Recently, he has focused on the post-reform outlook for the OTC derivatives markets, from both a regulatory and commercial perspective, as swaps markets adjust to central clearing.

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"We hope our recent guidance spurs firms to consider more proactive transition activities, by providing certainty of outcome if they are more passive."

Arif Merali

BANK OF ENGLAND

SENIOR ADVISER,
MARKETS DIRECTORATE

Arif Merali is a Senior Adviser for the Bank of England, focusing on Risk-Free Rate (RFR) transition, with 25 years' experience trading interest-rate derivatives at major investment banks including Credit Suisse, where he spent 15 years as a Managing Director in charge of sterling rates trading.

Here, he sets out the Bank's position on collateral referencing the London Inter-bank Offered Rate (LIBOR); the Sterling Overnight Index Average (SONIA) adoption in linear, non-linear and exchange-traded derivatives; and the Bank's advice to firms who are yet to start active portfolio transitions to RFRs.

"WE WOULD ENCOURAGE FIRMS TO ENGAGE WITH THEIR COUNTERPARTIES AS SOON AS POSSIBLE REGARDING ACTIVE TRANSITION, GIVEN THE LIMITED TIME AVAILABLE UNTIL THE END OF 2021."

The Bank has recently updated its policy for collateral referencing LIBOR. What has changed and how are you treating U.S. dollar collateral, given the later date for cessation?

The Bank previously announced that it would implement scheduled haircut add-ons on LIBOR-linked collateral. Last month we updated our approach. In particular, we reserve the right to waive those add-ons where we are satisfied that a robust fallback or a future rate-switch mechanism (meeting certain conditions) is in place.

In response to the updated transition timelines for certain U.S. dollar LIBOR settings, the Bank is reviewing its approach to collateral referencing those settings and will communicate its decision in due course. In the meantime, such collateral will not be subject to the scheduled add-ons unless it also references other LIBOR rates. Consistent with U.S. authorities' guidance on the use of U.S. dollar LIBOR in new contracts, the Bank will not accept new collateral linked to those U.S. dollar LIBOR settings if issued after 1 January 2022. Additionally, the Bank will only accept collateral linked to those U.S. dollar LIBOR settings that has been issued on or after 1 April 2021 and before 1 January 2022 if it is satisfied that a robust fallback or a future rate-switch mechanism is in place.

We have just passed the RFRWG end-Q1 milestone for ceasing new use of sterling LIBOR for most products. What are these, how successful have they been and how much focus is there on them from the Bank of England?

The Working Group on Sterling Risk-Free Reference Rates (RFRWG) recommended end-Q1 milestone is to cease initiation of new sterling LIBOR-linked loans, bonds, securitisations and linear derivatives (except for risk-management of existing positions) that expire after the end of 2021.

These milestones have certainly been successful in focusing attention and setting out a clear plan of action. And whilst it is too early to say yet whether they have been fully met by all, new issuance in sterling bond markets has been almost exclusively against the Sterling Overnight Index Average (SONIA) for some time now, and SONIA volumes in swap markets have continued to increase since the 'SONIA first' convention switch last year, such that most business is no longer on sterling LIBOR. Although lending markets were slower to adopt SONIA, we have seen a marked increase in new SONIA lending in the weeks leading up to the end-Q1 milestone.

There is very close supervisory focus on these milestones, as evidenced by the recent 'Dear CEO' letter from the Prudential Regulation Authority and Financial Conduct Authority (FCA), in which the authorities said that they expect all firms to meet the milestones of the RFRWG. They will be collecting information regularly from firms to assess progress.

Whilst there has been good progress in SONIA adoption in linear derivatives, progress in non-linear derivatives and exchange-traded derivatives has been slower? Are you concerned by this, and what are you planning to do about it?

The RFRWG has a recommended end-Q2 milestone for ceasing initiation of new non-linear and exchange-traded derivatives (except for risk-management of existing positions). This reflects a sequenced approach, allowing the market to build upon the very strong liquidity that has developed in the core swap market. And although SONIA volumes in non-linear and exchange-traded derivatives markets start from a relatively low base, they have increased significantly in recent months as momentum begins to grow.

The Bank and FCA have recently announced their support for a 'SONIA first' convention switch for non-linear derivative markets on 11 May, and are currently considering steps to support a similar convention switch for exchange-traded derivatives towards the end of Q2. Regulated firms were also encouraged to support steps to build liquidity in these markets in the 'Dear CEO' letter.

Looking further forward, the RFRWG's recommended timeline for market participants to cease initiation of cross-currency derivatives with a sterling leg is during Q2/Q3.

What advice would you give to firms who are yet to start active portfolio transitions to RFRs?

The RFRWG's milestones on active transition recommend that firms should have identified all legacy exposures that can be actively converted by end-Q1 and progress active conversion where viable, through to completion by end-Q3. This message was reiterated by supervisors in the 'Dear CEO' letter and active transition is the primary way for firms to retain economic control of their contracts.

Following the announcements on the end of LIBOR on 5 March 2021, firms now have certainty about the cessation dates of panel-bank LIBOR and the fixing of the 'spread adjustments' by the International Swaps and Derivatives Association (ISDA) creates a clear economic link between sterling LIBOR and SONIA, providing a firm basis for discussions about active transition.

As such, we would encourage firms to engage with their counterparties as soon as possible regarding active transition, given the limited time available until the end of 2021; and where active transition is not viable, firms will of course want to ensure that robust fallbacks are in place.

For support with these discussions, firms can refer to various informative documents produced by the RFRWG, available via the RFR transition pages on the Bank of England website.

What would you say is the biggest obstacle firms are facing as they prepare for the transition away from LIBOR?

The transition away from LIBOR is a significant shift for the market. LIBOR has been used for decades across multiple currencies, embedded in market infrastructure and used as the dominant interest rate benchmark in a wide range of contracts. It is not a challenge to be underestimated, but with cessation now imminent it is clearly essential and thankfully most market participants realised some time ago the importance of ensuring they are prepared for life without LIBOR.

Progress has been good, with effective cooperation between public and private sectors in each of the relevant LIBOR currency jurisdictions, leading to selection of robust alternative Risk-Free Rates (RFRs). Following the excellent work of ISDA, there is a fallback in place covering approximately 97% of sterling interest-rate swaps.

Legislative solutions to support tough legacy contracts are being progressed in a number of jurisdictions, including the U.K. However, we note that further work remains. In particular, we would encourage firms to continue to support their clients in switching to more robust alternatives, to ensure that infrastructure is aligned to the latest market conventions, and, where feasible, to actively transition legacy LIBOR contracts onto the most robust forms of RFRs.

Maria Daniels

BLACKROCK

SENIOR LDI CORE PM & LDI LIBOR TRANSITION PROGRAMME LEAD

Maria Daniels delivers the capabilities and expertise of the Global Fixed Income platform and the wider BlackRock organization, operating within the Liability Driven Investment (LDI) team responsible for trade construction, implementation and ongoing mandate and risk management of LDI investment solutions across the fixed-income risk spectrum. She told us about her experience of transitioning to the Sterling Overnight Index Average (SONIA), the liquidity and transaction costs in SONIA derivatives, and the biggest obstacles she sees for firms which are yet to transition.

"HAVING A CLEAR PLAN, WITH DEFINED OBJECTIVES, TIMESCALES AND TOLERANCES IS ESSENTIAL."

UK LDI asset managers were some of the first to transition sterling London Inter-bank Offered Rate (LIBOR) portfolios to SONIA. Could you describe how you approached the transition?

We had a clearly-defined transition plan with key objectives, investment principles, market tolerances and timeframes. This allowed for flexibility to take advantage of market liquidity and act swiftly to market axes, thereby reducing transaction costs and expediting the program. The transition was split into several phases with respect to risk management and was managed across all clients ensuring Treating Clients Fairly (TCF) was achieved across all portfolios.

Trade structuring and the ability to facilitate trading via both bilateral and cleared routes played a key role in managing complex portfolio structures and allowed us to take advantage of both inter-portfolio and cross-portfolio offsets across the whole BlackRock franchise, further reducing transaction costs for our clients. The LDI portfolio-management team worked closely with the BlackRock trading team to ensure smooth and efficient execution, limiting market impact and ensuring readiness to take advantage of market opportunities as they arose.

How have you found liquidity in the SONIA derivatives market since transitioning your portfolios? Are there any products in which liquidity is harder to find than it was in sterling LIBOR?

As part of our portfolio-management process, we monitor liquidity and transaction costs across SONIA and LIBOR products, and transaction costs for SONIA swaps have cheapened as the market has shifted from LIBOR and SONIA swaps have become more liquid. With the transition of the inter-bank market to SONIA as default on 27 October 2020, this further shifted the market towards SONIA swaps.

In terms of products where liquidity can be harder, whilst the swap transition is well progressed, non-linear instruments such as swaptions, as well as cross-currency swaps, are slightly behind in their journey. SONIA is what most long-term clients want to trade; it's the default in the inter-bank market and offers better liquidity and cheaper transaction costs, so active accounts use it for duration views. With additional support from the regulatory tailwinds to transition, its dominance over LIBOR is entrenched.

Now we have the LIBOR cessation/non-representativeness statement from the FCA, do you feel we will see a significant pick-up in active portfolio transitions across asset managers?

The cessation statement is another helpful step on the journey, although given it was expected by the market, and we'd already seen other significant catalysts (the ISDA Protocol; SONIA becoming the inter-bank default; steps to transition in other sectors like insurance, etc.), we are already well on the journey with many proactive market participants already having progressed through transitions.

What would you say is the biggest obstacle firms are facing as they prepare for the transition away from LIBOR?

There are obvious considerations that LIBOR is deeply entrenched in some markets, which has complicated the transition. We also have the further consideration of the impact of regulation in certain sectors. These factors can add to the challenges in the transition away from LIBOR. In addition, for some smaller market participants, it's logistically and operationally challenging to manage the transition. Firms need to ensure that all parts of the operational chain can facilitate the fallback. Another consideration would be that, given the phased approach across the different markets – e.g. the U.S. dollar and sterling not transitioning at the same time – this has further implications for instruments that cross these markets, e.g. the use of cross-currency swaps. The additional cost of not transitioning would be holding LIBOR instruments with declining liquidity.

Kari Hallgrimsson

J.P. MORGAN

MANAGING DIRECTOR AND CO-HEAD OF EMEA RATES TRADING

Kari Hallgrimsson joined J.P. Morgan as a graduate in 2002, after gaining a Master's degree in Finance and Economics from the London School of Economics, and a Bachelor's degree in Mechanical and Industrial Engineering from the University of Iceland. He shares his views on how the FCA's cessation statement will impact derivative liquidity, why a push to increase Secured Overnight Financing Rate (SOFR) trading could be beneficial, and what advice he'd give to firms who are yet to transition.

"FIRMS NEED TO HAVE THE RIGHT INFRASTRUCTURE TO TRANSITION AND BE MINDFUL TO AVOID THE POTENTIAL RUSH RIGHT BEFORE THE CESSATION DATES."

Liquidity in SONIA-based derivatives is quite far ahead of other markets. What impact will the FCA's cessation statement have on liquidity in SOFR-, SARON- and TONAR-based derivatives?

The statement should have a very positive impact on the liquidity for all Risk-Free Rates (RFRs). It provides much-needed clarity on the path of benchmark reform and, as a result, the market simply cannot delay transitioning away from the London Inter-bank Offered Rate (LIBOR).

By releasing the statement, the FCA effectively fixed the spread between LIBOR and the corresponding RFRs in the vast majority of the derivative markets, for any fixing after the predetermined cessation date. As a result, any market participant that had 'LIBOR risk' prior to the announcement, will have RFR risk now. This should materially increase the amount of trading in the underlying RFR, going forward, and hence the liquidity in the product itself.

Have you seen differences in approach to transitioning non-cleared derivative portfolios across customer segments? Do you think some customers will rely on the 2020 ISDA Fallbacks Protocol as the primary transition mechanism to RFRs for non-cleared derivative portfolios?

We can broadly group our clients into three categories with regards to transition speed. First, you have the early adopters that worked with us and proactively transitioned their linear derivative portfolios over the last couple of years. In the UK, this was mainly the liability-driven investment clients and bank treasuries. Secondly, you have clients that actively trade in derivative markets. Their positions change frequently and, as a result, they want their risk in the most liquid instrument. They tend to transition when the market for RFRs is as liquid as the corresponding LIBOR market.

In sterling, the liquidity tipping point where the Sterling Overnight Index Average (SONIA) became more liquid than LIBOR was, after the 'SONIA first' initiative where the market coalesced to change the default in markets to SONIA. I think a similar push to increase Secured Overnight Financing Rate (SOFR) trading would be beneficial; this could be done in stages where one part of the LIBOR market is targeted to switch to SOFR in each stage. The third group tend to be corporates who trade infrequently, and other clients who have underlying risk associated with products that have been slow to transition, such as non-linear or cross-currency markets.

I do think some participants may rely on the fallback, although there is a potential that any derivative which relies only on ISDA fallback could become less liquid.

The cross-currency and non-linear markets have been slow to develop in RFRs across the U.S., U.K., Japan and Switzerland, and some non-LIBOR jurisdictions have confirmed they will continue with a multi-index approach and maintain their domestic IBORs alongside existing or new RFRs. Meanwhile, domestic overnight index swap markets are not well developed across some of these jurisdictions. How do you think this will affect liquidity and the preferred quoting convention for the inter-bank cross-currency market?

The default convention for all major currencies is to trade against the U.S. dollar in the cross-currency market. That means that these cross-currency swaps are now effectively against SOFR for any transaction that has a maturity after June 2023. As a result, I expect that market conventions will change to be based on overnight indices on both sides. I would be supportive of an initiative where major market participants proactively change market conventions on specific dates, similar to what was successfully done in the sterling interest-swap market last year.

Across cash and loan markets, there are a number of different potential payoffs for RFR-based caps and floors. Do you expect the inter-bank market to coalesce around a single payoff for hedging purposes?

Yes, I do. Taking the sterling market as an example, which is far ahead of other markets in terms of transitioning, the inter-bank market for caps and floors trades daily-compounded SONIA, paid quarterly. I would expect other currencies to evolve in a similar manner.

How do you think alternatives to daily RFRs, such as term fixings and credit sensitive indexes, will play a part in the post-LIBOR world?

Their usage will ultimately depend on end users and the issues they face in using an Overnight Index Swap-based index instead of LIBOR. For example, some trade capital and Islamic finance products require variable rates that are pre-determined and, as a result, would need terms. Other products might need the index to be linked to credit conditions, which RFRs generally don't reflect.

What advice would you give to firms who are yet to start active portfolio transitions to RFRs?

The starting point is to understand their exposure to LIBOR. They should map out their LIBOR risk by product, currency and maturity. As a result, they will be able to understand the risk they face if they do not transition and rely on fallback methodologies. Secondly, they should make sure they have the infrastructure to transition. That includes ensuring they can book and risk-manage RFR products. Finally, they should develop a detailed plan on how they look to transition their portfolio through time, and be mindful to avoid the potential rush to transition right before the cessation dates.

What would you say is the biggest obstacle firms are facing as they prepare for the transition away from LIBOR?

Overall, I think infrastructure will be the biggest hurdle for many clients. Not only do clients have to be able to trade, book and risk-manage RFRs, but they will also have to untangle LIBOR from all their internal systems, which is easier said than done.

Philip Whitehurst

LCH

HEAD OF SERVICE DEVELOPMENT, RATES DERIVATIVES

In addition to his role within LCH's Rates Derivatives business, **Philip Whitehurst** represents LCH on a number of industry groups working on benchmark reform, including the Alternative Reference Rates Committee in the U.S., and the U.K.'s Working Group on Sterling Risk-Free Rates. We spoke with him about the future clearing eligibility for London Inter-bank Offered Rate (LIBOR)-based derivatives, the Federal Reserve's guidance on timelines for LIBOR-based contracts, and what advice he'd give to firms who are yet to transition.

"IT'S FAIR TO SAY THE TREND IN SOFR, SONIA, SARON AND TONAR CLEARED VOLUMES IS ONE OF GROWTH ACROSS THE BOARD."

LCH was the first CCP to consult the market on proposals to actively transition cleared LIBOR-based portfolios to market standard RFR-equivalents. Could you describe the proposal for conversion?

Great as the fallbacks are, we were concerned that they give rise to swaps where the label says one thing ("LIBOR") but risks are to something else. To square this back up, our consultation proposed a compensated contractual conversion of LCH-cleared LIBOR swaps into corresponding Risk-Free Rate (RFR) equivalents shortly before the cessation effective date. We were pleased to get really strong engagement from our members and clients, and strong support for the approach.

The one thing we've modified relates to the spread adjustment that Bloomberg is producing: we are going to carry that as a non-compounded spread on the RFR leg of the converted contract. We've also confirmed recently that we plan to preserve the economic effect of any representative LIBORs between now and the end of the year. And confirmation that U.S. dollar LIBOR will continue to be published until June 2023 means we can defer the conversion process in that market, for now.

What does this mean for future clearing eligibility for sterling, Swiss franc, yen and euro-LIBOR-based derivatives?

Our plan is to tie the withdrawal of clearing eligibility to the conversion dates. These are set now, as the weekend of 18 December 2021 for sterling LIBOR contracts, and 4 December 2021 for yen, Swiss franc and euro LIBOR trades. In short, we don't plan to clear swaps tied to these benchmarks beyond these dates. We've picked up on some concerns that this might create a challenge for swaption trades that physically settle into LCH-cleared swaps, so we are working on a potential solution for that – it's something that will need sensitive handling to ensure it's clear that no newly-traded LIBOR swaps would be eligible.

The U.S. Federal Reserve has recently reiterated guidance to regulated firms to not enter into new LIBOR-based contracts after the end of 2021. What implications might this guidance have for central clearing?

This is an interesting and potentially-challenging area. The guidance is clear, and there are only very limited circumstances in which entering into new U.S. dollar LIBOR contracts are viewed as appropriate. However, noting that there are such circumstances and that clearing obligations may still apply, it could help to minimize systemic risk if central counterparties (CCPs) were to keep eligibility open for a period. We would need to monitor liquidity very closely, and we have a risk framework that can be adapted to these conditions.

Could you talk about the trends in SOFR, SONIA, SARON and TONAR cleared volumes you have seen at LCH over the last 12 months?

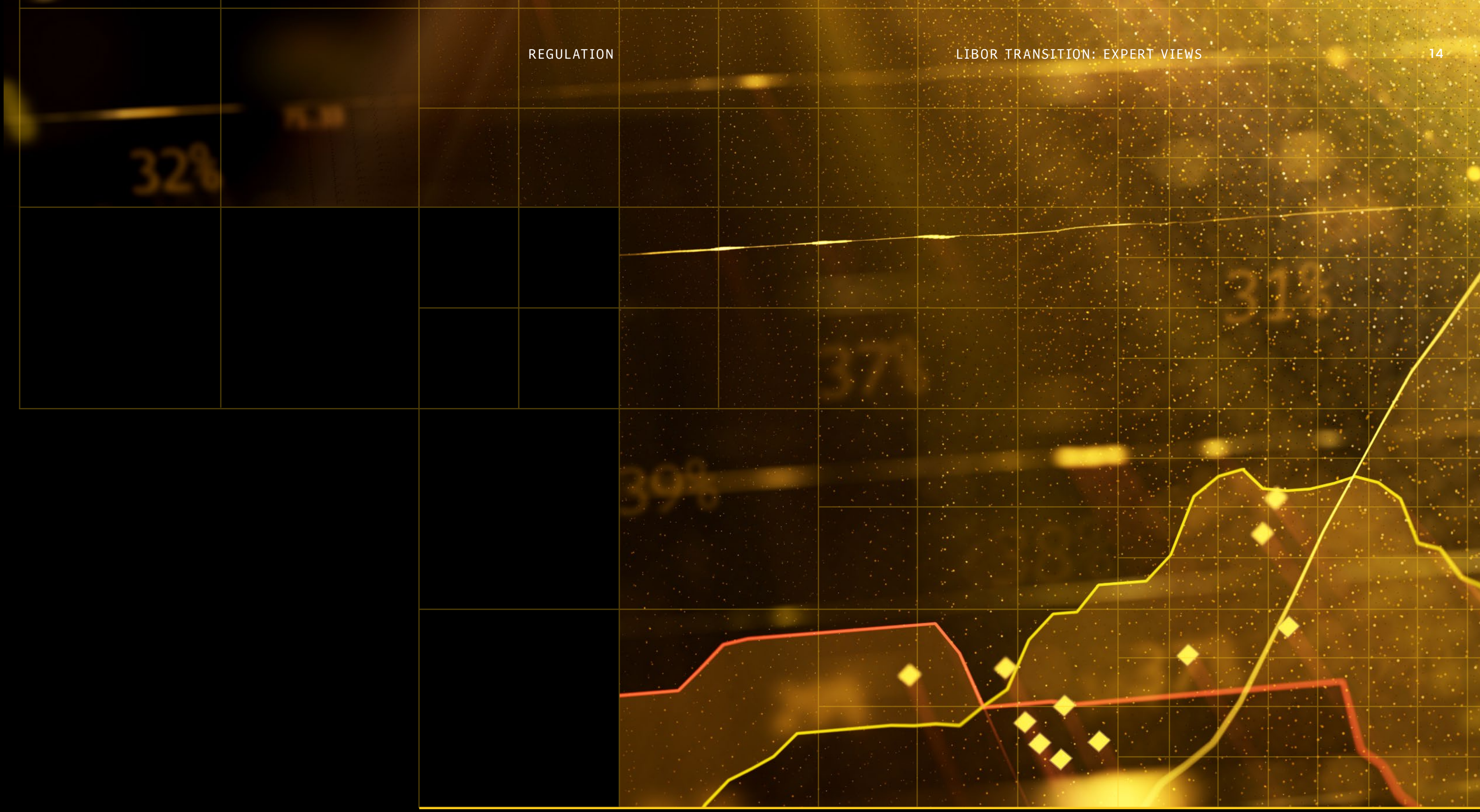
Each market is individual, but it's fair to say the trend is one of growth across the board. We've had two big events to spur Secured Overnight Financing Rate (SOFR) volumes: the first, the discounting transition, was specific to SOFR and arguably brought it into parity with other RFRs; and the second, which applies to all these benchmarks, was the UK FCA LIBOR announcement on 5 March 2021. This is likely to be a lift across the board, by infusing latent liquidity into RFR-based swaps in all LIBOR currencies.

What advice would you give to firms who are yet to start active portfolio transitions to RFRs?

One way to think about the conversion processes we have announced, which of course apply only to LCH-cleared swaps, is that they create a backstop or a baseline. Our participants now know what happens if they do nothing. We hope this spurs them to consider more proactive transition activities, by providing certainty of outcome if they are more passive.

What would you say is the biggest obstacle firms are facing as they prepare for the transition away from LIBOR?

We hear constantly about the sheer scale and complexity of the transition process. Against the backdrop, we hope that clarity about what will happen to their cleared swaps will help simplify at least one element of the transition.



Lost in transition?

As the move away from LIBOR continues, Bloomberg offers a comprehensive suite of data, analytics and portfolio solutions to help market participants assess the impact of the transition to risk-free-rates, providing transparency and support for all products across our platform.

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