LIBOR

Looking ahead to the post-Libor landscape

10 Jan 2022

Libor's days are coming to an end, so what does the future hold? A *Risk.net* expert panel discusses the original dream of a multi-benchmark world, and whether it is still alive

When the Financial Stability Board delivered its original report on Libor reform in 2014, the focus was on strengthening Libor and developing alternative rates. The future it envisaged was a multi-benchmark world, which would still have been a radical departure from the past. But, as it became clear that Libor could not be relied upon and was going to be discontinued, the impetus was to try to build liquidity in the risk-free rates (RFRs). And there has been criticism of various unofficial Libor replacements.

As the market transitions to the new rates, the debate about the evolution of alternative rates, including RFRs and credit-sensitive rates, is at an inflection point. In an industry panel, LCH and Bank of America offer their views on what lessons can be learned from recent conversions of cleared swaps, and what the future holds for Libor replacement rates. The panel also considers whether, in the nearer term, the market is ready for the first round of US dollar Libor conversions.

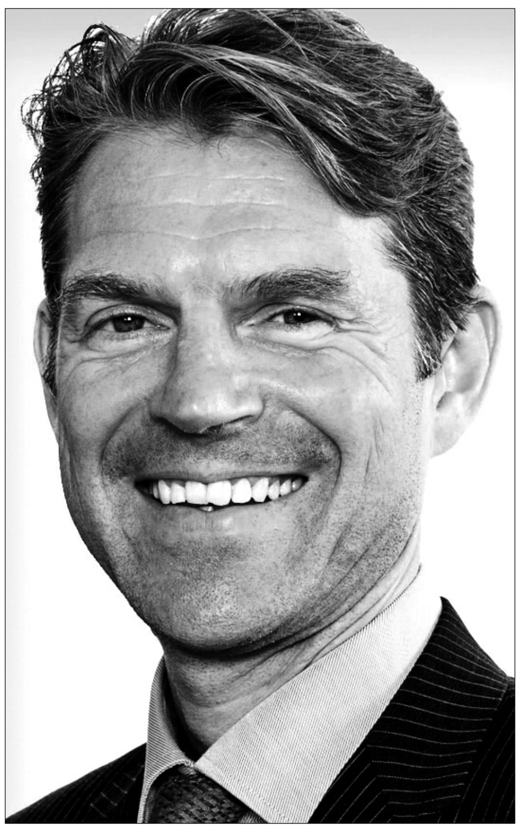
The Panel

- **Philip Whitehurst**, Head of Service Development, Rates, LCH
- **Mark Cabana**, Head of US Short Rates Strategy, Bank of America
- **Moderated by Duncan Wood**, Editorial Director, Infopro Digital

Recent conversions

LCH's recent cleared swaps conversion exercise in Swiss franc, Japanese yen, sterling and euro can offer some important insight for US dollar Libor conversion.

Philip Whitehurst said sterling Libor was the most substantial population LCH had converted, amounting to about 185,000 trades for around $15 trillion worth of cleared swaps. They were converted into sterling overnight index average (Sonia) equivalents on a compensated basis. The same was applicable for around 75,000 yen Libor trades, with aggregate notional of about $4.5 trillion, and 25,000 to 30,000 Swiss Libor trades worth about $1.5 trillion, as well as a very small population of euro Libor trades. He stressed that Euribor trades were not converted.



Philip Whitehurst, LCH

Whitehurst explained: “We have followed the guidance from the national working groups and what has been subsequently embedded into the International Swaps and Derivatives Association [Isda] definitions – which is to make use of the conversion exchange rate between the Libors and their recommended RFRs.”

He said that, essentially, LCH had put service users into RFR-equivalent instruments. The feedback from members and service users since the conversion has been generally positive, and LCH is satisfied with the volume of subsequent queries.

Whitehurst drew a parallel with the euro overnight index average (Eonia) to euro short-term rate (€STR) conversion, which was also a seamless night-and-day switch. “This is a signal that the market is very capable of making these quite abrupt changes, which is a great credit to the marketplace and the preparations that people have made.” Most would have expected a more gradual conversion. But Whitehurst said that LCH had expected this. “People tend to continue to do what they've always done for as long as they are allowed. It’s only when people are forced to recognise that the game is up that they will switch their liquidity across.”

LCH used the same playbook and protocols for all these conversions, with Whitehurst explaining: “LCH does not want to put the marketplace through different builds for equivalent processes.”

Credit-sensitive rates

A *Risk.net* poll revealed that 43% of participants believe most of the liquidity in cash and derivatives will be in RFRs, but there will be some use of credit-sensitive rates in low markets, and some hedging of those rates. One-third believed cash and derivatives liquidity will be split across two or three benchmarks. Fewer than 15% believe all liquidity in cash and derivatives will solely be in the RFRs.

Mark Cabana also imagined a multi-rate world. He said the secured overnight financing rate (SOFR) was not perceived by the market as a benchmark rate that could satisfy all of its needs. “Notably, it lacks term structure, at least in the way it is most widely utilised. More importantly, it lacks credit sensitivity.” Cabana says the market views the credit sensitivity inherent in Libor as a feature, despite what regulators might say. Conversely, the lack of credit sensitivity in RFRs was seen as a flaw.

“In the real-money universe, lenders like to lend off rates that have a term structure and dynamic credit sensitivity, because it is a hedge for their liabilities,” explained Cabana. He said these features help protect lenders when the underlying credit quality of their borrower deteriorates along with credit conditions. The overall rate they lend off might move higher, which affords lenders some inherent credit protection.

“Banks like their assets and liabilities to be somewhat correlated to a similar rate,” he said. “And their liabilities – or at least their marginal cost to borrow – are sometimes quite correlated with Libor.”

Cabana said that investors in a loan or some type of corporate debt issue also like some protection if broad credit conditions worsen. Libor widens or increases depending on the deterioration of the underlying credit quality of the loan or instrument in which they have invested. "Libor provides some additional compensation for that underlying deterioration, and a credit-sensitive rate will provide that in the future."

Whitehurst said LCH also anticipates a multi-rate world. "As a CCP [central counterparty], we support the availability of a choice of benchmarks so customers can make the most appropriate choice for their context." He said LCH foresees a swaps market in which most of the business takes place in the RFRs, and that not all swaps users are interested in benefiting from credit sensitivity. But he agreed there are many who wanted that feature.

Regulators seem to have been unswayed by arguments for credit-sensitive rates for the most part of the process. But Cabana said he believes rates would prove robust in times of stress. He also noted: "Once regulators have succeeded in their primary objective of ensuring a smooth transition away from Libor, the opposition to these underlying credit-sensitive rates will dissipate over time."

Pricing-in compensation for broad credit risk

Since SOFR does not offer compensation during periods of credit stress, Cabana said that lenders and investors on the real-money side are forced to introduce upfront compensation. But he noted that not all parties have a high degree of confidence in their ability to price this in appropriately, and many are concerned they are not being adequately compensated at current levels. "There has been a delay in the adoption of any type of SOFR-based lending, due to these challenges."

The market has grappled with what is an appropriate amount of compensation for broad credit risk in the economy to add to an RFR. But Cabana has observed that some conventions are beginning to be formed. "For example, investors in a loan that floats off SOFR would price that as SOFR plus the credit spread, based on the underlying loan quality, plus 10 basis points at one-month tenure. This would compensate them for when SOFR falls in times of market stress, when credit-sensitive rates typically rise."

However, Cabana emphasised that what the market is pricing in is influenced by current benign credit and liquidity conditions, and probably does not account for the less liquid economic, credit or monetary cycles of the future. "Some lenders or investors may find that what they think is adequate compensation proves to be insufficient."

Levels of compensation might be implied by past periods of credit stress for an RFR. But Cabana said this depends on how long that credit period is expected to last. Instead, Cabana suggested following Isda's fallbacks. "These do price in more compensation than the market has been getting."

The US dollar Libor transition

One of the key considerations that remains is US dollar Libor transition, which will involve the biggest share of the market. There is more uncertainty around market preparedness for this, given the volume of contracts in the market and the variety of replacement rate options.

With around one million contracts worth $100 trillion of exposure, Whitehurst said that the US dollar conversions represented a more significant task for LCH than the non-US-dollar conversions. US dollar Libor has a mid-year, as opposed to a year-end, cessation and he noted there would be a much longer period of heavily constrained trading in swaps linked to dollar Libor. "So, LCH will have to monitor liquidity carefully. But there are a few products that are specific to the US dollar market that we are already considering.”

“LCH may handle the US dollar Libor conversion differently, but only if participants think it would improve the process and give them an even smoother experience,” said Whitehurst. With the benefit of any lessons learned from the conversions of 2021, he said LCH would be having more dialogue with the market in the beginning of 2022. And he said LCH would consider holding another consultation on their proposals, for which it has had very good engagement in the past.

Summary

LCH’s recent cleared swaps conversion exercise was seamless, and used consistent protocols for the yen, Swiss franc, euro and sterling conversions. However, depending on feedback, LCH may handle US dollar Libor conversion slightly differently.

Participants believed that, by 2024, most of the liquidity in cash and derivatives will be in RFRs, but there will be some use of credit-sensitive rates because these can provide compensation for broad credit risk.
In the meantime, lenders and investors are advised to follow Isda’s recommendations for pricing compensation for broad credit risk into RFRs.

There has been good progress so far on mitigating systemic risk associated with benchmarks and cessation, although there are remaining idiosyncratic, geographic, product and institutional risks that must be managed. Moving forward, the conversation will turn from Libor reform and transition to how the rates mature and how the market starts behaving in them.