RESERVE BANK OF AUSTRALIA

Speech

# Progress on Benchmark Reform

**Guy Debelle** [*]
Deputy Governor

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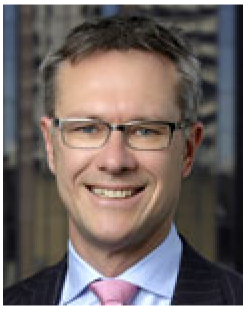

Good morning and thanks to ISDA for the opportunity to speak here today.

It has been almost two years since Andrew Bailey announced that the FCA (the UK Financial Conduct Authority) would no longer use its powers to sustain LIBOR (the London Inter-Bank Offered Rate) beyond 2021. [1] Since that time, preparing for the end of LIBOR has been a key challenge for the global finance industry. Today I will provide an update on the progress with benchmark reform internationally, and highlight some of the key issues in the Asia-Pacific region. [2]

## The End of LIBOR

There is now widespread recognition that LIBOR will come to an end. The fundamental problem is that there are not enough transactions in the short-term inter-bank market to underpin LIBOR. The banks that make the submissions that are used to calculate these benchmarks are uncomfortable about continuing to do this, as they have to mainly rely on their 'expert judgement' rather than actual transactions. To prevent LIBOR from abruptly ceasing to exist, the FCA has received assurances from the current banks on the LIBOR panel that they will continue to submit until the end of 2021. But beyond that point, there is no guarantee that LIBOR will survive. The FCA will not compel banks to provide submissions and the panel banks may choose to stop.

Financial regulators around the world expect institutions using LIBOR to be ready to transition to more robust benchmarks. If they haven't already done so, users need to identify their exposures to LIBOR now and be working on transitioning to alternative rates. We know that a sizeable number of financial contracts referencing LIBOR extend beyond 2021, including derivatives, bonds and loans. The transition will involve a substantial amount of work, both to amend contracts and update systems. The Financial Stability Board's (FSB) Official Sector Steering Group (OSSG) has been monitoring progress on the transition and on ensuring that contracts referencing LIBOR include robust fall-back provisions.

## Progress on Adopting Alternative Risk-free Rates

The transition from LIBOR to alternative risk-free rates (RFRs) is accelerating internationally. RFRs have been identified for all the LIBOR currencies by national working groups involving the private sector and regulators. The rates chosen are overnight RFRs, either measured from transactions in inter-bank unsecured lending markets or repo markets. It has now been a year since the Fed started publishing SOFR (the Secured Overnight Financing Rate), and since the Bank of England implemented reforms to SONIA (Sterling Overnight Index Average). Recently, the ECB announced that it will launch €STR (Euro Short-term Rate) at the start of October. These rates are more robust than LIBOR, since they are anchored in active, liquid underlying markets.

Usage of RFRs in derivatives markets is increasing. Futures and cleared swaps referencing SOFR have started trading, which is ahead of the schedule set by the ARRC (the Alternative Reference Rates Committee, which is the US working group on LIBOR transition). There has been even more progress for sterling, where trading in cleared OTC derivatives referencing SONIA is now broadly equivalent to that of sterling LIBOR.[3]

The RFRs are also being adopted in some cash products. In bond markets in particular, a wide range of institutions have issued floating-rate bonds referencing the RFRs. Since July last year, there have been quite a few deals referencing SOFR. The transition is further advanced for sterling, where SONIA has been used in just over half of the deals this year. This has included two Australian banks issuing sterling floating-rate bonds referencing SONIA. The rapid adoption of SONIA in the bond market demonstrates that RFRs *can* be used in cash products that previously only referenced LIBOR.

## Can Robust Term Risk-free Rates Be Developed in Time?

Some market participants argue that overnight RFRs may not be the most appropriate benchmarks to use in all cases. In particular, lenders and borrowers in the syndicated loan market have raised concerns about using the overnight RFRs in place of LIBOR. This is not that surprising, since LIBOR was originally set up to cater for the syndicated loan market. Participants in this market want to know the interest payments on loans in advance. This is possible with a forward-looking rate such as LIBOR, which is set at the beginning of the interest period. But it is not possible when compounding an overnight RFR, which can only be calculated at the end of the period.

In response to this, some of the national working groups have been considering how to develop 'term RFRs'. These forward-looking rates could potentially be constructed from derivatives referencing the overnight RFRs. However, for such term RFRs to be considered robust, there would need to be sufficient liquidity and transparency in the underlying derivatives markets. The ARRC is aiming for a term rate based on SOFR derivatives to be developed by end 2021, once there is sufficient liquidity to produce a robust rate.

The currency most progressed on developing a term RFR is sterling. But the recent consultation run by the UK working group found that there would need to be a 'step change' in activity in derivatives markets for a term SONIA rate to be sufficiently robust. [4] At the other end of the spectrum, the Swiss working group has found that a term RFR is not feasible given the low level of activity in derivatives referencing the Swiss franc RFR. [5]

While the development of term RFRs is desirable, it is not yet clear that they will be sufficiently robust. In this context, we encourage market participants preparing for the LIBOR transition to work on using overnight RFRs rather than waiting for the development of term RFRs. Furthermore, the FSB has made it clear that derivatives markets will largely need to transition to the overnight RFRs to ensure financial stability. Derivatives represent the largest exposure to LIBOR, and only transitioning to the overnight RFRs can address the core weakness of LIBOR, which is the absence of deep and liquid markets to underpin these benchmarks. [6]

## Finalising Work on Contractual Fall-backs

Another key focus over the past year has been on developing more robust fall-back provisions in contracts referencing LIBOR. This would reduce the risk of financial instability if these benchmarks were to abruptly cease. It is generally agreed that the existing fall-back provisions would be cumbersome to apply and could generate significant market disruption. To address this risk, the FSB encouraged ISDA to work with market participants to develop a more suitable fall-back methodology, using the RFRs that have been identified. The key challenge has been to agree on a standard methodology for constructing fall-backs for LIBOR using the overnight RFRs.

ISDA conducted a consultation on some key technical issues regarding the fall-back methodology in the second half of last year. [7] ISDA found strong support for using as the fall-back, the compounded RFR with an adjustment for the historical spread between the RFR and LIBOR. There are several further steps that need to be completed before the fall-backs will be ready for adoption:

- ISDA is working on the details of how exactly to calculate the historical spread between the RFR and LIBOR (in particular what historical period to use).
- The OSSG has asked ISDA to consult on including an additional fall-back 'trigger' that would take effect if the FCA found that LIBOR was no longer representative of the underlying market. [8] This would be a 'pre-cessation' trigger just for LIBOR. This would be in addition to ISDA's existing triggers, which deal with scenarios where a benchmark has ceased.
- ISDA will also conduct consultations for additional benchmarks that were not covered in the original consultation, including US dollar LIBOR.

Once ISDA has finalised the fall-back provisions, regulators expect users of LIBOR to adopt them. Thanks to ISDA's hard work, this should be relatively straightforward for derivatives markets. It will also be important for users to adopt equivalent fall-backs for cash products wherever possible. To support this, the ARRC has run a series of consultations to establish consistent robust fall-backs for different cash products referencing US dollar LIBOR. [9]

## Regulatory, Accounting and Tax Issues Affecting Transition

LIBOR is deeply embedded in the plumbing of the financial system, so replacing it with overnight RFRs has significant and widespread implications beyond financial markets. For instance, the LIBOR transition raises a number of accounting, tax and regulatory issues.

The LIBOR transition has the potential to disrupt the accounting treatment of products referencing LIBOR, particularly when they are used for hedging. This could generate volatility in the reported earnings of companies that is unrelated to their underlying financial performance. It could also have significant tax implications. In response to these concerns, the International Accounting Standards Board is working on amending the global accounting standards to provide relief for existing hedges from the uncertainty generated by the LIBOR transition. [10]

The treatment of legacy OTC derivatives referencing LIBOR is also under consideration. These contracts will need to be amended to adopt more robust fall-back provisions, which could affect their status under the G20's OTC derivatives reforms. Regulators are making progress on this. For instance, the Basel Committee and IOSCO recently announced that there would be relief from margin requirements where legacy derivatives are amended to address benchmark reforms. [11]

## Benchmarks Issues in the Asia-Pacific Region

Here in the Asia-Pacific region, considerable work is being undertaken to strengthen local benchmarks and prepare for the LIBOR transition. Australia, Hong Kong, Japan and Singapore are all represented on the FSB's OSSG, and we are also working within regional forums to highlight benchmark reform issues.

In Australia, we have taken a 'multiple rate approach'. The credit-based benchmark BBSW (the Bank Bill Swap Rate) has been strengthened and coexists alongside the cash rate, which is the RFR for the Australian dollar. [12] This has been possible since both BBSW and the cash rate are supported by underlying markets with enough transactions to calculate robust benchmarks.

BBSW can continue to exist even after LIBOR ends. For many financial products, it will still make sense to reference a credit-based benchmark. But as markets transition from referencing LIBOR to RFRs, there may be some corresponding migration away from BBSW towards the cash rate. This will depend on how international markets for products such as cross-currency basis swaps end up transitioning away from LIBOR. Good progress is being made on developing new market conventions for trading cross-currency basis swaps, referencing RFRs or combinations of RFRs and IBORs, to give market participants the choice.

Regulators in the region are also seeking to strengthen the contractual fall-backs for their benchmarks at the same time as LIBOR. The Australian and Japanese benchmarks (BBSW, JPY LIBOR and TIBOR) were included in ISDA's consultation last year, and the Hong Kong and Singaporean benchmarks (HIBOR and SOR) are expected to be considered in ISDA's next round of consultation. Once ISDA finalises these fall-backs, we strongly encourage all users of benchmarks in the region to adopt them.

One issue that has been generating quite a bit of angst in the region is the impact of the European Union's benchmarks regulation (BMR). Under the BMR, EU supervised entities – including banks and CCPs (central counterparties) – can only use benchmarks that are registered in the EU. To achieve this status, benchmarks administered outside the EU would need to be in a jurisdiction with a legal framework judged by the EU to be 'equivalent' to the BMR, or would need to substantially comply with the BMR. The EU had set a deadline of 1 January 2020, but has recently announced a two year extension.[13] This is a welcome development, and provides administrators in the region with valuable additional time to comply with the requirements of the BMR. In addition, the EU has recently issued draft decisions recognising the Australian and Singaporean regulatory regimes as equivalent to the BMR. This means that benchmarks such as BBSW and SOR can continue to be used in the EU after 1 January 2022.[14]

## Conclusion

There are three main points I would like to leave you with concerning interest-rate benchmarks.

First, the end of LIBOR is approaching. Market participants should continue preparing for this by transitioning to alternative risk-free rates.

Second, it is prudent for users of all benchmarks to have robust fall-back provisions in their contracts, not just those referencing LIBOR. ISDA's work on fall-backs is progressing well, and we encourage all users of interest-rate benchmarks to adopt ISDA's fall-backs once they are finalised.

Third, most jurisdictions in the Asia-Pacific region have chosen to strengthen their credit-based benchmarks. This includes Australia, where BBSW remains robust. Credit-based benchmarks can coexist alongside risk-free rates when they are supported by liquid underlying markets. Users can then choose the benchmark that is most appropriate for their circumstances.

## Endnotes

[*] I would like to thank Ellis Connolly for all his work in this area.

[1] See Bailey A (2017), 'The Future of LIBOR', Speech at Bloomberg London, 27 July. Available at: <https://www.fca.org.uk/news/speeches/the-future-of-libor>.

[2] I have talked about this issue previously: Debelle G (2018), 'Interest Rate Benchmark Reform' Speech at ISDA Forum, Hong Kong, 15 May; Debelle G (2017), 'Interest Rate Benchmarks', Speech at FINSIA Signature Event: The Regulators, Sydney, 8 September; Debelle G (2016), 'Interest Rate Benchmarks', Speech at KangaNews Debt Capital Markets Summit 2016, Sydney 22 February; Debelle G (2015), 'Benchmarks', Speech at Bloomberg Summit, Sydney, 18 November.

[3] This is in notional value terms. See Butler M (2019), 'Ending Reliance on LIBOR: Overview of progress made on transition to overnight risk-free rates and what remains to be done', Speech at the Investment Association London, 21 February. Available at: <https://www.fca.org.uk/news/speeches/ending-reliance-libor-overview-progress-made-transition-overnight-risk-free-rates-and-what-remains>.

[4] See Working Group on Sterling Risk-Free Reference Rates (2018), 'Term Sonia Reference Rates Consultation – Summary of Responses', November. Available at:

<https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/term-sonia-reference-rates-consultation-summary-of-responses.pdf?la=en&hash=CFD2AB11A3156B31CB15030962ECA9987BEFCED8>

[5] See National Working Group on CHF Reference Interest Rates (2018), 'Minutes from the meeting of the National Working Group on CHF Reference Interest Rates (31 October 2018)', 14 November. Available at: <https://www.snb.ch/n/mmr/reference/minutes_20181031/source/minutes_20181031.n.pdf>

[6] See Financial Stability Board (2018), 'Interest rate benchmark reform – overnight risk-free rates and term rates', 12 July. Available at <http://www.fsb.org/wp-content/uploads/P120718.pdf>

[7] See ISDA (2018), 'ISDA Publishes Final Results of Benchmark Fallbacks Consultation', Press Release, 20 December. Available at: <https://www.isda.org/2018/12/20/isda-publishes-final-results-of-benchmark-fallback-consultation/>.

[8] See FSB (2019), 'FSB Letter to ISDA about derivative contract robustness to risks of interest rate benchmark discontinuation', 15 March. Available at: <http://www.fsb.org/2019/03/fsb-letter-to-isda-about-derivative-contract-robustness-to-risks-of-interest-rate-benchmark-discontinuation/>. Also see Schooling Latter E, 'LIBOR transition and contractual fallbacks', Speech at the ISDA Annual Legal Forum, 28 January. Available at: <https://www.fca.org.uk/news/speeches/libor-transition-and-contractual-fallbacks>

[9] See ARRC (2019), 'Fallback Contract Language'. Available at: <https://www.newyorkfed.org/arrc/fallbacks-contract-language>

[10] See International Accounting Standards Board (2019), 'IBOR Reform and its Effects on Financial Reporting', Available at: <https://www.ifrs.org/projects/work-plan/ibor-reform-and-the-effects-on-financial-reporting/#about>

[11] See BCBS and IOSCO (2019), 'BCBS/IOSCO statement on the final implementation phases of the Margin requirements for non-centrally cleared derivatives', Press Release, 5 March. Available at <https://www.bis.org/press/p190305a.htm> and <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD624.pdf>

[12] For more details on recent benchmark developments in Australia, see Kent C (2019), 'Bonds and Benchmarks', Speech at the KangaNews DCM Summit, Sydney, 19 March.

[13] See European Commission (2019), 'Sustainable finance: Commission welcomes agreement on a new generation of low-carbon benchmarks', Press Release, 25 February, Available at: <http://europa.eu/rapid/press-release_IP-19-1418_en.htm>.

[14] See European Commission (2019), 'Recognition of financial benchmarks in Australia', Implementing decision. Available at: <https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2019-1806384_en> and European Commission (2019), 'Recognition of financial benchmarks in Singapore', Implementing decision. Available at: <https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2019-1806355_en>