PERSPECTIVES

THE BEGINNING OF THE END FOR LIBOR

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The end is nigh for the London Interbank Offered Rate. The CEO of the British markets regulator, the Financial Conduct Authority, announced yesterday that LIBOR will be phased out by the end of 2021. Though headlines proclaiming the "death of LIBOR" may catch some by surprise, this announcement is merely another step forward in a global process that has been underway since a 2013 G20 communiqué directed national regulators to investigate an alternative to LIBOR. This effort was motivated in large measure by scandals revealing manipulation of LIBOR by groups of banks and traders that resulted in multi-billion dollar fines for banks and criminal convictions for some individuals. In addition to the credibility hit from these scandals, LIBOR has long been criticized for reflecting bankers' estimates of their borrowing costs rather than actual transaction-based prices.

Regulatory agencies in the UK, Europe and Japan, in coordination with market participants in each jurisdiction, have made significant progress towards finding alternatives to LIBOR, with most having already selected an alternative reference rate. Here in the U.S., the Alternative Reference Rates Committee (ARRC), a group of market participants and regulators convened by the New York Federal Reserve, last month chose the Broad Treasury Financing Rate (BTFR) as the new reference rate to replace U.S. dollar LIBOR. The CME Group announced this week their intention to create a futures product linked to this new rate. From NISA's perspective, though the ARRC process is reasonably well designed and includes a quorum of the relevant stakeholders, the attempt to transition away from a reference rate that underpins hundreds of trillions of dollars of financial securities in multiple currencies around the world is a gargantuan undertaking. At this early stage, there are more questions than answers regarding the ultimate success of the endeavor.

Here in the U.S., the Federal Reserve (Fed) and the Office of Financial Research (OFR) have defined the BTFR as representing the volume-weighted median rate for a wide range of transactions in the triparty, general collateral finance, and bilateral repo markets for U.S. Treasuries. The Treasury repo market is large, diverse, and often opaque, and several important design details remain to be determined. This work is underway at the Fed and OFR, which plan to begin publishing the rate early next year, as the next step forward in the ARRC's multi-year transition plan. In addition to the design details of the actual rate, a host of related questions remain to be answered pertaining to market participants' ability to forecast the rate and price a term structure off the overnight tenor, as well as the volatility of the rate relative to other short term funding rates and the Fed's policy rates.

It is also very much an open question whether this effort will ultimately succeed in convincing a critical mass of market participants on the buy-side to abandon LIBOR-based derivatives in favor of the new BTFR. For this to happen, end users will need to gain comfort that the pricing and liquidity characteristics of the new BTFR derivatives are attractive relative to LIBOR derivatives and other alternatives like overnight index swaps (OIS) that reference the federal funds rate. The LIBOR derivative of greatest relevance to our pension clients is, of course, the fixed-floating interest rate swap and related options, though LIBOR is also the reference rate for Eurodollars and a variety of corporate and consumer floating-rate loans. ARRC members currently envision a sort of big bang date in the future beyond which all new interest rate swaps will reference BTFR rather than LIBOR. Even if this succeeds, the market will still be left with a huge amount of legacy LIBOR swaps outstanding.

The challenge of dealing with these trillions of dollars of legacy LIBOR swaps should not be underestimated. The outstanding securities represent a large and diverse universe with bilateral and centrally-cleared counterparty structures and a complex thicket of contractual arrangements for addressing contingencies like a disruption in the reference rate, potentially depending in some cases on ISDA rulings. Clearinghouses could implement rules to incentivize use of BTFR derivatives. There will be winners and losers, and potentially many lawsuits. Some swap counterparties will want to keep their LIBOR swaps. Others will want to amend their swaps to reference the new BTFR floating rate. The transaction cost of such an amendment would depend in part on the difference between LIBOR and BTFR, and the emergence of a basis market is a likely development as dealers and end users seek to manage their exposures.

As we've hopefully made clear, we are in the very early stages of an extraordinarily complex process with far-reaching implications for financial markets and an uncertain outcome. We continue to work diligently to stay on top of the latest developments and will provide occasional updates as warranted. Of course, we welcome inquiries or comments from clients as the transition process unfolds.