Box A

The Transition Away from LIBOR

For several decades, London Inter-bank Offered Rates (LIBOR) have been a widely used benchmark for global interest rates, underpinning derivatives, loans, bonds and other financial products. The UK Financial Conduct Authority (FCA) estimated in January 2021 that LIBOR underpinned around US$260 trillion of derivatives contracts globally.[1] However, LIBOR has notable deficiencies as a benchmark. Given this, regulators globally determined that LIBOR cannot be relied on beyond 2021 and markets need to transition to more robust and reliable market-determined interest rate benchmarks.

A smooth LIBOR transition is recognised by the G20 and the Financial Stability Board (FSB) as a key international regulatory priority. A disorderly transition would create significant risks for banks and other financial and non-financial firms, and for the financial system more widely. Market participants, with strong regulatory encouragement and support, are already transitioning to alternative benchmarks so that they are ready for the cessation of LIBOR by the end of 2021. Progress is greatest for larger financial institutions and derivatives markets. However, LIBOR transition is less advanced in other markets, such as loans, which affect a broader range of firms, including corporates, and where much remains to be done to be ready for the end of LIBOR.

LIBOR is not a viable benchmark for interest rates

LIBOR seeks to measure the interest rates that large banks offer to lend to each other on an unsecured basis in the London short-term money market.[2] It is calculated as the average of submissions from a panel of banks and published by ICE Benchmark Administration (IBA), which is regulated by the FCA. LIBOR rates are calculated for 5 major currencies with tenors ranging from overnight to 12 months.

LIBOR has several weaknesses, which became more apparent with the global financial crisis of 2007-08. In particular, some market participants had, for many years, been manipulating LIBOR to benefit their financial institutions. Benchmark reforms and regulation have addressed this. However, concerns remained over the reliability and robustness of LIBOR. In 2017, the FCA expressed concern that wholesale funding markets were not sufficiently active or liquid for LIBOR to be calculated based on transactions. In the absence of transactions, panel banks can make submissions based on 'expert judgement'.[3] However, banks became increasingly reluctant to make such submissions given the uncertainty around providing estimates when there is little or no market activity, owing to the risk of being associated with benchmark manipulation.

In 2017, the panel banks agreed with the FCA to voluntarily sustain LIBOR until end 2021 to limit the financial stability risks from a disorderly end to LIBOR. Over recent years, banks, other market participants and regulators have been jointly working on transitioning away from LIBOR. The market turmoil at the onset of the COVID-19 pandemic in early 2020 added impetus to the transition. The already limited number of market transactions underpinning LIBOR fell even further so that these rates were almost entirely based on expert judgement.[4]

Following an IBA consultation, the FCA announced on 5 March 2021 that all LIBOR settings will cease at the end of 2021, with the exception of several heavily used USD LIBOR tenors (overnight and one, 3, 6 and 12 month) which will cease at the end of June 2023.[5] The extended dates for the USD LIBOR tenors aim to 'allow most legacy USD LIBOR contracts to mature before LIBOR experiences disruptions', as there are challenges associated with transitioning these contracts to alternative reference rates.[6] Similarly, the FCA is considering whether there is a need to further extend the publication of a limited number of LIBOR settings in an amended form to support legacy contracts for which substituting another interest rate is exceptionally difficult ('tough legacy' contracts).[7] Nonetheless, regulators globally have reiterated that the use of all LIBOR settings in new contracts must cease after 2021.

A disorderly transition away from LIBOR is a risk to financial stability

When publication of LIBOR ceases, firms that are parties to contracts still referencing LIBOR without robust fallbacks in place (discussed below) will face considerable risks. For these contracts, it may be unclear what the new interest rate should be, or one or more counterparties to a contract may view the chosen new rate as being unreasonable. There would be a lengthy period of costly litigation to resolve ambiguities. If such contracts are widespread this would undermine confidence in some systemically important markets, and could affect the supply of credit to the real economy. There is also a risk that firms are not operationally ready for the transition away from LIBOR, even if they have agreed to alternative rates. This lack of readiness in systems and processes could mean that correct payments are not made, which would prove disruptive if many firms are facing operational difficulties.

In addition, there is a risk of unethical, inappropriate or unlawful behaviour, and resulting penalties, in the transition away from LIBOR. In particular, clients could be transferred to rates that disadvantage them or to inferior contractual terms, or their products may become unsuitable or not perform as expected. Regulators internationally have been providing guidance on conduct risk to support institutions in transitioning away from LIBOR. Appropriate mitigation strategies include a risk management framework that covers the LIBOR transition, as well as an effective and transparent communications policy. Domestically, the Australian Securities and Investments Commission (ASIC) released guidance in November 2020 on practices that Australian entities can adopt to manage conduct risk during the LIBOR transition.[8]

Much remains to be done by the end 2021 deadline for LIBOR

LIBOR transition is a major focus of the G20's financial reform efforts, involving the FSB, other international bodies, national regulators, benchmark administrators and market participants.[9] The key elements of

Table A1: Alternative Reference Rates replacing LIBOR

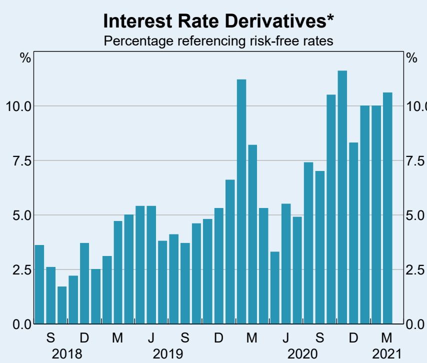
Currency	Alternative rate
US dollar	Secured overnight financing rate (SOFR)
Euro	Euro short-term rate (€STR)
Japanese yen	Tokyo overnight average rate (TONA) or TIBOR
Sterling	Sterling overnight index average (SONIA)
Swiss franc	Swiss average rate overnight (SARON)

Source: FSB

this work have been to replace LIBOR with alternative reference rates in contracts, and in the case of existing contracts where it is not feasible to amend the reference rate, to include the fallback rates to apply when LIBOR is discontinued.

National bodies have identified (nearly) 'risk-free rates' (RFRs) to replace LIBOR in the 5 major currencies (Table A.1). Despite the significant transition efforts to date, LIBOR is still the dominant benchmark in new global contracts.[10] A broad indicator of trading activity across derivatives markets in the 5 LIBOR currencies (plus the Australian dollar) shows increasing adoption of RFRs, but it remains at a low level (Graph A.1).

Graph A.1



* Percentage of activity across all interest rate derivatives (IRD) that is transacted in RFRs each month; it covers USD, EUR, JPY, GBP, CHF and AUD IRD contracts

Source: ISDA-Clarus

Where it is not feasible to replace LIBOR with an alternative reference rate in existing contracts (e.g. where multiple security holders would need to agree to the change), it is important that robust fallback provisions are included in the contract so that it is clear what rate will apply when LIBOR ends. Many contracts have fallback clauses, but these are often cumbersome to apply, involve significant discretion and could lead to substantial market disruption when LIBOR ends.

For derivatives, the International Swaps and Derivatives Association (ISDA) has developed robust fallbacks for LIBOR and other IBOR-referenced contracts, using the RFR benchmarks plus a spread.[11] These new ISDA fallbacks for derivative contracts came into effect on 25 January 2021, meaning they have been included in all new contracts that reference ISDA's standard interest rate definitions from that date. Over 13,500 entities across more than 85 jurisdictions have adhered to the fallbacks protocol, meaning their existing contracts relying on ISDA definitions will also include the fallbacks, thereby facilitating a smooth transition when LIBOR ends.

However, there are coordination challenges in developing robust fallbacks for other LIBOR-referenced products outstanding, such as bonds and loans. Work is currently underway across industry to progress LIBOR transition in these markets, but much remains to be done. These markets, which involve a broad range of financial and non-financial firms, present financial stability risks with the end of LIBOR if they are not moved onto new reference rates.

Under the FSB's Global Transition Roadmap, firms should have been in a position to offer non-LIBOR linked loans to their customers at the end of 2020 and have adhered to the ISDA Fallbacks Protocol by its effective date of 25 January 2021. By mid 2021, firms should have established formalised plans to amend legacy LIBOR contracts to reference alternative rates where this can be done, and otherwise have discussed with counterparties the steps needed to prepare for the use of alternative RFRs for LIBOR-linked exposures that extend beyond 2021. Authorities are taking steps to support limited legacy contracts that are particularly difficult to transition from LIBOR.

Over coming months, the transition away from LIBOR to RFRs will need to accelerate with further adoption of ISDA fallback provisions so that the industry is ready for the cessation of LIBOR by the end of 2021. Globally, regulators are coordinating and monitoring progress closely, and taking action as required to ensure that risks are appropriately managed.

Australia has adopted a multiple-rate approach for domestic reference rates

The bank bill swap rate (BBSW) is the main domestic credit-based benchmark, and remains robust. This is because, unlike LIBOR, there are enough transactions in the local bank bill market. Australia has an active bank bill market as the 4 major banks issue and hold bills as a source of funding and to manage their liquidity, and a wide range of wholesale investors purchase bills. Moreover, the methodology underlying the benchmark calculation has been strengthened in recent years. BBSW, unlike LIBOR, will not end and market participants will be able to choose to base contracts on BBSW or the cash rate (Australia's RFR). However, there is little issuance of one-month bank bills. At this tenor BBSW largely represents the repurchase by banks of their bills that have one month to maturity. Given this tenor is less liquid, users of one-month BBSW should consider using alternative benchmarks.

While BBSW remains a robust benchmark it was included in ISDA's Fallbacks Protocol for derivatives contracts as a matter of prudent risk management. Fallbacks provide an important contingency for financial contracts based on any reference rate. The fallback rate for BBSW is the overnight cash rate plus a spread based on the historical difference between BBSW and the cash rate. In the future, the Reserve Bank will be requiring contracts that reference BBSW to include robust fallback provisions in order to be eligible collateral in its open market operations. The implementation of this requirement is being determined with input from industry.

Notwithstanding the robustness of BBSW, LIBOR transition is nonetheless a key priority in Australia. LIBOR contracts are still a substantial component of banks' and other firms' exposures in Australia due to the international nature of their activities. At the end of 2020, the aggregate notional LIBOR exposures of major Australian financial institutions was around $8 trillion. Progress is being made, however, with LIBOR exposures declining overall for the key Australian financial institutions over the course of 2020. But exposures still rose at some individual institutions.

Given these sizeable exposures, financial regulators strongly encourage and support the transition away from LIBOR.[12] The Australian Prudential Regulation Authority and ASIC are monitoring progress on LIBOR transition by the entities they regulate, and working with institutions as required to ensure adequate progress in transition and, in particular, that they meet the LIBOR deadlines. ASIC and the Reserve Bank have strongly advised Australian institutions to adhere to the ISDA Fallbacks Protocol, and expect institutions to work towards meeting the timeline for LIBOR transition readiness set out in the global transition roadmap and ceasing the use of LIBOR in new contracts beyond the end of 2021.[13] In the remaining months of this year, firms should work intensively on ensuring a smooth transition away from LIBOR by the end of 2021.[14]

Endnotes

[1] See Schooling Latter E (2021), 'LIBOR – are you ready for life without LIBOR from end-2021?', Speech at City & Financial's Managing LIBOR Transition Event, 26 January. Available at <https://www.fca.org.uk/news/speeches/libor-are-you-ready-life-without-libor-end-2021/>

[2] There are other IBORs besides those in the London market. For example, there are euro and Tokyo-based reference rates (EURIBOR and TIBOR, respectively). However, this box focuses on LIBOR given it is the most widely used benchmark globally.

[3] There are 3 levels of LIBOR submissions. Level 1 is 'transaction-based' submissions – an average of transactions in unsecured deposits and primary issuances of commercial paper and certificates of deposit. Level 2 is 'transaction-derived' data, including information from historical transactions. Level 3 is 'expert judgement' – where a submitting bank has insufficient Level 1 or 2 transactions, it estimates the rate at which it could fund itself in the unsecured wholesale funding market.

[4] See Bank of England (2020), Interim Financial Stability Report, May. Available at <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/may-2020.pdf>

[5] See FCA (Financial Conduct Authority) (2021) 'FCA Announcement on Future Cessation and Loss of Representativeness of the LIBOR Benchmarks', 5 March. Available at <https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf>

[6] See Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (2020), 'Statement on LIBOR Transition', 30 November. Available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf>

[7] See FCA (2021), 'Announcements on The End of LIBOR', 5 March. Available at <https://www.fca.org.uk/news/press-releases/announcements-end-libor/>

[8] See ASIC (Australian Securities and Investments Commission) (2020), 'Managing Conduct Risk during LIBOR Transition, 30 November. Available at <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2020-releases/20-304mr-asic-issues-information-sheet-on-managing-conduct-risk-during-libor-transition/>

[9] The FSB's work on benchmark reform has been coordinated at the international level by its Official Sector Steering Group, of which the Reserve Bank of Australia is a member.

[10] For its most recent progress report on benchmark transition, see FSB (Financial Stability Board) (2020), 'Reforming Major Interest Rate Benchmarks: The Year of Transition Away from LIBOR', 20 November. Available at

<https://www.fsb.org/wp-content/uploads/P191120.pdf> For trends in the USD LIBOR market, also see Alternative Reference Rates Committee (2021), Progress Report: The Transition from U.S. Dollar LIBOR, March. Available at <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/USD-LIBOR-transition-progress-report-mar-21.pdf>

[11] See ISDA (International Swaps and Derivatives Association) (2020), 'IBOR Fallbacks Protocol', 23 October. Available at <https://www.isda.org/protocol/isda-2020-ibor-fallbacks-protocol/>

[12] See APRA (Australian Prudential Regulation Authority), ASIC and Reserve Bank (2020), 'Regulators Release Feedback on Financial Institutions' Preparation for LIBOR Transition', Media Release No 2020-12, 8 April.

[13] See APRA, ASIC and Reserve Bank (2020), 'Regulators Urge Australian Institutions to Adhere to the ISDA IBOR Fallbacks Protocol and Supplement', Media Release No 2020-25, 13 October.

[14] See Kent C (2021), 'The End of Libor and the Australian Market', Keynote Address to the ISDA Benchmark Strategies Forum Asia Pacific, online, 18 March.