Replacing LIBOR: an overview

RBS

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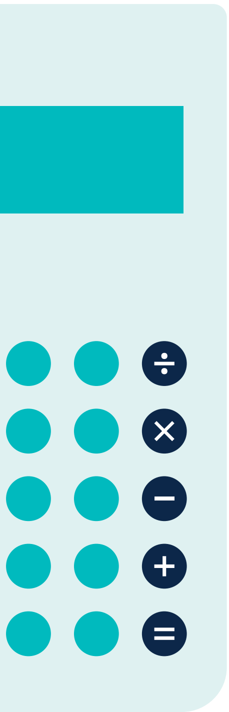
The LIBOR interest benchmark is changing. This is an introduction to the key changes and how they may affect you and your business.

"The absence of active underlying markets raises a serious question about the sustainability of the LIBOR benchmarks that are based upon these markets… **the planning and the transition must now begin.**"

Andrew Bailey, Chief Executive Officer, FCA



What is LIBOR?

The London Interbank Offered Rate (LIBOR) is one of a number of Interbank Offered Rates (IBORs) that are widely used in the global financial markets.

It's used as a key interest rate benchmark across a number of derivatives, bonds, loans, securitisations, deposits and other products, as well as for banks' and other financial institutions' own funding and capital needs.

LIBOR is calculated and published daily across five currencies (GBP, USD, EUR, JPY and CHF) and seven maturities (overnight, one week, and 1, 2, 3, 6 and 12 months) by the Intercontinental Exchange Benchmark Administrator (ICE BA).

It's based on submissions by a panel of banks using available transaction data and their expert judgement.

LIBOR should provide an indication of the average rate at which each LIBOR contributor can borrow unsecured funds in the London interbank market for a given period, in a given currency. This average is published and used by the financial markets.

What's changing and why

Since 2013 International regulators began focussing on IBOR reform.

With the number of interbank unsecured borrowing transactions reducing in recent years, there has been an increasing reliance on the expert judgement of panel banks on which to base LIBOR. This has led to concerns that LIBOR is no longer a representative or reliable benchmark reference rate.

July 2017 Andrew Bailey, Chief Executive Officer of the Financial Conduct Authority (FCA) announced that the FCA would not persuade or compel LIBOR panel banks to make LIBOR submissions beyond the end of 2021.

July 2018 The FCA and US Commodity Futures Trading Commission (CFTC), among other regulators and industry groups, told the global market they need to accelerate efforts to stop using products that reference LIBOR, and transition to alternate Risk-Free Rates (RFRs).

There are a number of Risk-Free Rates being considered

Working Groups have been set up to select alternative RFRs across all major currencies.

£ The Bank of England's Working Group on Sterling Risk-Free Reference Rates has recommended using the Sterling Overnight Indexed Average rate (SONIA) as its preferred option. This reference rate is already widely used in the derivatives markets with a growing number of Bonds using it as well. The requirement for a Term SONIA Reference Rate (TSRR) is actively being considered by the industry in conjunction with the Bank of England and the FCA.

$ In the US the Alternative Reference Rate Committee (ARRC) has recommended the Secured Overnight Financing Rate (SOFR). The requirement for a Term SOFR is also being considered by the industry and the ARRC.

€ The European Central Bank (ECB) has recommended that the Euro Short Term Rate (ESTER) replaces the Euro Overnight Indexed Average rate (EONIA), which is currently not EU benchmark regulation compliant. ESTER is due to be published by the ECB from October 2019.

SONIA

LIBOR is a forward-looking term rate. However SONIA is a backward-looking, overnight rate based on actual transactions that have taken place the day before.

Recognising that certain markets, for example cash and lending, may prefer forward-looking term characteristics, the Bank of England has gathered market views on a forward-looking Term SONIA Reference Rate (TSRR). A decision should be made later this year.

A summary of responses to the consultation can be found at www.bankofengland.co.uk *

* Externally hosted website. The Royal Bank of Scotland Group plc (RBS) is not responsible for the accuracy or content on this site.

Summary of IBOR replacement rates

Currency	Alternative rate	Working group	Nature
US	SOFR[1]	Alternative Reference Rates Committee (ARRC)	Overnight, Secured
UK	Reformed SONIA	Working Group on Sterling Risk-Free Rates	Overnight, Unsecured
Switzerland	SARON[2]	National Working Group on Swiss Franc Reference Rates	Overnight, Secured
Japan	TONAR[3]	Study Group on Risk-Free Reference Rates	Overnight, Unsecured
EU	ESTER[4]	Working Group on Euro Risk-Free Rates	Overnight, Unsecured

1. Secured Overnight Financing Rate;
2. Swiss Average Rate Overnight;
3. Tokyo Overnight Average Rate;
4. ESTER is the new wholesale unsecured overnight bank borrowing rate, which the ECB will produce before 2020.

What this means for you

These changes may be relevant to some products you have purchased or may be thinking about purchasing.

While the market for alternative RFRs is still developing, LIBOR continues to be a widely accepted benchmark in corporate and commercial loans and other financial products.

For new or existing products that may be affected, the global financial markets are working together to agree how best to transition to the alternative RFRs by the end of 2021, or in some cases earlier.

We'll continue to speak to you as these plans develop and you may also find it helpful to get in touch with your independent professional advisers on what the transition may mean for you and the products you hold.

Existing contracts

Ahead of the likely discontinuation of LIBOR, market participants will need to think about the best way to review and amend documentation, processes and contractual agreements for any existing contracts that reference LIBOR and mature after 2021.

New contracts

New contracts that reference LIBOR will need to consider whether fallback provisions would be needed in the absence of a specific RFR being identified. Work is ongoing in the market to determine the best way to do this with minimal disruption.

A few things to think about

Overnight rate versus a term rate

- LIBOR is a term rate that includes an element of credit spread reflecting the borrowing risk in the interbank market.
- A term rate provides borrowers with a known interest rate for the period of borrowing and therefore the amount of interest due at the end of the borrowing term, something that some borrowers may find helpful for cashflow forecast.
- An overnight rate, based on actual transactions and reset on a daily basis in arrears, removes any expectation of future events inherent in a term rate.
- SONIA is likely to be a less volatile rate known only at the end of the borrowing period and borrowers may favour this rather than a more volatile term rate known at the start of the borrowing period
- Development of a TSRR would provide borrowers with a rate at the beginning of the borrowing period, similar to LIBOR, although it wouldn't include credit spread.
- Alternative term RFRs are also being considered in the US and Europe that may operate in different ways to a TSRR.

Different product approaches

- The general market consensus is that it may be sensible to include fallback provisions in contractual documentation (fallback provisions are already included for derivatives products) in case an IBOR stops being used before the relevant transition is completed.
- This may take the form of a roadmap to determine a replacement rate or reference to a specific replacement rate.
- As the alternative RFRs market develops, it's possible that differences could occur in relation to fallbacks for different products. These could be, for example, different trigger events, timings, or even a different fallback rate.

Multi-currency products

Replacement RFRs may change how a multi-currency product operates, and again the market is working together to find the best solution.

What's happening now?

RBS supports the market transition from LIBOR. We're working closely with our regulators, market participants, industry bodies and trade associations, to make sure the transition is as smooth as possible.

What happens next?

We are waiting for the outcome of the Bank of England's consultation on a term SONIA to help guide the direction of both existing LIBOR products and the development of new products. This will shape many of our transition plans. We'll be back in touch with you as these progress.

In the meantime, if you'd like to know more please speak to your Relationship Manager or usual contact within the bank.

2015

IBOR review
Bank of England (BoE) Working Group on Sterling RFR founded

2017

Andrew Bailey announcement
FCA announced that they will not persuade or compel banks to submit the inputs used for LIBOR after 2021

2018 H1

SOFR data published in US
The planned replacement of USD LIBOR, Secured Overnight Financing Rate, did not exist historically

BoE publishes Reformed SONIA
The Sterling Overnight Indexed Average rate was chosen as the preferred RFR to replace GBP LIBOR

SONIA linked issuance
First FRN issuance linked to SONIA

2018 H2

Regulatory announcements
Co-ordinated UK and US regulatory statements that LIBOR discontinuation "is a certainty"

ESTER announced
ECB proposes ESTER as replacement of EONIA

SOFR activity
Financial institutions begin SOFR-linked issuance in the US

SOFR swaps to be cleared on CME

BoE Term SONIA Working Group
Consultation paper issued.

Banks submit detailed LIBOR transition plans to FCA/PRA

2019

Drive to future state
Development of the TSRR continues

ESTER (EUR RFR) publication starts

EURIBOR decision on EU Benchmark compliance

Regulatory responses to banks' LIBOR transition plans

2021

EU Benchmark Regulation
Transition period ends, only EU Benchmark Regulation compliant Benchmarks allowed in new contracts

EONIA will no longer be compliant

RFRs in place
Banks no longer compelled to submit LIBOR

Disclaimer:

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