Toward post-IBOR reference rates

July 2019

Many corporate loans, derivatives and floating rate bonds use interbank offered rates (*IBORs*) to set an underlying market reference rate to which a lending margin or premium is then added.

The finance world is moving from IBORs to an alternative rate setting method less vulnerable to manipulation. While the commonly used New Zealand dollar (*NZD*) Bank Bill Benchmark Rate (*BKBM*) will remain, it will require amendment.

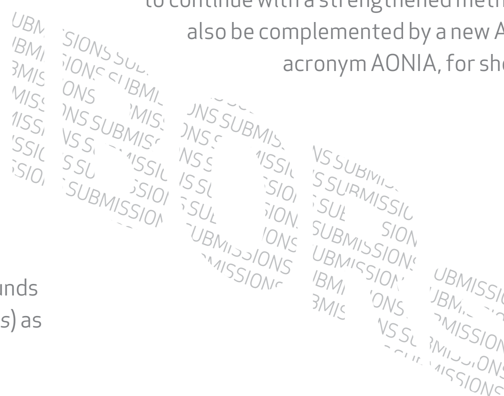
Reported back from select committee this month, the Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Bill will facilitate New Zealand's compliance with recent European Union (*EU*) and Group of Twenty (*G20*) benchmark reforms in this area, but most of the heavy lifting will be down to market participants, particularly banks.

We outline the practical implications of the change, and the forces driving it.

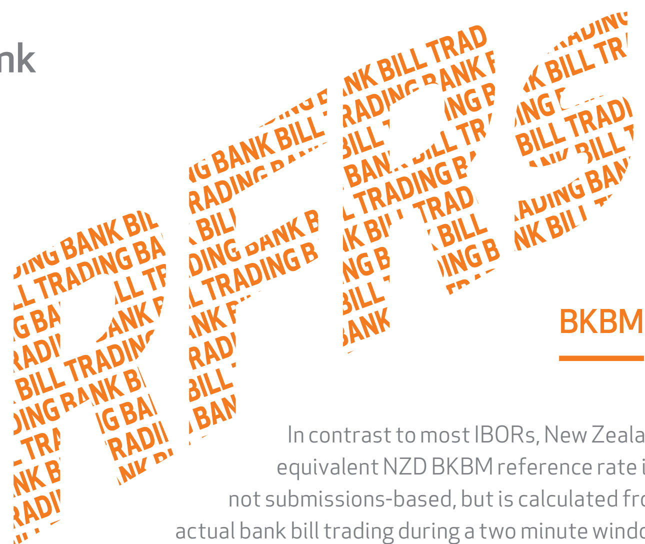
LIBOR – leaving under a cloud

The London Interbank Offered Rate (*LIBOR*) has long been used as the market reference rate for derivative contracts and interest on loans in Great British Pounds (*GBP*) or United States Dollars (*USD*). However, its legacy will likely be mired in scandal and manipulation. LIBOR and most of the other IBORs around the globe, will be phased out by 2021 because they have lost market and regulator confidence.

Like most IBORs, LIBOR is calculated daily from submissions provided by prime banks. Each working day a panel of large banks in London is asked at what rate they could borrow funds for set terms in the interbank market. From these submissions LIBOR is calculated for currencies including GBP and USD. LIBOR's flaws as a wholesale market rate are now well known – it may not reflect the bank's true cost of funds, contains elements of subjective judgement about how funding could be obtained and is vulnerable to conflicts of interest and manipulation. Since 2012, LIBOR has been a focus of regulatory scrutiny, with heavy fines for traders.



As a result, the market is moving away from the traditional IBORs to set an underlying market cost of funds rate and towards consideration of 'risk-free rates' (*RFRs*) as discussed below.



BKBM

In contrast to most IBORs, New Zealand's equivalent NZD BKBM reference rate is not submissions-based, but is calculated from actual bank bill trading during a two minute window each morning, from 10:20am to 10:22am. This requires observable trades and real life counterparties to trade with, substantially reducing any risk that the resultant rates will be gamed.

For this reason, BKBM stands on firmer ground and is likely to remain (with some amendment) for the foreseeable future.

Accordingly, our focus in New Zealand is to:

- ensure that the BKBM remains an acceptable reference rate in the EU by legislating through the **Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Bill** (the Bill) to bolster the supervisory powers available to the Financial Markets Authority (*FMA*), and
- establish by regulation a separate RFR which can be used both as a replacement for, or as the fallback to, BKBM.

It is expected that the New Zealand Financial Markets Association will shortly initiate a review of New Zealand benchmark rate administration to ensure our current model meets EU and international regulatory standards and best practice developments. The outcome of that review may introduce an updated benchmark administration process.

The Australian dollar (*AUD*) reference rate Bank Bill Swap Rate (*BBSW*) is similar to BKBM in many ways. The intention is for it to continue with a strengthened methodology. This rate will also be complemented by a new AUD RFR, known by the acronym AONIA, for shorter dated products.

New kids in town

The new market rates are commonly referred to as 'risk free'. This term was coined in reference to the fact that they are calculated on an overnight secured or unsecured basis with no built-in term or liquidity premia.

It is important to understand the key differences between the new RFRs and IBORs, particularly in relation to what the rates measure and how they are calculated.

For instance, the Sterling Over Night Interest Average (*SONIA*) rate, is measured as the average of interest rates paid overnight on eligible Sterling deposit transactions.

- As an overnight rate, it is a backwards looking measure and has no term element (i.e. it is a snapshot of a particular time, and does not seek to reflect expectations of the market and credit over subsequent periods).

- LIBOR includes a built-in credit premium for the risk that the borrowing bank will default on its unsecured debts before the end of the interest period, as well as a liquidity premium and term premium. SONIA does not require any assessment of these risks. This is an easier 'sell' to borrowers who are typically unsympathetic to incorporating banks' credit risk into an underlying wholesale base interest rate (that, as seen in 2008, may move in the opposite direction to central bank policy rates).

Similar RFRs have been established for many other currencies, such as the Secured Overnight Financing Rate (*SOFR*) for USD, and the Euro Short Term Rate (*€STR*).

What it means for bonds and derivatives?

Reference rates are vital, not only to general loan facilities but also to the wider financial markets, including bonds and (particularly) derivatives. The International Swaps and Derivatives Association (*ISDA*) and regulators are well advanced in:

- identifying suitable replacement benchmark rates for use in new contracts, and

- agreeing transitional provisions for existing contracts that refer to IBORs, the reference rate to switch to once the relevant IBOR is discontinued and how to adjust credit margins to 'equalise' with the commercial status quo ante.

An historical mean (or median methodology) is generally proposed to adjust the margin when transitioning existing derivatives on the discontinuance of an IBOR. This would compare the difference between an IBOR and its equivalent RFR over a certain period. ISDA has recently concluded its consultation process and, once finalised, a protocol will be issued to guide implementation by the general market.

This is not to say market participants are waiting for formal protocols. SOFR and SONIA referenced derivatives have shown exponential growth during the first half of this year.

Given the longer term horizons of bond programmes, and the difficulties in amending them following establishment, SONIA and SOFR are now the standard rates for new GBP and USD floating rate bond public issuances. The majority of public UK and US securitisation programmes now also reference these RFRs.

What it means for loan facilities?

Loan facilities referencing BKBM are unlikely to need amendment in the immediate term. But, once the separate RFR is formulated later this year, it will likely be quickly incorporated into existing and new funding contracts (at least initially as a fall back option to the discontinuance or unavailability of BKBM). Over the longer term, changes to offshore funding costs and models, together with evolving market practices, may encourage greater adoption of a RFR as the primary NZD funding base rate.

RFRs will need to be adapted to accommodate longer term loan market borrowings and their set interest periods. These changes will also need to be reflected in the supporting hedge arrangements and updated bank operational systems.

For derivatives and offshore bonds (the markets for which are more advanced in applying RFRs), the favoured approach to this issue has been to compound the daily SONIA or SOFR rate throughout that interest period (ISDA refers to this as the "Compounded Setting in Arrears" approach).

While compounding will tend to smooth out any daily rate spikes, unlike the current rate set at the beginning of an interest period, the exact interest payment amount will not be known until the end of the interest period. In addition, a slight lag of a few days between calculation and payment may be included for operational ease of use.

The financial media is increasingly publicising the establishment of revolving credit facilities for corporate UK and US borrowers using this compounding overnight method as the primary rate set calculation. While the international loan market has yet to universally agree on a method of calculating and implementing these rates for selected interest terms, we expect New Zealand borrowers to increasingly be engaged by their banks over the coming year in incorporating base interest rate fall back provisions when establishing new or amending current foreign currency loan facilities.

The European, UK and US Loan Market Associations (*LMAs*) are all in the process of developing standardised syndicated loan documentation for overnight RFRs that align with ISDA led derivative methodologies.

ICE Benchmark Administration, the current LIBOR administrator, is also consulting on the potential to continue to provide certain LIBOR settings for a transitional period following 2021, for LIBOR-based contracts that are impossible or impractical to modify.

Takeaways

The big takeaway is that all of the global base rates are changing and that parties to bond, loan, bond, derivative and other financial products will be expected to reflect those changes in their hedging and floating rate contracts.

In particular:

- parties to new contracts using LIBOR (or other offshore reference rates) should consider new fallback language for the discontinuation of that rate, such as has been developed by the LMA
- parties to cross-currency (or other non-NZD) derivatives should keep track of progress by ISDA in developing a transition strategy, and consider adhering to the relevant protocol when released, and
- financial sector participants, especially banks, should follow the progress of the Bill, which includes an ability for the FMA to compel them to continue contributing information for reference rates.

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