ISDA. Safe, Efficient Markets

ISDA Symposium - Financial Benchmarks
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Good morning, and welcome to ISDA's benchmark symposium.

This event comes at an opportune time. Next week, the Alternative Reference Rates Committee, or ARRC – a US public-private sector working group led by the Federal Reserve Bank of New York – will announce its choice for a risk-free rate that could be used as an alternative to US dollar LIBOR for certain transactions in future. With similar groups in the UK and Japan already settling on their choice of risk-free rate, attention will start to focus more and more on market transitions to these alternative rates.

This is on top of a separate project led by ISDA to develop robust fallbacks to key IBOR rates, and work by benchmark administrators to strengthen the IBORs by changing their methodology to utilize transaction data as far as possible.

Together, the implementation of alternative risk-free rates and the development of fallbacks for key IBORs will affect trillions of dollars in notional in interest rate derivatives trades. So it's important that people understand what these developments are and what they mean. And it's important that market participants are able to implement any changes in a way that creates most certainty and least disruption.

ISDA is playing a key role in the benchmark reform effort. As well as being an observer on the three public-private sector risk-free rate working groups, we're leading the work to develop robust fallbacks for the IBOR rates, together with the FSB. We're also working with the industry to prepare for compliance with the EU benchmarks regulation from January next year.

In my remarks this morning, I'll briefly outline each strand of that work, share with you the work ISDA is doing, and make some recommendations on next steps.

Risk-free Rates

I'll start by touching upon the work to develop alternative risk-free rates. This stems from a recommendation by the FSB for jurisdictions to develop risk-free rates as an alternative to benchmarks like LIBOR, and to encourage use of these new rates in the future.

Significant progress has been made so far. Along with the work of the ARRC in the US, a working group led by the Bank of England announced in April that it had recommended SONIA as an alternative risk-free rate for sterling. And at the end of last year, a group overseen by the Bank of Japan recommended the uncollateralized overnight call rate for yen, known as TONA.

With the new rates decided in those jurisdictions, focus will now start to shift to how, when and to what extent to encourage a shift to these new rates. Given the alternative rates have only recently been chosen or – in the case of the US – have yet to be chosen, there's understandably been little information so far on the steps that will be taken to encourage the use of these rates.

This is important. Market participants, particularly those in the end user community, will need a plan. To achieve this, it's critically important for regulators and the industry to continue to work together to produce a clearly articulated transition that takes the needs and concerns of benchmark users into account.

This promises to be a complex issue – more so because each case is unique, and there's no one-size-fits-all transition plan that will work in all circumstances. For example, any transition plan will depend on whether the chosen alternative rate is new or already well established.

Despite this, we think there are a few high-level principles that should guide market adoption of the new rates.

Principles for Rates Transition

First, it's crucial that the alternative rate is sufficiently liquid to support its role as a key market benchmark. If not, the priority should be to encourage trading in the underlying rate first, before any benchmark transition occurs.

Second, the volume of outstanding trades needs to be considered. Where the volume of trades referencing the existing rate is significant – as is the case for the relevant IBORs – the impact of basis risk is greater. That means a liquid basis market to enable hedging of basis risk between the existing rate and new rate is a necessary prerequisite before any transition begins.

Thirdly, serious consideration must be given to whether the transition should apply to legacy trades. Switching the reference rate for legacy transactions would likely result in shifts in valuations and similar issues that could be disruptive to the market. Therefore, any such changes should be strictly voluntary, and not part of a transition plan for situations where the existing rate will continue. We understand this will be the case for the transitions to risk-free rates that are being contemplated.

Linked to this, there needs to be a clear understanding of what end users want to achieve and the risks they want to hedge. In the case of the IBORs, the transition plans will likely anticipate end users entering into new transactions based on the alternative risk-free rates, but it is also expected that end users will continue to use the IBORs for certain hedges.

Next, we think there should be formal public-private sector cooperation in order to ensure smooth implementation and transition. As witnessed by the work of the three existing public-private sector working groups, this cooperation is incredibly beneficial.

Finally, any transition should provide ample time for market participants to make the necessary changes to systems and processes – as well as changes to documentation. This can't be rushed.

The three public-private sector risk-free rate working groups are well aware of these issues. The ARRC, for instance, has set out a preliminary transition strategy that incorporates most of these principles. It emphasizes the building of liquidity in the new rate before encouraging market participants to use it for trading. It also highlights the importance of building a market for hedging basis risk between the existing and new rate. Critically, it only refers to transitioning new contracts to the alternative rate, rather than forcing the transition of legacy contracts.

The sterling working group also wants to ensure the basic building blocks are in place to ensure a functioning SONIA market as a first step. That might include extending the maturity of cleared SONIA OIS transactions, developing a market for cross-currency basis swaps using SONIA, and encouraging the growth of a futures and options market referencing SONIA.

In all cases, the working groups are committed to end-user outreach and market consultation – which is important.

While the US, UK and Japan are making progress, there's more uncertainty in Europe. Unlike the other three jurisdictions, there's no formal public-private sector initiative to choose an alternative risk-free rate – although it's expected that EONIA could serve in that capacity. The European Money Markets Institute, the administrator of EONIA, is currently conducting a review of the EONIA governance framework, and we look forward to hearing how that's progressing later on this morning.

We would also encourage the ECB to increase its involvement in this work.

Fallbacks to Key IBORs

I'd now like to briefly outline our work to choose fallbacks to the IBOR rates.

As many of you may know, ISDA was asked by the FSB last year to ensure robust fallback rates are specified within derivatives documentation in the event of a permanent discontinuation of a key IBOR.

Before I proceed, however, I want to acknowledge the significant and important changes made to the existing IBOR benchmarks such as LIBOR. Consistent with the IOSCO principles, many of these benchmarks are today more transparent and resilient. They have been modified to give greater weight to actual transactions, and include waterfall calculations that make the published rate more resilient and transparent to the market regulators. This good work must not be overlooked.

Nevertheless, regulators would like to see fallback rates as a safety measure, and our working groups are currently focusing on US dollar, sterling and yen – in other words, the markets where there is a formal initiative under way to develop alternative risk-free rates. Work has also recently extended to Australian dollar, Hong Kong dollar and Singapore dollar. In addition, we are monitoring the situation for euro and Swiss franc to determine whether it would be appropriate for our work to apply to key IBORs in these currencies.

Good progress has been made, and the working groups have decided that the risk-free rates selected by the relevant public-private sector working groups are the most appropriate fallbacks for IBOR benchmarks in the respective currencies that are covered by those groups.

There are, however, some sticking points. The first is that the IBOR rates are traded with tenors – one, three months, six months and 12 months – but the selected risk-free rates are overnight. This discrepancy could result in a significant valuation impact in the event the fallback is triggered.

Preliminary working group discussions have considered potentially adding a spread to the overnight rate to minimize these valuation impacts. So, a three-month sterling LIBOR contract might fall back to SONIA plus the applicable three-month spread.

In order for that to work, it's important there's a single set of spreads, rather than everyone calculating their own. If this approach is adopted, the working group has stressed the importance of a centralized calculation and publication that everyone could access. Our working groups have raised this point to regulators, and we're working to develop more specific recommendations.

Another issue is basis risk. Unlike the transition to alternative risk free rates, which is expected to focus on new contracts only, there's a logic to identifying a robust fallback for all key IBOR contracts, both new and existing. The reason is simple. If a tail event occurs and a key IBOR ceases to be published, everyone would be using the same, published fallback rate.

If it's decided to specify a fallback in legacy IBOR contracts, ISDA may develop a protocol to enable market participants to make those changes efficiently. However, all protocols are voluntary, and some entities may decide not to sign up. That might be due to a variety of reasons – it might simply pose too much of an additional operational burden for some firms.

However, if one part of the market specifies a certain fallback and another part of the market doesn't, firms could face significant basis risk in the event of a sudden discontinuation of the relevant IBOR. This is a worry – and it could mean regulators need to consider requiring these changes to be made for new and legacy transactions across the market via regulation.

As I mentioned earlier, ISDA's work to develop fallbacks has focused on those markets with formal initiatives under way to select risk-free rates. That means work to determine a fallback for euro LIBOR and EURIBOR is still at an early stage.

European Benchmarks Regulation

Which brings me to the third strand: the EU benchmarks regulation.

As part of that regulation, counterparties subject to the rules are required to include a plan of action in their documentation, which sets out the steps that will be taken if the reference benchmark ceases to exist or is materially altered.

ISDA is running a separate industry working group looking at the implications of this requirement on the broader benchmark universe, with the aim of making a recommendation on how to approach this. It could involve an amendment to the ISDA definitions. One of the questions the group has is whether this requirement is forward-looking only, or also applies to legacy contracts. If the latter, then the same issues with regard to basis risk will potentially arise.

It's a complex issue, and time is short. The regulation comes into force from January 1 next year.

This isn't the only complexity or area of uncertainty. From 2020 – or 2018 for new benchmarks – EU entities will be prohibited from using any third-country benchmark in the EU unless that benchmark has been recognized, been deemed equivalent or has been endorsed by European authorities. As it stands, it's currently unclear how the recognition/equivalence/endorsement process will work in practice. That lack of certainty is creating concern about whether these third-country benchmarks will be available in future.

Even at this stage, there is no certainty that rates produced by central banks, including the risk-free rates I referred to earlier, will be exempt from the prohibition or otherwise qualified for use in the European Union. We are continuing to engage with regulators to resolve this.

There are similar concerns with regards to EU-administered benchmarks. Applications for registration and authorization need to be submitted from January 1, but there's no indication of when the infrastructure to allow applications to be made will be up and running.

Certainty about these issues is vitally important, particularly given the short time frame to implementation. ISDA's working groups are closely involved in these issues, and are liaising with regulators, but the answers to these and other questions are needed quickly in order to finalize rollout plans.

As you can see, there's a lot happening in the benchmark space, and ISDA is playing a central part in the effort to ensure these changes can be implemented safely and efficiently.

We will continue to provide feedback on the alternative risk-free rate transition strategy, with a focus on the high-level principles I outlined earlier. We'll continue to work on the IBOR fallbacks, work to implement these fallbacks in our interest rate definitions, and develop a protocol to modify legacy contracts if required. And we'll continue to work with members to prepare for compliance with the EU benchmarks regulation.

All of these topics will be discussed in more detail throughout the morning, starting with a session on the EU benchmarks regulation.

With that, let me thank you for coming today. I hope you enjoy the symposium.

Thank you.