# * Maintaining Momentum

*The cessation of most LIBOR settings at the end of 2021 has been on the horizon for a long time, but this does not mark the end of benchmark reform.* **IQ** *asked senior policy-makers and market participants what challenges lie ahead as LIBOR is retired*

**Q: What will the UK interest rate derivatives market look like on January 4, 2022? What role will synthetic LIBOR play?**

**Edwin Schooling Latter**
Director of markets and wholesale policy, UK Financial Conduct Authority

December 31, 2021 will be the very last day for four of the five LIBOR panels.

For those firms with counterparties that have joined them in signing up to ISDA's IBOR Fallbacks Protocol, their non-cleared sterling, yen, euro and Swiss franc LIBOR swaps, along with all cleared swaps and futures, will have safely transitioned to compounded risk-free rates (RFRs) as the new year begins. That accounts for around 97% of sterling LIBOR interest rate derivatives.

For those that haven't yet signed up but want their legacy derivatives books to benefit from the transition to compounded RFRs – chosen by market participants as the new central point of interest rate market liquidity – it's not too late to sign the ISDA protocol.

But any firms that have not signed the protocol (or have counterparties that have not signed) will still have one-, three-, and six-month sterling and yen LIBOR screen rates to refer to throughout 2022. This continued LIBOR screen rate will be what markets have come to know as synthetic LIBOR. It will be based on term RFRs plus the relevant fixed adjustment spreads used in ISDA's fallbacks.

As we announced on September 29 this year, our proposal is that all legacy contracts, except cleared derivatives, will be able to use these synthetic LIBOR rates. But to be clear: synthetic LIBOR is not for new business, and it is not going to be available indefinitely.

Publication of yen synthetic rates is scheduled to cease at the end of 2022. Each of the synthetic sterling LIBOR settings will also end in due course. Moreover, in many cases, counterparties will be able to find better options than remaining on synthetic LIBOR. Staying on synthetic LIBOR could, for example, make updating hedges more expensive.

Through synthetic LIBOR, we've extended the runway for those firms that might otherwise have struggled to get the whole of their legacy LIBOR fleet down to a smooth landing on solid RFR-based land by the end of 2021. But there's no long-term parking on this runway. Market participants still need a plan to get all these old LIBOR contracts off their books. Synthetic LIBOR does not mean market participants can down tools on their programmes to convert these books.

**Q: How important is a legislative solution to enable tough legacy trades to switch from EONIA to €STR?**

**James von Moltke**
Chief financial officer at Deutsche Bank and chair of the Working Group on Euro Risk-free Rates

As an industry, we have been making good progress in our efforts to transition actively from EONIA to €STR in a way that ensures continuity and economic certainty on those contracts for market participants.

However, regulators and market participants alike have recognised that a material number of harder-to-transition – or tough legacy – contracts remain. These are at risk of not being transitioned before the discontinuation of EONIA, which is expected on January 3, 2022. Despite the industry's best efforts, progress on the renegotiation of these contracts has inevitably been affected by the simultaneous and unprecedented challenges of the global pandemic and Brexit.

Non-binding regulatory milestones have been helpful in encouraging active transition. However, these alone will not solve the challenge of dealing with these tough legacy contracts. That is why a legislative solution is needed. A legislative solution has additional benefits as it creates a greater expectation of market acceptance and reduces the risk of disputes between market participants.

In the EU, the framework for this legislative solution already exists in the form of new designation powers accorded to the European Commission (EC) through recent amendments to the Benchmarks Regulation.

As chair of the Working Group on Euro Risk-free Rates, I have welcomed these new powers and requested that the EC consider designating €STR plus 8.5 basis points as the replacement rate for EONIA. I am pleased the EC has since confirmed this through the publication of an implementing act, which designates this rate as the statutory replacement rate for EONIA, due to take effect from January 3, 2022.

The EC's decision is a positive move. It reduces the risk of undue disruption to the economy, provides legal certainty, and assures market participants that the proposed replacement rate is appropriate and does not disadvantage end users.

This designation, combined with industry initiatives already under way, will play an important role in achieving a successful transition to €STR and mark a key milestone in interest rate benchmark reform.

**Q:** How will the US Federal Reserve Board drive increased adoption of SOFR in 2022 as five US dollar LIBOR settings continue publication? What other benchmarks might be expected to be significant?

**Nathaniel Wuerffel**
Head of domestic markets, markets group, Federal Reserve Bank of New York*

Following nearly a decade of efforts to support the transition from LIBOR to alternative reference rates, the end is in plain sight. At the end of this year, new use of US dollar LIBOR will come to a stop.

When approaching a stop sign, every good driver knows to slow down. Waiting until the last moment and then slamming on the brakes risks a major accident. So too does waiting to stop the use of LIBOR in new contracts. US bank regulators have provided a bright and clear stop sign: new use of US dollar LIBOR should cease at the end of December.

It's time to brake. I strongly encourage firms to slow their new use of LIBOR now in order to safely stop by year-end. Waiting until December not only puts markets overall at risk of a disorderly transition, but also risks operational and financial disruptions to the individual firms that hold off.

As you consider where to head after LIBOR, I encourage you to choose the safe road. The official sector has long emphasised the importance of anchoring the transition on rates that are robust enough to uphold the trillions of dollars in contracts that will reference them.

Fortunately, for many years now, the Alternative Reference Rates Committee (ARRC) has been developing the roadmap for the future. After extensive public consultation, it recommended SOFR as US dollar LIBOR's replacement. SOFR is a robust rate built on a durable base of around $1 trillion in transactions each day in the Treasury financing market, and is produced by the Federal Reserve Bank of New York in accordance with the International Organization of →

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**Nathaniel Wuerffel, Federal Reserve Bank of New York**

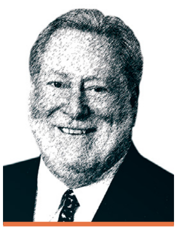
Securities Commissions' (IOSCO) standards for financial benchmarks. It can be used in any number of contracts, and policy-makers have emphasised that it will be the dominant reference rate in derivatives and capital markets products.

When considering alternative reference rates to LIBOR – whether that's SOFR or another rate – market participants should carefully examine their underlying markets and construction. IOSCO recently highlighted regulators' concerns that LIBOR's shortcomings may be replicated by credit-sensitive rates that lack sufficient underlying transaction volumes.

Looking to year-end and into 2022, the Federal Reserve and official-sector partners will continue encouraging market participants to take timely action to bring LIBOR to a full stop and to choose the road of robust alternative reference rates like SOFR. Drive safely!

*The views expressed are those of the author and not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.

**Q:** How effective has SOFR First been in driving increased adoption of SOFR? What else needs to happen? What does the US benchmark landscape look like in 2022?



**Tom Wipf**
Vice chairman of institutional securities at Morgan Stanley and chair of the Alternative Reference Rates Committee

The SOFR First initiative was a key step toward supercharging growth in SOFR derivatives trading, and we continue to see strong progress on that front. Liquidity in SOFR has increased to the point where it is as good or better than liquidity in LIBOR, and this trend in turn is incentivising clients to move to SOFR. The UK gave us the blueprint for SOFR First through the success of the SONIA First initiative and, as we saw there, injecting liquidity into the interdealer markets has proved critical to bringing in the buy side.

We anticipate that these trends will only increase as we approach the year-end deadline for no new LIBOR. Following the ARRC's formal recommendation of forward-looking SOFR term rates in July, market participants now have all the tools they need to transition safely and smoothly, in a way that ensures we never have to repeat this reference rate transition. All that remains now is for market participants with LIBOR exposures to take immediate action – that means writing new contracts based on forms of SOFR, using effective fallback language or renegotiating existing contracts where needed, and supporting the federal legislative solution for contracts without effective fallbacks.

Those priorities will remain as we head into the new year. We will continue to encourage the adoption of robust, transaction-based, IOSCO-compliant rates like SOFR, the use of ARRC-recommended fallback language, and the progress and passage of the legislation now making its way through Congress.

Importantly, with LIBOR no longer available for use in new contracts after 2021, the ARRC will continue to advise that market participants 'know' the reference rates they choose as LIBOR alternatives – a recommendation consistent with the best practices of the Treasury Market Practices Group. Understanding the construction, vulnerabilities, design and suitability of various reference rates can help market participants avoid navigating yet another costly and risky transition.

**Q:** Given the widespread exposure to US dollar LIBOR across Asia, how much progress has been made on transition in the region and what does 2022 hold?

**Arthur Yuen**
Deputy chief executive, Hong Kong Monetary Authority

By now, there are less than 50 days before end-2021, when 30 out of 35 LIBOR settings will cease to exist. Financial authorities and institutions globally should be busy with the transition. In Hong Kong, the Hong Kong Monetary Authority set out transition milestones in July 2020 for financial institutions and has closely monitored their LIBOR exposures.

In Asia, however, the pace of transition varies across jurisdictions. Surveys by the Financial Stability Board (FSB) early this year found that supervisors of the more-ready markets have monitored exposures and provided regulatory guidance to financial firms on transition planning, while those of the less-ready markets have just started to engage financial institutions.

This relative lack of awareness and preparedness for transition could be because most Asia jurisdictions have smaller LIBOR exposures, and over two thirds were concentrated in US dollar LIBOR. The FSB survey estimates that the share of LIBOR exposures in assets with adequate fallbacks amounted to only 10% of total LIBOR exposures in assets for Asian financial institutions in 2020.

In March 2021, the UK Financial Conduct Authority and ICE Benchmark Administration confirmed the cessation dates for all LIBOR settings after end-2021. So, we should act quickly and collectively. We should stop the new use of US dollar LIBOR-linked contracts as soon as possible and no later than end-2021. In the meantime, if there is a need to enter into LIBOR contracts, make sure hardwired fallbacks are in place. And regardless of their level of LIBOR exposures, financial institutions should make sure their IT systems are ready and legal documents are available for new RFR products. Any lack of preparation would only lead to severe disruption in the performance of LIBOR contracts, models and infrastructures as we approach end-2021.

Many supervisors cited the lack of a term structure for RFRs and liquidity in these markets as challenges in the loan markets. On this, the ARRC recommended SOFR term rates in July this year, which will provide market participants with the tools they need for the transition. Recently, the Asia Pacific Loan Markets Association and Treasury Market Association in Hong Kong also issued a joint note, setting out the options available to utilise SOFR in loan transactions.

In Asia, the EMEAP network of central banks and monetary authorities has served as a useful platform for regional central banks to monitor international developments and share experiences on best practices in preparing for the transition. These efforts, along with ISDA's IBOR Fallbacks Supplement and protocol, which have contributed to an orderly transition of the derivatives market, will help expedite the transition process towards end-2021.

The end of 2021 is, however, not the end of the journey. The transition of legacy contracts that reference US dollar LIBOR – of which a majority of settings will cease only after end-June 2023 – will be another challenge as we enter 2022.

Make haste, everyone: there's no time to waste. IQ

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**Arthur Yuen, Hong Kong Monetary Authority**

## FIND OUT MORE

- IOSCO statement on credit-sensitive rates, September 8: bit.ly/3lYC2qg
- UK Financial Conduct Authority announcement on further arrangements for the orderly wind-down of LIBOR at end-2021, September 29: bit.ly/3n92ooN
- ISDA-Clarus RFR Adoption Indicator, October 2021: bit.ly/3C54f3c
- Understanding IBOR Benchmark Fallbacks: bit.ly/3Habpa7