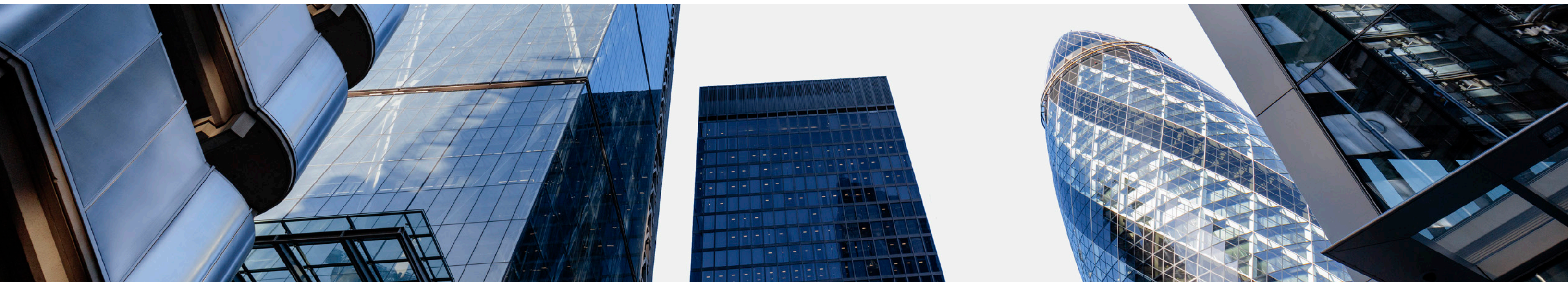
# BENCHMARK REFORM

Understanding the impact of the transition from LIBOR
December 2019



## Background

**The London Interbank Offered Rate (LIBOR) is a benchmark interest rate that indicates borrowing costs between banks. It is the accepted reference rate in financial markets globally as well as the basis for consumer loans in countries around the world since the mid 1980's. LIBOR is based on quotes submitted by banks.**

In 2014, the Financial Stability Board[1] (FSB) recommended a series of steps to strengthen the existing key Interbank Offered Rate (IBOR) benchmarks, and to promote the development and adoption of alternative nearly risk-free reference rates (RFRs) where appropriate:

- Reform IBORs by making them more transaction based
- Develop viable RFRs to potentially replace IBORs for certain types of transactions

In July 2017, the Financial Conduct Authority[2] (FCA) announced that they will no longer compel LIBOR panel member banks to contribute to the benchmark after the end of 2021. **The discontinuance of LIBOR may affect products you use to manage your business have purchased or entered into with CIBC.**

[1] The Financial Stability Board is an international body that monitors and makes recommendations about the global financial system. The Board includes all G20 major economies, FSF members, and the European Commission.

[2] The Financial Conduct Authority is a financial regulatory body in the United Kingdom, but operates independently of the UK Government. It regulates financial firms providing services to consumers and maintains the integrity of the financial markets in the United Kingdom.

# Evolution of benchmark reform

**January 2022**
Under EU Benchmarks Regulation, non-compliant Third Country and Critical benchmarks can no longer be used in the EU (E.U.)

**Q4 2021**
End of LIBOR
"The FCA has secured panel bank support to continue submitting to LIBOR, but only until 2021. Beyond this date the future of LIBOR is not guaranteed."

**Q3 2020**
CME and LCH to begin discounting cleared USD derivatives using SOFR (U.S.)

**Q2/Q3 2020**
Montreal Exchange to launch CORRA futures (Canada)

**January 2020**
Under EU Benchmarks Regulation, non-compliant European non-critical benchmarks can no longer be used in the EU (E.U.)

**Q2 2020**
Bank of Canada to begin publishing enhanced version of CORRA (Canada)

**Q1 2020**
ISDA's protocol for new fallback to be published

**Q4 2019**
ISDA Fallback Consultation results published

**July 2019**
New CORRA methodology approved.
Bank of Canada announces new CORRA administrator role (Canada)

**April 2019**
ARRC release of fallback language for cash products

**January / February 2019**
Enhanced CORRA Consultation paper published.
Fallback Principles published (Canada)

**December 2018**
ISDA Fallback Consultation results published

**September 2018**
WG on euro RFR recommends €STR as the RFR (E.U.)
Size and Scope subgroup report published. (Canada)

**July 2018**
Recommended "enhanced CORRA" as the RFR (Canada)

**April 2018**
SOFR published (U.S.)
Reformed SONIA published (U.K.)

**March 2018**
CARR created

**September 2017**
Working group created to identify EUR RFR

**July 2017**
Andrew Bailey announces that the Financial Conduct Authority ("FCA") would not compel banks to submit LIBOR quotes after 2021



# Global RFR initiatives: United States and United Kingdom

## United Kingdom

- The Working Group on Sterling Risk-Free Reference Rates recommended the reformed Sterling Overnight Index Average (SONIA) in April 2017 as the preferred alternative RFR for GBP:
  - Overnight unsecured rate
  - Increased the number of transactions in the calculation of SONIA by including transactions arranged both via brokers and negotiated bilaterally
  - The Bank of England began publishing the reformed SONIA in April 2018
- 1- and 3-month SONIA futures contract launched since December 2017:
  - Intercontinental Exchange (ICE) started publishing indicative 1, 3 & 6-month SONIA futures based term RFRs in October 2018
- First SONIA linked floating rate note issued by EIB in June 2018:
  - GBP FRN market has fully transitioned to reference SONIA, with all major GBP FRN investors having the capability to invest in SONIA FRNs

## United States

- The Alternative Reference Rate Committee (ARRC) has recommended the Secured Overnight Financing Rate (SOFR) in June 2017 as the preferred U.S. dollar overnight RFR:
  - Broad-based overnight repo rate - over $900 billion of transactions underlying the rate
  - The Federal Reserve Bank of New York began publishing the SOFR in April 2018
- ARRC was reconstituted in March 2018 to focus on implementing its transition plan for SOFR, including developing a term rate and addressing fallback language:
  - 1- and 3-month SOFR futures launched in May 2018
  - April/June 2019: ARRC released its recommended LIBOR fallback language for syndicated loans and bilateral loans
  - Beginning 2020: To facilitate use of SOFR in financial products, the Federal Reserve Bank of New York is preparing to publish averages of daily SOFRs

# Global RFR initiatives: Canada

- In March 2018 CARR formed the Alternative Rates subgroup specifically to evaluate options for enhancing CORRA
- In July 2018, after reviewing several options, the Alternative Rates subgroup recommended and CARR agreed that the subgroup should focus on enhancing the current CORRA benchmark
- The term risk-free rate would act as a complementary reference rate for the Canadian market and would operate alongside the Canadian Dollar Offered Rate (CDOR)
- The proposed enhancements result in CORRA being based on approximately $10 to 20 billion in daily repo transactions instead of the current $1 to 5 billion. On average we expect the underlying volume to increase by approximately fivefold
- CORRA is currently set at the Bank of Canada's target rate on those dates that the eligible daily repo volume is below $500 million. This occurred on 10 occasions in 2018. Under the proposed enhancements the minimum daily CORRA repo volume would have been approximately $9 billion in 2018, or at least 18 times higher than seen under the current methodology
- Make historical data available to market participants:
  - Existing CORRA data is currently available back to August 1997
  - Enhanced CORRA data will be made available for analytical purposes back to January 2016

# Global RFR initiatives (cash products): Loan agreements

- Loan agreements govern syndicated and bilateral credit facilities. While they all contain common provisions, they are also highly customized based on the currency, industry, credit profile, loan size etc.
- Many agreements currently contain LIBOR fallback language to Prime/Fed Funds + 50 bps (significantly higher than LIBOR); This was primarily meant to capture market disruptions in reference rates.

## United States

- On April 25, 2019, the ARRC released its final recommendations regarding more robust fallback language for LIBOR syndicated loans, and the market has already started incorporating this language.
- The recommendations offer two approaches, the Hardwired Approach and the Amendment Approach. CIBC is endorsing the Amendment Approach for all new or amended loan agreements. This approach provides specificity with respect to successor rate triggers, but decisions about the successor rate itself and any spread adjustments will be made in the future. This allows for continued market development.
- The Hardwired Approach is similar to the Amendment Approach, but locks in SOFR as the replacement rate. This approach may become more appropriate as the market develops.

## Canada

- Canada is also working on a risk free reference rate (CORRA) that will operate alongside CDOR. The impact of changes, if any, to the Canadian reference rate in loan agreements is not yet known.

## United Kingdom

- Replacement rate language has been bolstered in loan agreements to allow for additional flexibility in formally selecting a replacement for GBP LIBOR (replacement of screen rate clause). SONIA has been readily adopted in the UK cash markets as the replacement for GBP LIBOR.
- The first SONIA-referencing bilateral loan was issued in July 2019.

# Global RFR initiatives (derivatives): ISDA

- The great majority of participants in Derivatives markets operate under an ISDA agreement
- ISDA has been negotiating with regulators and market participants on LIBOR transition since 2013
- Before the end of 2019 ISDA will release a "Supplement" to the 2006 ISDA Amendment. This will redefine the underlying products and with it their fallback conditions in the case of the cessation of LIBOR
- The new ISDA Supplement will be effective at a date in Q1, 2020
- If there is a "permanent cessation" of LIBOR (due to regulator or administrator public announcement), the ISDA Supplement will determine a fall back to SOFR – compounded, in arrears.
- There is a lack of clarity and certainty as to whether clients would be economically impacted as a result of the fallback to SOFR. In addition, the discontinuation of LIBOR may result in a mismatch between the rate referenced in various financial instruments, including potentially those that are intended as hedges
- All new ISDA documented derivatives will by default pick up this language as of execution date
- On the same schedule, ISDA will announce a Protocol, which will apply to existing transactions – when agreed by willing participants. The protocol will define "Term Spreads" recognizing the rate difference between the legacy LIBOR curve points and the SOFR curve point all along the maturity curve. These spreads will be transparent and be available from a designated 3rd party vendor



# Contact and relevant working groups

| Committees/Organizations | Link |
|---|---|
| Alternative Reference Rate Committee (ARRC) | • newyorkfed.org/arrc |
| The Working Group on Sterling Risk-Free Reference Rates | • bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor |
| Working group on euro risk-free rates | • ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html |
| Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks | • boj.or.jp/en/paym/market/jpy_cmte/index.htm/ |
| National Working Group on Swiss Franc Reference Rates | • snb.ch/en/ifor/finmkt/fnmkt_benchm/id/finmkt_reformrates |
| Canadian Alternative Reference Rate working group (CARR) | • bankofcanada.ca/markets/canadian-alternative-reference-rate-working-group/ |
| International Swaps and Derivatives Association, Inc. (ISDA) | • isda.org/category/legal/benchmarks/ <br>• isda.org/2019/09/10/supplement-to-the-plain-english-disclosures-for-derivatives-referencing-libor-and-other-ibors/ |
| Chicago Mercantile Exchange (CME) | • cmegroup.com/trading/interest-rates/secured-overnight-financing-rate-futures.html |
| Financial Stability Board - Official Sector Steering Group (OSSG) | • fsb.org/work-of-the-fsb/policy-development/additional-policy-areas/financial-benchmarks/ |
| Financial Conduct Authority (FCA) | • fca.org.uk/markets/benchmarks |
| ICE Benchmark Administration (IBA) | • theice.com/iba |

Questions about LIBOR can be directed to: Mailbox.IBOR@cibc.com

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