Emily: Hello and welcome to this DerivSource podcast. I am Emily Fraser Voigt, deputy editor of Derivsource.com.

Andrew Bailey CEO of the Financial Conduct Authority wants to see a replacement of Libor by 2021. This will not be an easy task although it is inevitable, according to Ivan Harkins, director and head of the structuring and advisory team at JCRA. In this podcast, he discusses the pros and cons of the proposed alternatives.

Conducting the interview, here is DerivSource's founder and editor, Julia Schieffer.

Julia: Welcome to the podcast, Ivan.

Ivan: Thank you very much for having me.

Julia: My first question for you is what impact does Andrew Bailey, CEO of the Financial Conduct Authority setting a deadline of 2021 have on the industry and is this deadline feasible?

Ivan: In my mind, the main impact of Andrew Bailey's announcement is to bring awareness to the issue and to remove that perception that exists that LIBOR is going to continue to be perpetually published. I don't think it's any coincidence that the announcement was well timed to bring focus to the Bank of England's work on using risk-free rates. The Bank of England has made its choice around SONIA as its preferred risk-free rate, so it is now directing its attention for the transition from LIBOR to SONIA.

While we know there's a lot of change that market participants are having to face, for example, MiFID II which comes into force in January 2018, and market participants are a little bit wary, I think there is recognition that there's real benefit to putting a timetable to this change. Ultimately, a big factor in the success of the transition from LIBOR to a new risk-free rate will be getting liquidity into new instruments and liquidity can only really be achieved if you get those increased network effects of lots of participants moving to that new risk-free rate. Putting a deadline of 2021 will encourage market participants to break that natural inertia of moving to a new risk-free rate.

Julia: Can LIBOR survive in a reformed way as some participants have suggested?

Ivan: The only element keeping LIBOR alive at present is that the FCA are instructing banks to make submissions to ICE, the LIBOR administrator. Andrew Bailey gave the extreme example where in one particular currency

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tenor [inaudible 00:02:07] across the dozen banks who are making daily submissions of LIBOR that over the course of 2016, there's only 15 trades over the entire year. Many banks are feeling quite uncomfortable making these judgment-based submissions and when that FCA requirement falls away to make submissions in 2021, they're quite likely to stop.

Then you're going to have to ask yourself what's going to cause LIBOR to survive? The question you should pose yourself what is it about LIBOR that can't be fulfilled by the new risk-free rate? Often when you probe this issue with people who are advocating for the survival of LIBOR, it's not always clear what it is about LIBOR that they want to keep and often, it's just the fear of change rather any insurmountable hurdles associated with a new risk-free rate.

When you combine this fact with the fact that there is now starting to be real concerted efforts to create liquidity in the new risk-free rate, this is likely to contribute to the death of LIBOR as we know it. Saying all that, at a recent ISDA conference, I heard that the Japanese who have selected TONA as their risk-free rate except that expect that TIBOR will continue to exist and that the two reference rates will operate alongside each other. That will certainly give some hope to those participants who are wedded to LIBOR continuing to exist.

Julia: **Question three, what are some of the options in the US and UK and how do they work?**

Ivan: In the US, the Alternative Reference Rate Committee or ARRC has selected the Secured Overnight Funding Rate or SOFA as their preferred risk free rate. SOFA is yet to be published, but it's based on the cost of overnight loans that use US government debt as collateral. The market for that as an average daily volume is something like 660 billion. Unlike LIBOR, SOFAs will be backed by a liquid market, which is one of the key drivers away from LIBOR into these new risk-free rates.

In the UK, the Bank of England Working Group on risk-free rates has chosen almost unanimously to adopt the Sterling Overnight Index Average or SONIA. SONIA is published daily and it's on based on unsecured overnight transactions. That's one distinction between it and what they've chosen in the US. US is based on secured transactions. In the UK, it's based on unsecured transactions. Again, that SONIA market is quite a liquid market. It's got in excess of 40 billion of average daily volumes.

One distinction I'll draw is that a large part of the reason behind the choice of SONIA is that there is an existing market for SONIA-linked swaps, whereas that's not the case with SOFA. It's going to be much easier to build on that existing market infrastructure in order to create a liquid market alternative to LIBOR instruments. As I mentioned before,

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ultimately, liquidity is going to be one of the key factors that will lead to end users switching to these new risk-free rates.

Julia: **Focusing on SONIA, what are the challenges with SONIA in general for market participants?**

Ivan: As I mentioned, the Bank of England are slightly better placed than some regulators because there is already a functioning market for SONIA swaps. LCH clears those swaps up to 30 years currently, and they are looking at increasing that to 50-year tenures. We're going to face the large challenges as the US do with SOFA, where it's a brand new rate that's going to be published and it doesn't have any assisted market infrastructure. There are still some challenges.

One of the challenges that comes along and may or may not impede transition is some of the practicalities that some of the end users in the non-financial community might face. If we consider what SONIA is, it's an overnight rate and from next April, it's going to be published on the next working day. If you're a corporate and you've got to take quarterly interest periods, whereas under the current framework with LIBOR, LIBOR fixes at the start of that interest period, so you know exactly what your interest expense and your interest cash flow will be at the end of the period. Moving to SONIA, you wouldn't know your actual interest expense until the very end of the period, so that's going to have an impact on such practical tasks such as cashflow forecasting, doing journal entries and hedge accounting.

Saying that, I don't think it's an insurmountable challenge and there are some solutions to it. For example, you could just introduce a small payment lag for those smaller end users so you get to your end of your interest quarter and rather than paying on the last day, you might pay on the last day plus a small buffer of three to five days to help facilitate some of those practical issues that you will face. Or you could explore looking at term fixings linked to the new risk-free rate. For example, you could take swaps, say a three-month swap that references SONIA and take traded liquidity in that instrument to create a term fixing for three months. The Bank of England have started a subgroup within their working group to look at term fixings that will be linked to the new risk-free rate. It's going to be an area we're going to have to monitor.

Julia: **What happens to the legacy portfolios of derivatives that reference LIBOR?**

Ivan: Good question. The goal of transition as I kind of talked about before is going to definitely to bring liquidity to the new risk-free rate derivative market and in my view, a natural consequence of that is that liquidity in LIBOR-linked instruments is going to start to reduce and if you consider

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the broader ecosystem that makes a market function, a reduction in liquidity can start to have some domino effects, which may ultimately speed up the transition of some of those legacy portfolios.

If we take for example, the role of LCH as a clearing house and what it plays in the wider market, if we start to reach a position where there's just a tail of legacy swap portfolios in the market, then it's quite likely that the LCH may get into a position where they're not able to adequately risk manage those positions and in which case, they'll probably stop providing clearing services for those LIBOR swaps. If we get into that sort of situation, we would start to see some of the domino effects, because banks who are no longer able to clear LIBOR swaps will start to face higher costs holding these swaps, and so they will sit outside the netting set of their cleared derivatives book. Then in turn, banks will probably likely to seek to pass on those higher costs to the end users and that poor pricing in the end user space will further encourage transition.

Julia: **Last question and looking ahead, in the longer term, market participants expect to see the creation of liquid futures market for the new benchmark. How can this be developed?**

Ivan: This is firmly on the agenda for the Bank of England Working Group and it's already been identified as one of the aspects that's going to be needed for a successful transition to the new risk-free rate. They've started engaging with banks and market participants who are active in that current futures market just to gather feedback on how a futures market referencing the new risk-free rate will operate. It's an area that we're continuing to monitor.

If I was to speculate in terms of how I think that might work, I think what we might have is we'll have defined delivery periods. For example, you could define these to be monthly, and then during each delivery period, you would look to calculate the compounded daily average SONIA rate for the delivery period and then, settlement of that future would happen at the end of the delivery period based on this compounded daily average SONIA rate. Then trading the future could probably continue right up until the last day of that delivery period.

Very high level, I expect that that's sort of the mechanics of how that contract may work, and once that's agreed between market participants working with the Bank of England, once its up and trading, then it's just a question of driving liquidity into that new futures instrument.

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Julia: **Great. Thank you, Ivan, for sharing your insight and expertise on this very timely topic with our audience.**

Ivan: A pleasure. Thank you very much.

Emily: Thanks Julia and thank you Ivan for sharing your insights.

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