NatWest Markets
ON POINT
INTELLIGENTLY DIFFERENT THINKING FROM NATWEST MARKETS

IBOR Reform: Ringing the bell for the end of term?

As reiterated by the FCA last month, the production of LIBOR is likely to end in 2021 and all markets need to transition to the replacement Risk Free Rates (RFRs) or face 'chaos'…

Phil Lloyd

Head of Market Structure & Regulatory Customer Engagement

March 2019

The GBP FRN market has fully and consistently embraced the new world of RFRs with over £16bn of SONIA referenced issuance; all using the same daily compounded rate and a five day reset lead. Before the first issuance by the EIB, the market was sceptical on the practicalities of a daily reset but we now have a market of 18 global issuers with a continually growing investor base. The infrastructure works and liquidity in SONIA FRNs is comparable to legacy LIBOR instruments. To date, there has been no corporate issuance, but corporate GBP FRNs have always been rare. One corporate, Associated British Ports, is working to amend their two outstanding FRNs to SONIA, with NatWest Markets as the advisor.

But where is the loan market??? So far there has been no evidence of SONIA loans and much is made of the need for a term rate, similar to where the FRN market was 12 months ago.

Are term rates needed for new loans and what could be the impact with and without them?

What is the issue with term rates?

On the face of it, a term SONIA rate could make the loan market transition relatively simple. Systems could change their reset feed and most documentation terms would be unchanged. Margins would likely need to change to reflect the loss of term premium, but pricing for the change could be transparent and utilise the LIBOR vs SONIA basis swap, as seen in the FRN market.

There are clear downsides though. A term SONIA rate could be based on a market observed rate such as the fixed rate on an interest rate swap vs SONIA (e.g. the 3 month Overnight Index Swap or OIS) - this rate moves intra-day and would need to be observed using a public fixing. Regulators will need to be comfortable that sufficient protections are embedded into financial markets to ensure that conflicts of interest and manipulation risks are removed (how different is that to LIBOR?). Yes a liquid market helps but what about illiquid days? Easter Thursday, Christmas Eve and even some summer days see very little trading.

This has even bigger impacts on derivative trading too. A swaps trader currently makes markets and prices in OIS as well as LIBOR swaps. If that trader is then quoting on OIS and managing swaps which use the OIS fixing as their floating index, this creates a clear conflict of interest.

In light of these points, in November 2018, the Working Group on Sterling Risk-Free Reference Rates stated that “Finding ways to avoid the systematic usage of TSRRs (Term SONIA Reference Rates) in derivatives markets will be essential as TSRRs develop”.

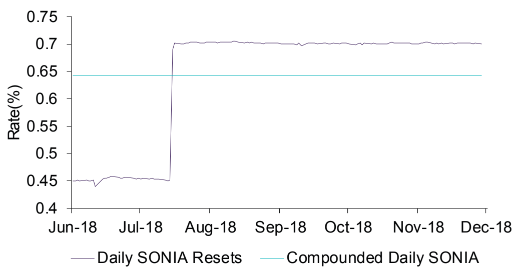
Given that the daily SONIA market for bonds and derivatives is likely to be bigger than that for term SONIA, the risk is that some firms will avoid the latter to avoid the regulatory costs and litigation risk. There is also a question of whether all users will be able to use term rates, or whether they will only be allowed in specific situations. For those using term SONIA, liquidity could be low and costs could rise. Who remembers the Betamax vs VHS format war in the 80’s? Although Betamax was preferred by some, the more efficient VHS market created pricing that led to it emerging as the preeminent format. Some readers may have never even heard of Betamax.

There is also the risk that there is more than one term rate available. The publication of such rates could rely on private administrators and so we shouldn’t assume that only one benchmark will be released. Multiple versions could further impact liquidity and it may be difficult for product providers and advisors to offer / recommend one over the other.

Is daily SONIA manageable for the loan market?

The derivative and FRN markets both use a compounded daily SONIA rate and so a loan product that was aligned to this would be helpfully consistent.

The August 2018 25bps hike led to a rise in 6 month Compounded Daily SONIA in December of less than 20bps



Source: NatWest Markets

The biggest concern around daily SONIA is the lack of certainty on interest payments until towards the end of the period. These concerns are appreciated but we encourage a review of the actual volatility in a compounded SONIA. Central banks have been very careful not to shock the market and forward guidance is now viewed as a critical part of their approach, making unexpected large changes in an interest period less likely. In addition, changes will have a blended impact due to the averaging nature as seen in the second half of 2018 when the BoE hiked by 25bps.

Short term pain for long term gain?

There are ways to manage such risks and technology could play a key role. Technology for short dated FX hedging has evolved massively in recent years with online platforms reducing execution and operational costs dramatically. Such platforms are used by all customer types, including the smallest corporates.

Could such platforms be extended to allow customers to easily hedge their short term SONIA reset risk using interest rate swaps? If so then this would give increased flexibility compared to the current LIBOR world - you could fix your loan payments to a specific date rather than 1m, 3m or 6m. Yes there would be some work and execution costs every time the decision to fix was made, but in an efficient market with efficient technology these may be manageable in the same way that FX trades already are.

A compounded rate would require system improvements for many. Daily compounded SONIA has a relatively simple formula but given it only compounds on business days and would likely have an extended reset lead, some work would be required – our experience in the FRN market tells us this is possible though.

There are benefits to the underlying loan document too. LIBOR loans have break costs if they are pre-paid intra-period (a function of the LIBOR locked in vs the LIBOR for the remaining term) but a daily SONIA loan shouldn’t require them and could be drawn and repaid for any specific period within operational realism. In addition, as a BoE published rate, SONIA has its own fallbacks embedded, removing the need for bespoke terms involving reference banks and future proofing from the unlikely event that we have to reform benchmarks ever again!

In summary

We expect a SONIA loan product to gain increasing interest in 2019. There are clear benefits to daily compounded rates and if the market can embrace them from the outset we could avoid the risk of being in a Betamax situation and better still, if the pace of innovation is fast enough we could skip straight to streaming video!

377_0319NWM | March 2019