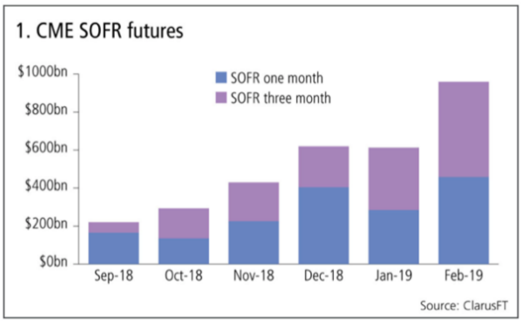
The slow death of LIBOR and its multiple consequences

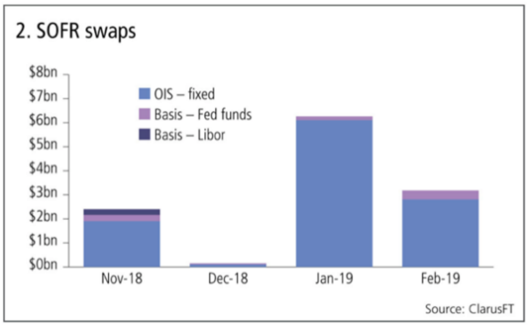
[Air France-KLM row shows new-found Dutch taste for French statism- FT Mar 01, 2019]

After the multiple abuses and following scandals of LIBOR, the rush to find reliable replacements for the globally used benchmark has turned into a marathon crawl. It is not easy as it seems, to come up with a solution that has the properties to protect participants from the abuse of rate setters and then to rebuild the trust in benchmarks that will allow continued trading and hedging in long date rate instruments with fixings based on a common benchmark.

Then it is even harder to gain consensus amongst the over politicised decision makers who could be said to be putting self-interest before the common interest of all. As a result, solutions in various centres are experiencing different problems. On top of that, because of the long-term nature of rates products, you have to come up for a replacement of LIBOR in existing contracts and make provisions (fallbacks) for when agreed fixings fail.

So new benchmarks are being watched closely. The CME is going for SOFR (Secured overnight funding rate) and the futures on this are hitting new highs in open interest and volumes. But at the same time Swaps using SOFR as a risk-free rate benchmark are seeing volumes decrease.





An example of where consensus is failing is in Europe where they have gone their own way in replacing the LIBOR fixing process, with the new risk-free rates (RFRs) chosen as the successor for the Libors. This is against the recommendation of various regulators and associations such as ISDA. ISDA, bearing in mind its history and relative neutrality would be ideally placed to lead the way in common solutions. Their recommendation was for fallbacks based on an adjusted version of the relevant risk-free rate. Regulators would prefer to see adjusted RFRs as fallbacks because the underlying markets – overnight deposits and repo, for example – are more robust. A term version would probably have to be based on derivatives that reference the RFRs and could fall into the low-liquidity trap that has fatally undermined LIBOR. Compounding the challenge for the euro market, its chosen RFR – the euro short-term rate, or Ester – will only be published regularly from October.

In Switzerland SARON (Swiss Average rate overnight) was chosen as replacement for Swiss Libor back in 2017 with transitioning completed by end of 2021. So far it is only used in 10% of the swiss swap market. But the benchmark has failed to gain traction in other products such as Bonds and loans in using it as a reference rate. SAs a result LIBOR still dominates and liquidity and therefore a lack of a liquid replacement could mean that the full transition will create dangerous risk. Finally, with the advent of uncertainty, required margins will increase to cover potential increase in risk. Although fundamentally sound Basel are pushing for this not to happen as it will only lead to further barriers to a smooth transition to new benchmarks.

The key point is that a lack of liquidity, disagreements and a lack of common fallbacks could send the rates market into disarray, creating unwanted and unnecessary basis risks because participants have different versions. With a market with no standard fallbacks for a failing benchmark, it looks very gloomy indeed and would result in a non-functioning rates market.

This would cause huge problems also for corporate hedges and the corporates themselves. In addition, traders and risk managers would be faced with massive issues in trying to measure the new basis risks and then trying to hedge them would be another thing all together.

The Intuition Know-How Library consists several Courses related to this article:

- **Introduction to Derivatives** (6 tutorials)
- **Swaps** (19 tutorials)
- **Interest Rate Risk Management** (5 tutorials)

For Intuition blended learning related to this article, some of our popular workshops include:

- Interest Rates, Yield Curves And Derivatives – Sales & Risk
- Blockchain Applications In Banking
- Bonds – Understanding Risks & Identifying Opportunities

The topics covered in Intuition Asia Perspectives are current developments or topics currently in the market. Intuition Asia provides bespoke learning solutions, both eLearning and Instructor-led courses. These can also be blended in a program to provide the most effective form of learning. These workshops can be structured as lunch & learns, webinars or full day deliveries. Clients can use these to keep their workforce updated with the latest developments in the market and complete their mandatory CPD learning hours.

Get in touch with us at asiainfo@intuition.com for more details.

Get the app