Since our last release on LIBOR reforms, there have been a number of significant developments especially for PRA/FCA-regulated banks in the UK.

The UK FICC Markets Standards Board (FMSB) has published a consultation draft of their proposed 'Core Principles' on the use of Term SONIA Reference Rates (TSRRs) for Sterling FMSB Term Rate Standard Transparency Draft.

This explores the use cases for TSRRs and, for trade finance, requires that there be a "robust rationale" for using TSRRs. The paper endorses their use for discounting products and market participants should not, find it difficult to justify use of TSRRs in this case, assuming the final paper is published in the current form. For export finance or emerging markets lending, the paper shows less enthusiasm for the use of TSRRs, and simply says that a rationale "may" exist.

In all cases, according to the eight draft Core Principles set out in the paper, banks must be able "to track and retain appropriate records of the volume of products used or issued by such bank... which reference Term SONIA"[1] and have "adequate policies, procedures, systems and controls in place to identify and mitigate any conflict of interest which may arise"[2] by using TSRRs.

Banks and dealers using TSRRs are also being asked to "publish comprehensive risk disclosures to end users who are offered products" referencing TSRRs to highlight relevant risks relating to these rates[3]. No guidance is given as to what these might be, so each user will need to consider this carefully (helpfully these can be published in a central location e.g. an intranet page and do not need to be done trade-by-trade). From our reading of the 'Background and rationale' of the FMSB paper, it is possible that some of the relevant factors to consider in relation to risk disclosure could include:

- lack of liquidity in the TSRR market;
- TSRRs not representing actual market funding costs as they are extrapolated from SONIA swap rates;
- difficulty hedging products using a TSRR

This list is not exhaustive and users will need to look at the situation at the time and the market guidance and rationale for using the TSRR.

ITFA believes that a good rationale exists for the use of TSRRs in emerging markets transactions. This includes (i) the need for cash-flow certainty in smaller banks;(ii) operational constraints and the cost of making such changes and; (iii) the need to apply to central banks for the use of hard currency reserves which typically requires lengthy notice. Market participants will need to work with their customers to ascertain the rationale in each case and record and track the use of TSRRs for possible future examination by a regulator.

The Loan Market Association (LMA) has also published a note "Considerations in respect of the use of forward-looking term SONIA reference rates"[4] on 26 March 2021 on the use of TSRRs and usefully explores the fallback options for when the TSRR is not available on temporary or permanent basis. Their suggestions include:

- Bank of England Bank Rate;

[1] Draft Core Principle 4
[2] Draft Core Principle 5
[3] Draft Core Principle 6
[4] See the LMA website and LIBOR microsite at www.lma.eu.org

- SONIA compounded in advance (using the rate for the matching preceding period) and interest applied on a forward basis;
- SONIA compounded for the week prior to the interest period and interest applied on a forward basis;
- Bond index yields (referencing the closest coupon-adjusted maturity bond yield at the relevant time (e.g. UK gilts);
- A fixed rate; or
- An alternative TSRR. [5]

Using past rates to calculate future rates involves obvious risk where rates are volatile and may lead to significant off-market positions, the shorter the period these are used for, the less likely this risk will be to arise.

Using a fixed rate would more often than not equate to a cost of funds usage and is likely to be used by many, even though the paper is not very enthusiastic about its use. As we have previously said, this may also lead to regulatory censure if these draft Core Principles are adopted by the market as new standards and if the regulator elevates them from a Code of Conduct to the status of regulation. Again, the shorter the relevant interest period, the less likely there are to be any problems. The options above are not listed in any order of preference and are a useful "shopping list".

Both papers are concerned with Sterling transactions only.

For our members generally, US Dollars are a much more important currency. In the United States the ARRC (Alternative Reference Rates Committee, a body set up by the market in the US with backing from, amongst others, the US Federal Reserve) announced in its press release on 23 March 2021 "Update on Forward-looking SOFR Term Rate" that it is unlikely SOFR term rate will be available. It encourages market participants to use other SOFR options e.g. averages and indexes which function in a similar way to some of the options suggested by the LMA, involving constructing forward-looking rates from past rates, with some of the same drawbacks.

Both the ARRC and the PRA/FCA (in a recent Dear CEO letter 'Transition from LIBOR to Risk Free Rates' (bankofengland.co.uk)) are, however, very clear that they expect the use of USD LIBOR to cease for new transactions as from the end of 2021.

This will place many UK banks (and those financial institutions in other countries which follow the ARRC's recommendations) in a difficult position as clients are likely to ask to continue using US Dollar LIBOR until it is finally phased out in June 2023. Greater use of acceptable term rates may be a partial solution. Some alternatives are currently under development (by Bloomberg for example https://www.bloomberg.com/company/press/bloomberg-confirms-its-bsby-short-term-credit-sensitive-index-adheres-to-iosco-principles/) and are expected to seek certification from the US Federal Reserve. Market adoption will then dictate which if any, will become the go-to reference rate when forward-looking term rates are required in the trade finance market.

ITFA will continue to monitor the situation and make recommendations on behalf of the market.

For a longer look at some of these issues we also refer you to the recent bulletin published by Sullivan And Spring Heralds SONIA....and Alternative Rates (sullivanlaw.com)

[5] Extracts from the LMA note 26 March 2021.

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