

Global LIBOR Reform: Questions and Answers



How important is the London Inter-bank Offered Rate (LIBOR)?

- **LIBOR provides an indication of the average rate at which a panel of banks could obtain wholesale unsecured funding.** It has been used by the British Bankers Association since 1986 with a governance that involves asking traders from a panel of banks to estimate at which level they consider they could borrow funds. There are 5 active LIBOR currencies (CHF, EUR, GBP, JPY and USD) for 7 maturities.
- **LIBOR has a central role in today's financial system.** LIBOR is used as a reference rate for millions of contracts ranging from derivatives to mortgages that are worth more than \$400 trillion globally and around US\$ 250 trillion for USD.

What is the Financial Benchmark Reform?

- **In 2013, under the G20 mandate, the Official Sector Steering Group (OSSG) convened Central Banks and regulatory authorities to undertake a review of major interest rate benchmarks.** To transition from LIBOR to alternative risk-free rates (RFRs), working groups were created in various jurisdictions for this “market-led” transition effort (US ARRC, UK and EU working groups, etc.)
- **As LIBOR is only indirectly linked to transactions, regulators believe LIBOR is not a viable benchmark going forward.** Concerns result from the limited liquidity and transactions underlying LIBOR indexes in many jurisdictions (USD, GBP, EUR, CHF, etc.). This limited market representation creates vulnerabilities and risks to financial stability.
- **LIBOR panel banks agreed to continue submitting LIBOR voluntarily only until 2021.** They feel uncomfortable to do so as the result of contingent liabilities (e.g., fines) and the limited market representation of the indexes. Legacy and new contracts and transactions are expected to move to alternative Risk-Free Rate (RFR) indices before this date.
- **The process to move away from LIBOR to the new Indices - the LIBOR Transition - has legal, operational and financial implications across all**

market participants. In addition to the financial sector, public and private sector,

- as well as the retail market participants (loans, investments, etc.) will be affected.

What are the capital market development challenges of the LIBOR Transition?

- **Development of Risk-Free Rate (RFR) references need to be robust and firmly based on transactions.** For this purpose, they need to provide (i) an accurate representation of key money markets that cannot be manipulated, (ii) provide forward-looking rates as currently LIBOR does, and (iii) serve as a benchmark for lending and funding. Overnight SOFR, SONIA and ESTR have been chosen for the US, UK and EU markets and due diligence has been done by regulators and the financial markets to ensure they provide robust and credible overnight rates. Both SOFR and reformed SONIA indices started to be published in April 2018. The ESTR index is expected to be launched in October 2019.
- **Deep and liquid capital and derivatives markets need to be developed for the alternative RFRs.** Future and derivative markets for SOFR (US) and SONIA (UK) started trading since 2018. Since inception, the former has now reached more than USD7 trillion of notional value. Without these markets developing further to provide a solid interest rate curve for various maturities, adequate forward-looking pricing of loans and investments (as done today with LIBOR) could be challenging.

Key considerations from the LIBOR transition for our member countries and the IDB?

- **Legal Considerations.** Include identifying fallback provisions in existing loan contracts and ensuring future loan contracts contain adequate fallback provisions.
- **Financial considerations.** Result from the fact that there is no guarantee that values of the banks' financial instruments will not change when markets and products change to new RFRs or a hedgeable or non-hedgeable mismatch in the balance sheet arises from the transition.



The transition from LIBOR to an alternative rate will require the banks' portfolios of outstanding loans, bonds and swap agreements to transition to a replacement index.

- **Operational considerations are linked to the ability to operate in the new RFRs and the revised market infrastructure.** These include IT platforms and systems, review of legal fallback provisions, payment systems, market protocols, trade entry, etc.

What has the IDB done with respect to the LIBOR transition?

- **IDB has positioned itself at the forefront of the LIBOR transition.** IDB participates as an observer in the FED's ARRC working group meetings and consultations. Also, Management established a formal working group for the LIBOR Transition early in 2018.
- **Much work has already been done at the Bank to ensure readiness.** On the capital markets side, exposures and risks have been mapped, issuance of LIBOR index notes beyond 2022 has been discontinued, and monitoring is performed on regulatory and market developments. Additionally, quantification of resources to ensure a smooth transition, including processes and IT systems has been performed.
- **On the sovereign guaranteed lending side, standard language for contractual transition has been identified.** Initial findings indicate that for the Flexible Financing Facility (FFF), the relevant fallback provision which ties Loan Pricing to the Bank's cost of funding, would allow the Bank to change the base rate of the loans by providing notice to the borrower of the intended change. However, based on existing fallback language in legacy financial products, changes to the base rate of the loans would require the agreement/consent of the borrowers and guarantors, as the case may be.
- **Non-sovereign guaranteed lending side.** IDB Invest's legal team is analyzing LIBOR related provisions in existing contracts and expects amendments to such contracts may be required for LIBOR based loans.

What is IDB's communication strategy and work on the transition with member countries?

- **IDB's communication strategy.** The strategy includes interactions with sovereign borrowers during the annual

meetings, the 2019 LAC Debt Group Meetings, and the Regional Network of Finance Ministries and Central Banks of Latin America and the Caribbean to bring awareness to the coming changes and start working with our country members on this critical transition.

- **Specific changes to IDB loan rates cannot be determined until the market and regulators have settled on new reference rates that have liquid cash and derivative markets.** As the IDB needs to be able to manage against financial counterparts its balance sheet exposures when funding, hedging and providing loans and other financial products to our borrowing member countries, more clarity on the decisions taken by regulators and market participants is needed, as well as an understanding of the needs of our borrowing countries. These decisions include (i) the agreement on the fallback language for legacy and new cash and derivative instruments, (ii) the adoption of new ISDA derivative protocols, and (iii) regulatory clarity on margin and tax treatment of changes arising from the transition.

References and useful links

- J.P. Morgan Perspectives, April 30, 2019. Global Emerging Markets Research.
- Preparing for Transition - A thoughtful Approach to a LIBOR Program. RBC Capital markets. March 2019.
- Schrimpf Andreas, Vladyslav Sushko (2019). Beyond LIBOR: a primer on the new reference rates. BIS Quarterly Review, March 2019.
- SOFR: A year in Review. Federal Reserve Bank of New York. April 2019.
- SOFR, So Good: An Update on the Transition from LIBOR to SOFR. Wells Fargo Rates Symposium, February 2019.
- Time to Switch Rates: LIBOR Transition. Oliver Wyman, June 2019 Edition.
- For information on selected consultations and working groups see: US ARRC (www.newyorkfed.org/arrc), UK www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-LIBOR and Europe (www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html).