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INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

The London Inter-Bank Offered Rate (LIBOR) is being reformed.

What do investors need to know?

(Version 1)

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DISCLAIMER

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What do investors need to know?

LIBOR is the benchmark interest rate measuring the average rate at which banks are willing to borrow wholesale unsecured funds. It is calculated based on submissions from a selected panel of banks and is published in 5 currencies across 7 tenors from overnight to 12 months. Although timings vary somewhat by currency, it is expected that LIBOR will be phased out by 2021.

Benchmarks play a crucial role in the global financial system; more reliable, unbiased indices will benefit investors, issuers and regulators.

Why is LIBOR being phased out?

Over the past few years LIBOR has faced well-publicised challenges. The credibility of LIBOR was eroded after evidence of manipulation was identified in an international investigation in 2012, leading the UK Financial Conduct Authority to call for its eventual phasing out. Financial authorities around the world have sought to identify new, transparent and more robust benchmarks.

The search for a LIBOR replacement

Regulatory working groups across the globe have been tasked with trying to develop alternative risk-free rates (RFRs) to replace LIBOR. The aim is to base the new benchmarks on transactional data which measures overnight interest rates, thus eliminating the subjective nature and illiquidity of LIBOR, as well as the term credit component. Hence the use of the term 'risk-free rates' (RFRs) to describe the new benchmarks. Whereas LIBOR is a forward-looking rate quoted for a specified period, the new RFRs are backward-looking overnight rates, with the rate quoted after the expiration of the period to which it relates.

Conventions on how to compound rates over a given period have yet to be standardised and are still a matter for consultation.

US Dollar

The Board of Governors of the Federal Reserve (Fed) and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (ARRC) in 2014. The committee considered several alternatives, including repurchase agreement (repo) rates. After three years of careful study, the ARRC identified SOFR as its preferred alternative to USD LIBOR and established 2021 as the target date for USD LIBOR's phase-out. SOFR is the Secured Overnight Financing Rate drawn from actual transactions that have taken place in the overnight treasury repurchase (repo) market. These include broad general collateral rates and repo rates cleared by the Fixed Income Clearing Corporation (FICC). In April 2018, the Federal Reserve Bank of New York began daily publication of SOFR.

Sterling

Following the Financial Stability Board's recommendation, the Bank of England set up a working group on Sterling Risk-Free Reference Rates in 2015. In April 2017, the Bank of England's Working Group recommended the Sterling Over Night Index Average (SONIA) benchmark as their preferred risk-free reference rate. SONIA was originally established in 1997 by the Wholesale Markets Broker's

Association (WMBA), calculated using the weighted average of unsecured overnight sterling transactions brokered by WMBA members. In April 2018, the Bank of England took over the calculation and publication of SONIA rates. The Bank of England now incorporates all reported unsecured transactions over £25m and uses a volume-weighted trimmed mean method for calculating the rate. SONIA is published at 9am on the business day following that to which the rates relate. The target is to cease issuance of sterling LIBOR-based cash products maturing beyond 2021 by the end of Q3 2020.

Euro

The ECB's Governing Council created a working group in Feb 2018 to develop a euro short-term rate to replace the previous overnight index EONIA and EURIBOR. In September 2018, the ECB's working group recommended the Euro Short Term Rate (€STR, or ESTR) as the new euro risk-free rate. €STR reflects the wholesale euro unsecured overnight borrowing costs of euro area banks and has been produced by the ECB from 2 October 2019. It is based on the trading activity of the previous day from unsecured overnight bank lending and borrowing, using a volume-weighted trimmed mean.

Why is the transition important to investors?

The transition to new RFRs will affect all contracts that currently reference LIBOR, including corporate loans, floating rate notes, floating rate mortgages and securitised bonds. With the publication of replacement rates already live, investors can plan for transition now.

Looking ahead – impact on Money Market Funds

Due to the maximum allowable maturity of 397 days for instruments purchased within short-term MMFs, securities currently being held in portfolios will have matured or could be sold before LIBOR is phased out. However, as the date draws closer, investors should stay engaged with their fund providers to understand the levels of securities still referring LIBOR rates.

Some funds reference LIBOR as a benchmark, and documentation will therefore need to be updated to reference the new rates, in addition to industry-agreed fallback language for securities that reference LIBOR.

Trading platforms and systems used by fund providers will have to be updated to accommodate the new RFRs, in line with the market. The volume of transactions and issuance with the new RFRs is expected to gain momentum in 2020.

With markets across the globe already starting to adopt the alternative reference rates, the impact to IMMFA MMFs come 2021 should be minimal. Fund providers will be able to provide further detail on their individual timelines and action plans.