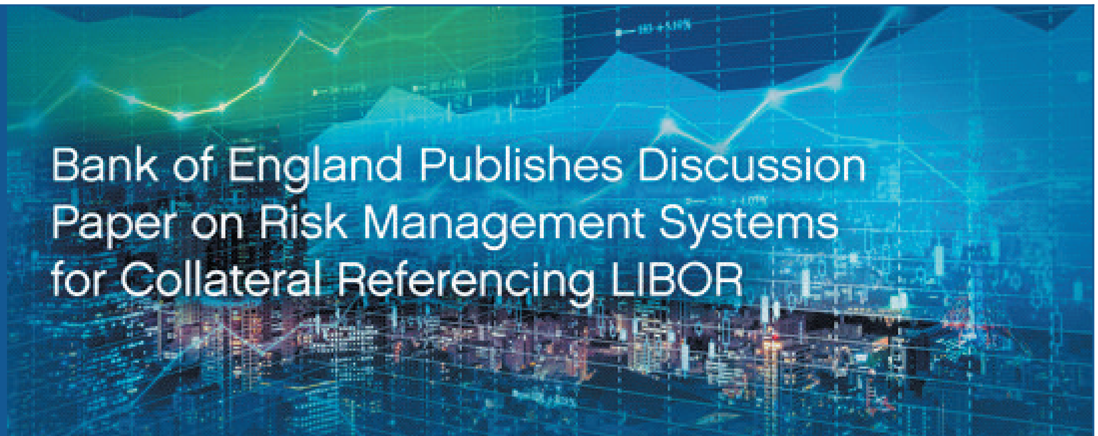
JONES DAY

COMMENTARY

JULY 2019



Bank of England Publishes Discussion Paper on Risk Management Systems for Collateral Referencing LIBOR

IN SHORT

The Situation: The LIBOR manipulation scandal and vanishing liquidity in the London interbank market for time deposits led the Financial Conduct Authority ("FCA") to announce that at the end of 2021, banks would no longer be required or compelled to submit for a daily fixing of LIBOR. Market participants have started transitioning to the use of more secure benchmarks, for example, the Sterling Overnight Index Average ("SONIA").

The Action: The Bank of England ("BoE") has initiated a review of its own exposures to LIBOR transition, with one key area being the collateral that banks and other financial firms are required to provide when borrowing from the BoE under the Sterling Monetary Framework ("SMF"). Issues arise when the collateral that is being offered by the borrower references GBP LIBOR and other indices at significant risk of termination at year-end 2021 (or otherwise). In fact, roughly a tenth of the banks' SMF drawing capacity is collateralized by assets referencing GBP LIBOR. This has prompted the BoE to pose different options for managing this risk leading up to and into the post-LIBOR era which are discussed in its June discussion paper.

Looking Ahead: The BoE requests that views be submitted to the discussion paper by September 27. It intends that the implementation of any risk management approach should be structured and introduced in a clear manner, with the objective of maintaining the strongest possible level of lending capacity in the SMF.

LIBOR transition is imminent, and firms must take the necessary precautions to adapt to the use of new interest rate benchmarks. Already, SONIA swaps rival GBP LIBOR swaps and referencing SONIA in newly issued bonds has now become routine. These new interest rate benchmarks and the SMF promote the BoE's mission of financial stability. In particular, the SMF provides liquidity insurance for banks and certain other financial firms during periods of market-wide stress. This function also exposes the BoE to certain risks, which it manages through the specifications and valuation of eligible collateral. As the BoE only lends against collateral of sufficient quantity and quality, firms will have to ensure that they adjust their collateral referencing LIBOR to maintain borrowing capacity at the BoE.

Implications of LIBOR Transition on New and Existing Collateral

Due to the interdependencies of the BoE's lending against collateral referencing LIBOR, the following steps should be taken to minimize negative effects of the LIBOR transition:

- First, firms should make sure that their newly issued GBP collateral references alternative risk free rates.
- Second, firms should re-reference LIBOR-linked collateral that matures beyond 2021. The Bank has already made certain collateral that references new risk-free rates eligible for use in the SMF.
- Third, LIBOR-linked collateral should include adequate fallback language indicating an alternative rate in case LIBOR ceases to exist.

> Roughly a tenth of the banks' SMF drawing capacity is collateralized by assets referencing sterling LIBOR.

The BoE has two underlying collateral policies: (i) it only accepts collateral that it judges can be valued and effectively risk managed; and (ii) it mitigates loss by applying a "haircut" so that it lends an amount less than the market value of the collateral that it takes. The LIBOR transition thus poses the following risks on these two principles:

- LIBOR linked collateral increasingly raises complex valuation and risk management issues. Although it has not yet been articulated by the BoE, we suspect the BoE is potentially considering such factors as the prospective inability to value LIBOR coupons into the future when LIBOR may not exist after 2021, the number of potential fallback rates for each of the multiple currencies, and the lack of historical data to support valuation and risk management for a majority of these coupons.

- Regarding **long dated securities** where the interest rate is calculated with reference to LIBOR, the liquidity of LIBOR-linked assets may deteriorate or be absent if there is uncertainty in the documentation of fallback language.

- Regarding **untraded or rarely traded collateral**, the valuation risks outlined could be made significantly worse due to the lack of transparency on the market price.

- Liquidity could also be impacted for any amendments to the terms and conditions of collateral while decisions are pending in response to the discontinuation of LIBOR.

- Regarding **asset-backed securities and covered bonds**, securities and bonds with embedded swap payments calculated by referencing LIBOR pose a risk as the fallbacks for swaps and bonds may operate at different times, resulting in payment disruptions.

- Regarding **unsecuritized "raw loans"** or securities backed by loans with interest rates determined by LIBOR, the risk posed here is that the terms and conditions of the loan may not allow for LIBOR replacement.

Proposed Risk Management Approaches

In response to these risks, the BoE has proposed three different options for minimizing the risk. In making eligibility decisions on collateral, it will consider whether widely-adopted standards to minimize risks have been incorporated.

Option A: The BoE would announce during the transition period that all collateral referencing LIBOR that matures beyond end-2021 would become ineligible, *regardless of the issue/origination date*, unless mitigated by adequate market solutions, such as fallback language, that sufficiently mitigates the risks to the BoE's balance sheet.

Option B: The BoE makes ineligible all collateral issued/originated *after a certain date* that references LIBOR and matures beyond end-2021, unless it incorporates adequate market solutions.

Option C: The BoE does not make collateral ineligible, but instead applies an additional "haircut" that increases over time to all collateral that references LIBOR and matures beyond 2021.

The discussion paper invites interested parties to weigh in on the positives/negatives of each of the options, the impacts on SMF participants, and how implementation of one of these options would look in practice. It recognizes there may be other alternatives that become clearer at a later stage in this comment period.

Conclusion

It is imperative that the BoE is able to value and risk manage any collateral taken in case it needs to access that collateral in a default. The significant amount of SMF borrowing capacity that is dependent on LIBOR-related collateral raises serious concerns about its ability to accomplish this objective. Therefore, companies and their boards should use these remaining 30 months to ensure that they have adjusted their businesses from LIBOR to SONIA and to minimize the risk posed by securities and loans maturing after end-2021. The BoE's proposed options could have significant consequences if the LIBOR-related collateral is not adjusted for this transition. Finally, taking the BoE's suggest approaches one step further ahead, financial institutions will need to consider whether LIBOR-related assets qualify as (highly) liquid assets for purposes of the Liquidity Coverage Ratio, or LCR.

THREE KEY TAKEAWAYS

1. The BoE is proposing three different options for mitigating their collateral risk, which may include the ineligibility of any collateral referencing LIBOR.

2. Firms can choose to re-reference LIBOR-linked collateral to SONIA, either by amending its terms or issuing new instruments. An alternative could be ensuring that LIBOR-linked collateral includes adequate fallback language specifying an alternative rate in the event that LIBOR ceases to exist.

3. The BoE's key message is that firms stop writing new LIBOR-related business that fixes or matures past 2021.


Polly O'Brien
London

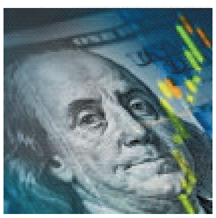

Michael R. Fischer
Frankfurt

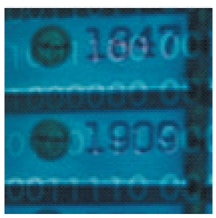

Ulf Kreppel
Frankfurt

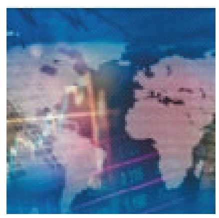

Locke R. McMurray
New York

All Contacts >>>

YOU MIGHT BE INTERESTED IN: **Go To All Recommendations >>**


ARRC Publishes Final LIBOR Transition Recommendations for Securitizations and Bilateral Business Loans


Germany to Implement EU Anti-Money Laundering Directive with Cryptocurrency Licensing Requirements


ISDA Forges Ahead With Market Consultations on Critical IBOR Transition Issues

SUBSCRIBE   SUBSCRIBE TO RSS