USD Libor survey, part IV: ARRC and Fed's Libor transition management deemed 'disruptive' by market

Published 22 Dec 2021 **Last Updated** 22 Dec 2021 23:46

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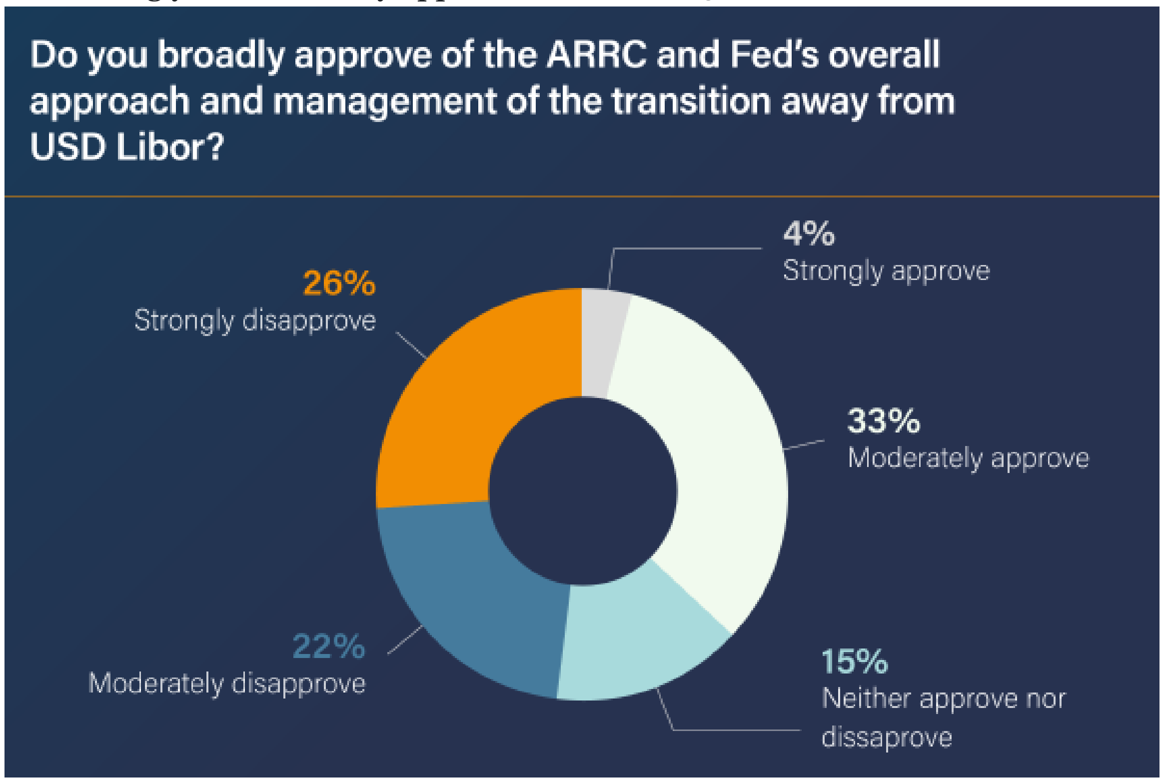
This is part 4 of a 4 part survey, you can read the previous sections here.

The Alternative Reference Rates Committee's (ARRC) and Federal Reserve's (Fed) handling of the USD Libor transition has caused significant discontent among US market participants, results from our *IFLR* survey have revealed.

Nearly 50% of respondents either strongly or moderately disapproved of the authorities' overall approach and management of the transition, compared to 37% who strongly or moderately approved. A further 15% were neutral.



"There's some discontent in the market with the public sector's heavy-handed approach in what was supposed to be a market-led transition," said Alexandre Bon, group co-head of ibor and interest rate benchmark reform at Murex. "An institution like the ARRC should represent the entire market, yet, some view it as an echo chamber for the Fed and Libor panel banks, with an interest in getting rid and getting out of the Libor publishing mess as soon as possible – albeit with some concessions along the way, such as a late U-turn on term SOFR."

A key criticism towards the authorities has been their inability to appreciate the benefits of Libor's inherent term structure and credit sensitivity – both of which are essential features that allow financial institutions to efficiently manage their cost of funds and lower all-in costs for borrowers, explained Michael Koegler, managing principal and co-founder at Market Alpha Advisors.

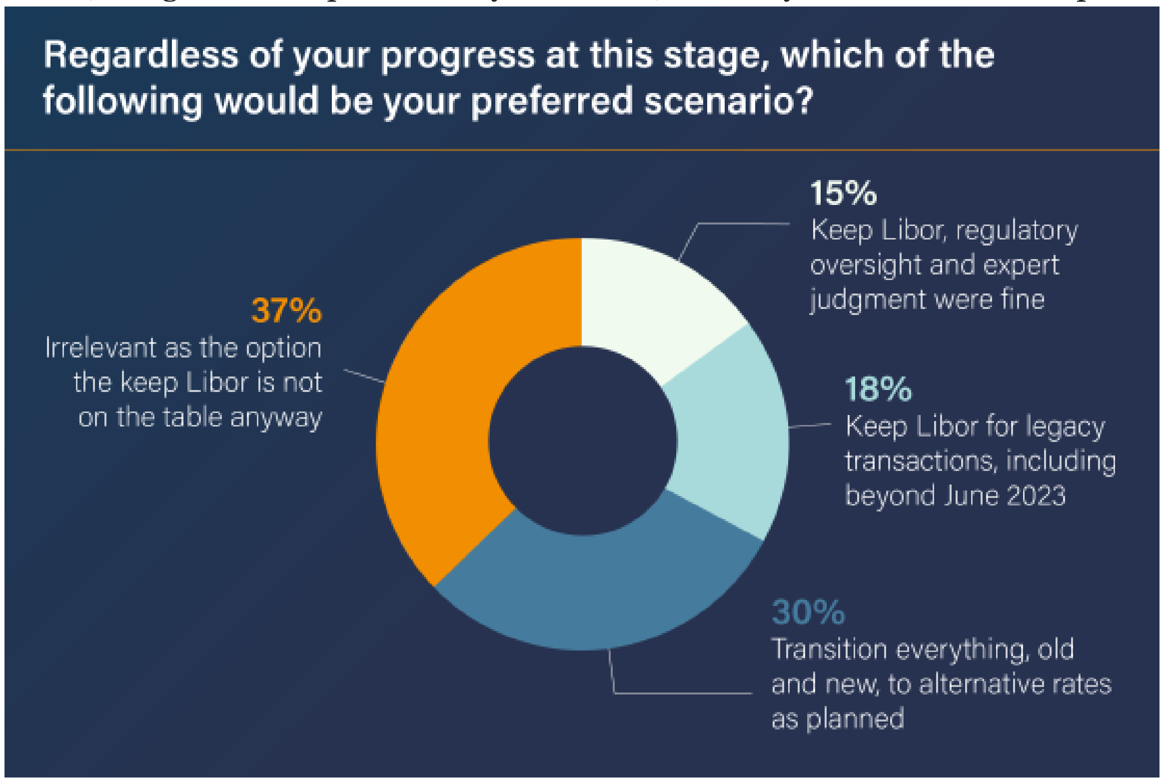
"Some of the decision-makers on the ARRC either misunderstood or chose to ignore the difficulties that market participants would have in implementing SOFR for all use cases, and focused only on one aspect, which was the trading volume in overnight SOFR," he said. "Instead of forcing the widescale use of a benchmark that would undoubtedly create inefficiencies, they should have reformed Libor. At this point it is too late for that, but they can stop trying to force SOFR First on everyone and being so critical of credit-sensitive rates (CSRs)."

This top-down approach was also criticised by other sources. "The senior people tell the junior ones what to do and nobody talks back," said a senior director at a bond rating agency. "The Fed is manipulating SOFR so it's been flatlining since March 2021."

"They totally missed it, but that ship has sailed," they added. "We are done looking at the wreckage of this because there's no hope, no banks will go ahead and toy with the Fed and their bank examiners."

The source also argued that the choice of SOFR as prime replacement for USD Libor may have served the interests of the few, rather than the many. "SOFR was a dream come true for large banks," the source added. "It's perfect for the derivatives market – that's what it was always designed for. Lending was a secondary idea, it was designed with futures, trading and the swaps market in mind. People who lend on OiS [overnight interest swaps] know all about this, but what about funds transfer pricing and loans?"

With some nostalgics still thinking that keeping Libor would have been a better option – 15% of respondents to our survey said so – the jury is still out on whether SOFR, designated and promoted by the ARRC, was truly the best available option.



"Almost no one in the marketplace actually wanted to make this change: the construction of Libor broke in a way, but the right answer was fundamentally to keep the rate and rebuild it," said Adam Schneider, partner at Oliver Wyman. "When SOFR was invented we had a wonderful, global, verbose and enormously transacting financial system that didn't need this rate. It was invented for strength of construction, not for use – and not in lending. We've been fighting with how to adapt it to $10 trillion of US lending tied to Libor ever since."

See also: ***US market stands ready for no new Libor***

Line of defence

Speaking during a private press conference last week, Tom Wipf, ARRC chair and vice chairman of institutional securities at Morgan Stanley, defended the committee's track record and decision-making.

“Given the complexity of this transition, trying to deconstruct a rate like Libor that is so widely used from consumer products all the way to the most sophisticated derivatives has, at times, been challenging,” he told *IFLR* during the session. “Some things are also quite market-dependent. Nevertheless, when I look across the composition of the ARRC and the diversity of the membership, we’ve really worked hard to ensure that all voices were heard.”

In a separate address during a Libor telethon, Wipf also said: “We had worked under the assumption that people would see that SOFR was obviously the best choice from a transparency perspective to avoid repeating mistakes of the past. We felt it also served to get the derivatives market focused on this, which opened the door to the CFTC's Market Risk Advisory Committee’s SOFR First recommendation.”

The SOFR First initiative, Wipf added, gave the ARRC enough confidence to recommend a term SOFR rate, as the volumes had followed. “When it was all over and the dust settled, sequencing might not have been perfect, but we actually got the attention of the derivatives market,” he said. “We got people moving to SOFR and were able to endorse term SOFR. In the end, it [SOFR First] got us there, but I wouldn't say it was the smoothest road.”

Some market participants also expressed more lenient views on the US authorities’ handling of the transition, mainly emphasising the situation they were dealt with compared to other jurisdictions, such as the UK.

“It has always been difficult, because the ARRC and Fed have a very limited toolkit at their disposal and have insisted on a market-based solution that is the product of that toolkit,” said Anne Beaumont, partner at Friedman Kaplan Seiler & Adelman. “The FCA [Financial Conduct Authority] has a different set of tools, and much more in the way of big sticks. It can back up its implicit threats with real, binding prohibitions, whereas US regulators are not in a position to say it is illegal to enter into a Libor-based contract, which means they end up sounding less definitive than the UK regulators.”

This, Beaumont continued, is an artifact of the two different regulatory and governmental systems that exist in the UK and the US. “It does make one wonder what tools they wish they’d had to make things happen differently, and what they would have done differently,” she added.

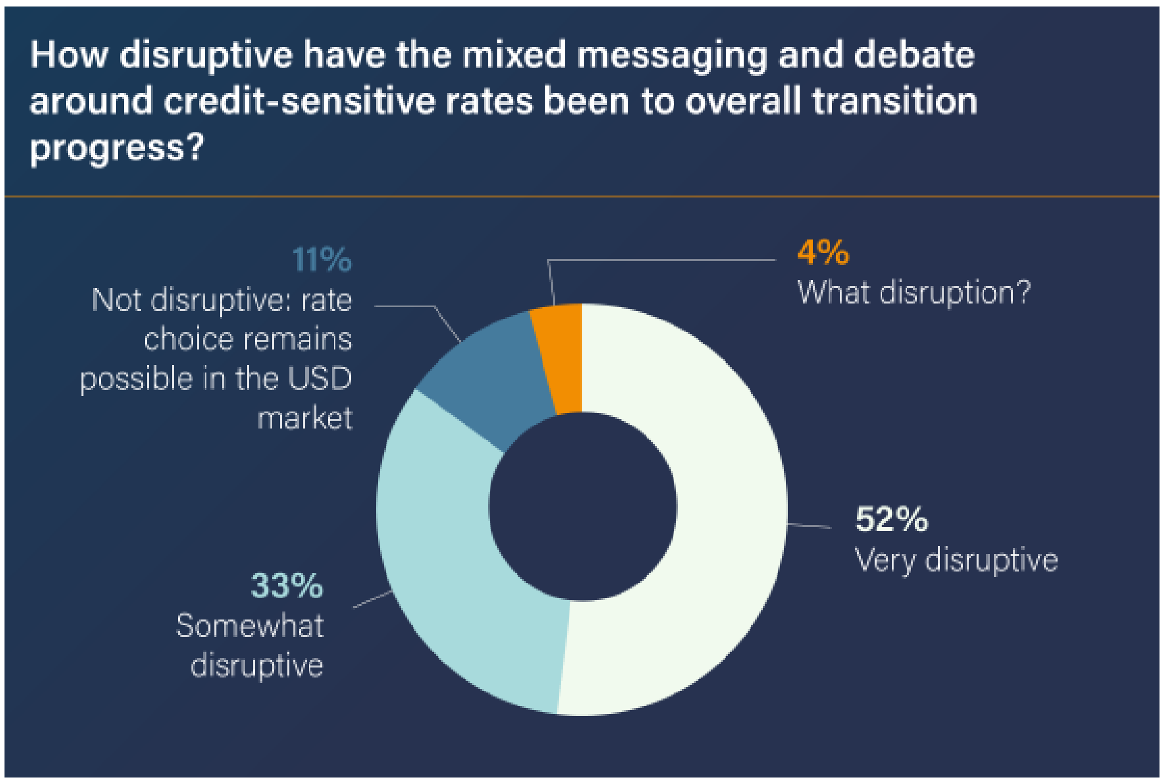
The very nature of the US financial market system also means there is a degree of latency and compromise between federal and state levels, according to TCS consulting partner and manging director Navin Rauniar. “In the UK, there was no split between the Bank of England, the FCA and the Prudential Regulation Authority – everything was in sync,” he said.

“The ARRC and Fed have generally done a very good job at attempting to communicate what is a huge change to the marketplace,” said Robert Mackenzie Smith, senior research analyst at Bloomberg Intelligence. “They were stuck between a rock and a hard place in that they needed for swaps liquidity to pick up in order to recommend a term rate. I wouldn't say the ARRC failed in terms of making SOFR the rate of choice or the dominant rate, but I don't think the scale of demand there was for term SOFR earlier this year was anticiapted. That was obviously corrected, and now we are where we are.”

Knock-on effects

An area that has focused much of the US market’s discontent around the transition is the debate around alternative rates for USD Libor other than SOFR.

As such, 52% of our survey respondents said they found the mixed messaging around CSRs very disruptive for overall transition progress, and another 33% somewhat disruptive. Only 15% said it had caused no disruption at all.

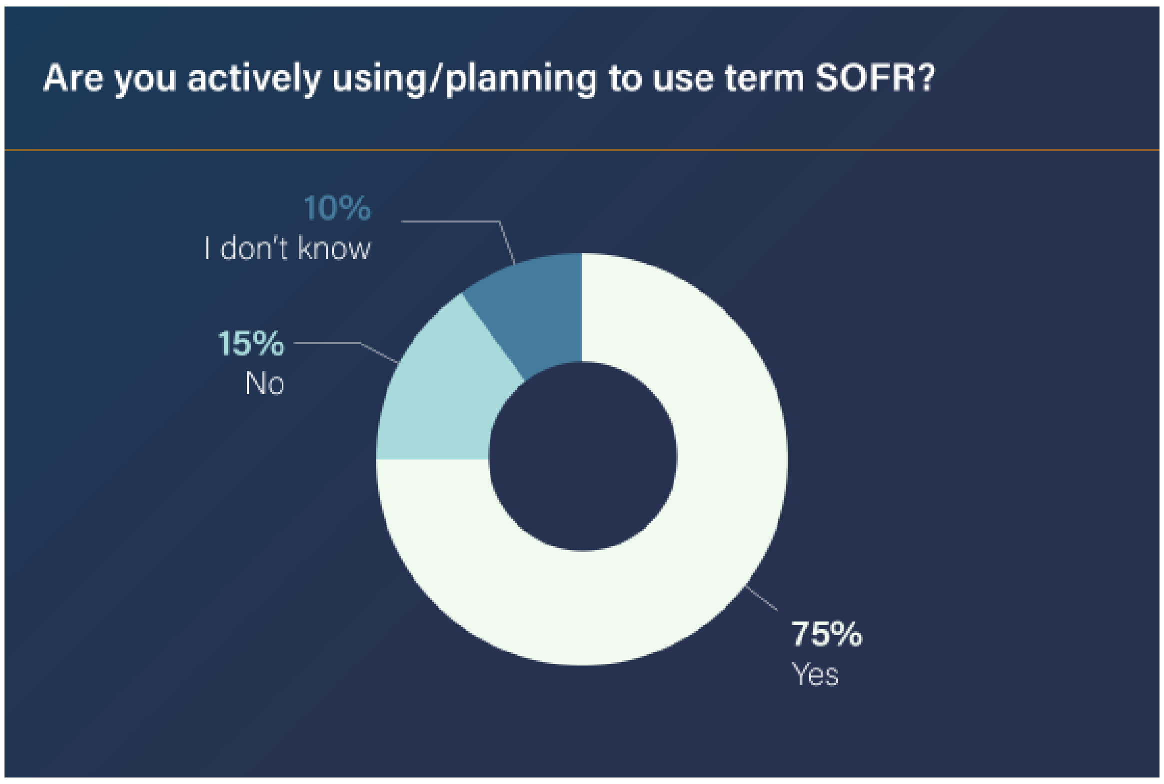


"It seems clear that the ARRC underappreciated the portion of the market that would need CSRs," said Ed Ivey, counsel at Moore & Van Allen. "They went down the route of seemingly bashing them, which resulted in clients fearing they would be using a rate that would not be approved. This could have been handled in a better way, but it wasn't, and here we are."

See also: Federal legacy law 'essential', says market

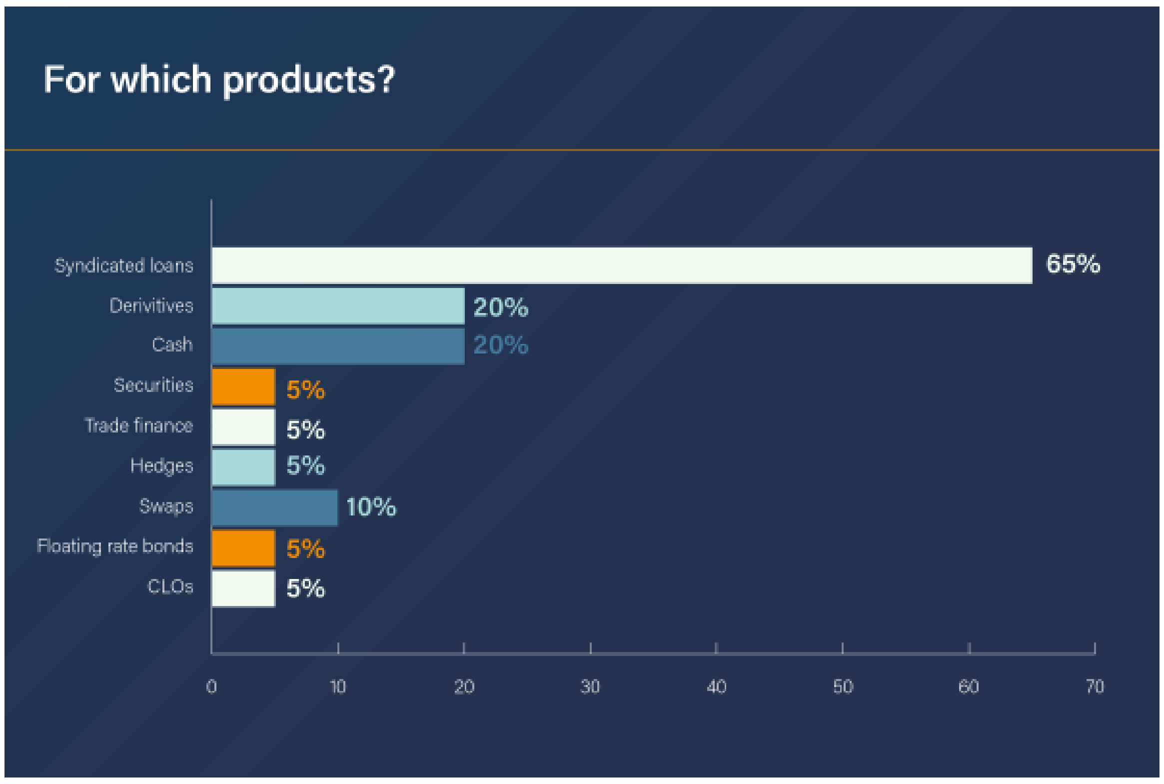
According to Ivey, the authorities underestimated how much demand there would be for CSRs, and how little there would be for daily compounded SOFR instead. "Daily simple [SOFR] might pick up because people appreciate that it should be a lower interest rate overall, but in the summertime, no one wanted it," he added. "The main disruption I anticipate from all this is that, as term SOFR was only given the green light late in the year, banks may struggle to roll out the full suite of new products for year-end."

For Beaumont, the discussion around replacement rates all comes down to expectation-management. "People want things that feel familiar," she said. "They were told term SOFR was going to come, and then they were told it wasn't, which is frustrating. To an extent, they're still getting mixed messages on that."



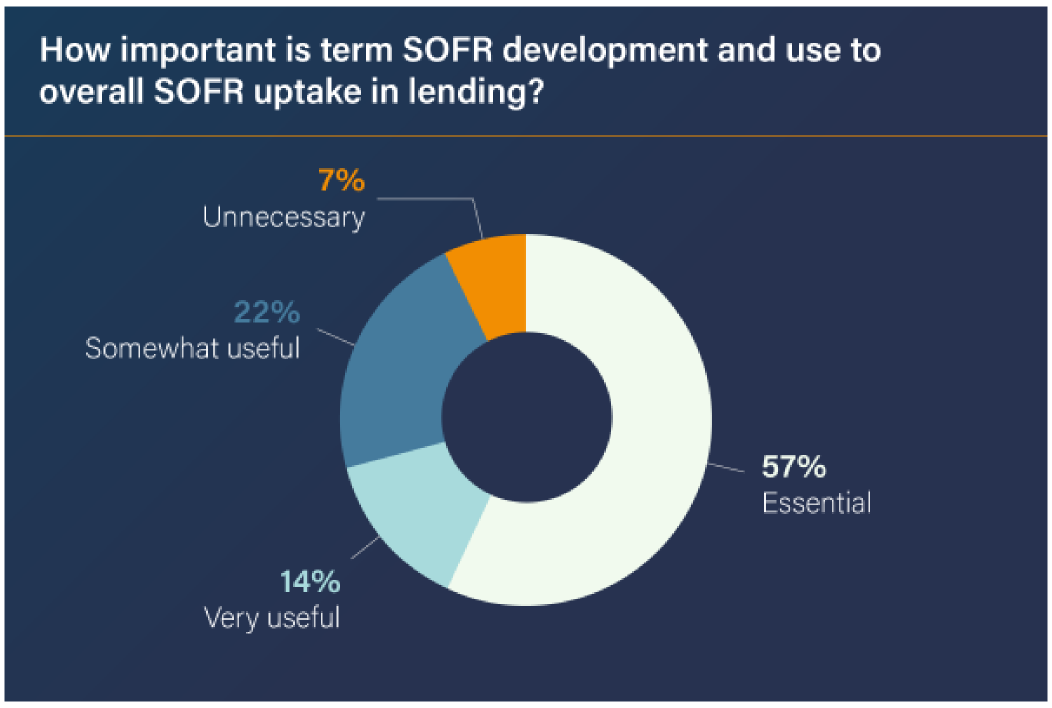
In our survey, 75% of respondents said they were planning to actively use term SOFR, mainly for syndicated loans (65%). Over 70% of participants also deemed the development of a term rate to be either essential or very useful to overall SOFR uptake in lending.

"We see extraordinary interest in using [term SOFR], with the sole question being how to hedge it as there is no hedge market there yet," said Schneider. "The ARRC had a lot of stop and goes relative to getting term SOFR out and recommended for various products. In hindsight, had it started working more broadly on what the future of lending was, it could have gotten a quorum to that effect, which would have been an extraordinary advantage over where we are now."



Recent data from CME Group, which administrates term SOFR, also showed high demand for the rate, with over 1,400 term SOFR licenses issued to 330 firms to date.

"The regulators have been forcefully promoting plain SOFR over other viable options – largely out of ideological reasons," said Bon. "Yet, most would prefer a multi-rate environment. SOFR-sceptics would also point out that the benchmark is a much more effective means for the Fed to transmit monetary policy, but this is really not what this transition was supposed to be about."



For George Bollenbacher, independent consultant and former head of fixed income at Tabb Group, confusion among market participants continues to "reign supreme", and many will likely spend the next year and a half disentangling the mixed messaging that has arisen from the authorities' communication.

"As we approach the end of the year, there are really two areas of concern: the first area has to do with moving new products and instruments to a replacement rate – that's where a lot of the flaws, particularly in SOFR, start to be apparent," he said. "And second, the necessity to fall back. If we look at the swaps market, which is a pretty good indicator of where we're at, more than a trillion dollars a week of new Libor swaps are still issued. This will inevitably continue to make the fallback problem even worse."

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See also: Ameribor dominates CSR landscape, survey reveals