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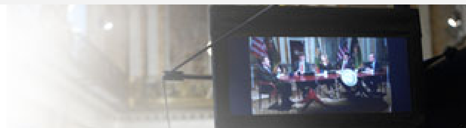

Remarks by Acting Assistant Secretary for Financial Markets Daleep Singh on Interest Rate Benchmark Reform at FIA's 32nd Annual Futures & Options Expo

10/20/2016

CHICAGO – Thank you for having me here today. I am very pleased to have this opportunity to discuss interest rate benchmark reform, a topic that deserves attention from market participants, policymakers, and the general public. As you all know, financial benchmarks in general – and interest rate benchmarks in particular – perform a critical function in financial markets, with real consequences for the U.S. and global economy.

LIBOR has been the dominant measure of how much it costs large banks to borrow from each other on an unsecured basis for a long time and continues to play an outsized role in our financial system. Interest payments on an estimated $350 trillion in notional value of derivatives contracts, and at least $10 trillion in loans, move up and down with LIBOR. Retail borrowers use LIBOR to evaluate the price of loans. Corporations and investors use LIBOR to hedge interest rate risks in their businesses and portfolios. Market participants rely on LIBOR as a gauge of stress in the banking sector and confidence in the financial system more broadly. Given the breadth and scale of LIBOR's usage, its integrity and reliability is essential for all of us.

In this context, today I would like to discuss the imperative of strengthening the foundations of LIBOR, while at the same time working collectively to develop more robust and credible alternatives. Many of you know that the Alternative Reference Rate Committee, led by Governor Powell at the Federal Reserve, is working on alternative reference rates and transition plans. However, for the process to be successful, we need you, the users of LIBOR, to engage on the selection of and transition towards an alternate rate. Any transition away from a dominant benchmark will surely be complex and lengthy, but the more we act collectively, the more orderly and less costly the transition will be.

Stepping back, let's review the shortcomings of LIBOR that prompted this effort. First, during the financial crisis, LIBOR was manipulated by banks attempting to conceal funding trouble. Some banks kept LIBOR submissions artificially low, despite evidence of increasing credit risk and higher cost of funding in CDS and short term funding markets. Second, some banks appeared to make their LIBOR submissions with financial considerations in mind, submitting rates that would result in greater payments to them from derivatives counterparties. The large size of LIBOR derivatives markets relative to the underlying market in short-term unsecured bank borrowing made the situation all the more ripe for malfeasance. Lastly, the LIBOR methodology at the time, including public disclosure of the cutoff for the daily trimmed mean calculation, meant that even a single panelist could potentially alter the LIBOR rate.

In response to these and other vulnerabilities, the international regulatory community has taken significant action. In 2012, the Wheatley review made several important recommendations: oversight of LIBOR by an independent organization, transaction-based submissions by LIBOR panelists, and the embargo of panelist submissions for three months to reduce the risk that the submissions would be used to judge a bank's creditworthiness.

Since 2013, FSOC Annual Reports have repeatedly noted the financial stability risks presented by continued reliance on LIBOR and called for similar reform efforts. In 2013, IOSCO developed principles for financial benchmarks, highlighting the importance of interest rate benchmarks "anchored by observable transactions." In 2014, an FSB report called for strengthening existing benchmarks while beginning to develop alternative reference rates. And later that year, the Fed convened the Alternative Reference Rate Committee for this purpose.

ICE Benchmark Administration, the administrator for LIBOR has also undertaken efforts to strengthen LIBOR. These efforts include modifying LIBOR's construction to reduce the likelihood of manipulation and, along with the Financial Conduct Authority, putting in place standards to ensure strong governance practices for LIBOR submissions. In March 2016, IBA published a roadmap of further measures, including a waterfall process for banks to follow in making their submission, to ensure that LIBOR is grounded in observable transactions to the greatest extent possible. Treasury supports these efforts and encourages IBA to continue implementing the proposals detailed in the roadmap.

While these measures to strengthen LIBOR are constructive, potential risks to the long-term viability of LIBOR remain. Most importantly, banks are no longer relying on short-term unsecured funding to the degree that they did pre-crisis. Make no mistake – this is a positive development, reflecting an improvement in banks' liquidity profiles and funding resilience. But it also means that the base of underlying transactions for LIBOR is decreasing and unlikely to return to pre-crisis levels.

Without as many underlying transactions on which to base their responses to the daily LIBOR survey, banks may become more reliant on "expert judgment" for this purpose. Even today, only about 30 percent of submissions for USD 3 month LIBOR are directly based on transactions, with the remainder relying on a bank's interpolation of market data or judgment. Though LIBOR is now better supervised and governed by a rules based process, submissions based on expert judgment may be more vulnerable to the problems we confronted in the past.

Even absent the decline in underlying transactions, a transition away from LIBOR would still be in the self-interest of market participants. LIBOR's widespread use is more historical accident, reinforced by liquidity-driven network effects, than the result of a considered process. Recall that LIBOR was introduced by the British Bankers Association in 1986 merely to standardize the interest rates banks charged each other on loans. It was not contemplated as the world's dominant interest rate benchmark.

If you are a user of LIBOR, and I'm sure nearly all of you are, I ask you to think about whether it's really the best choice for your purposes. If you are borrowing money in an adjustable rate loan, does it make sense to you that your interest rate will go up if the market starts to view a handful of banks as

less creditworthy on average? Gloomier yet, are you prepared for your rate to *increase* in an environment of broadly elevated stress? Even if Treasury and monetary policy rates are declining, LIBOR, given its link to bank credit, could be headed in the other direction.

The same issue arises for corporates. As a corporate treasurer that swaps fixed rate borrowings into floating payments, are you prepared for those floating rate payments to go up, not because markets have reappraised your creditworthiness, but because the market has begun to view certain banks as less creditworthy?

If you are a pension fund or insurance company hedging liabilities with interest rate swaps, do you want P&L from changes in the market's perception of bank credit risk? Again, in an episode of stress, most other short term rates will likely be going down, but LIBOR-linked rates may be going up. Is this the hedge you were looking for?

If not LIBOR, then what are the alternatives? The Alternative Reference Rate Committee has evaluated many potential alternatives to LIBOR, and identified two promising candidates: the Overnight Bank Funding Rate (or OBFR) published by the New York Fed, or an overnight Treasury GC repo-based rate. The OBFR is constructed from money market transactions in the Fed Funds and certain Eurodollar markets – it has been published since March 2016, with about 10 years of simulated back history available. Separately, while the Treasury GC repo-based rate is still under development, the large transaction base of the secured funding market is a significant potential benefit. Both of these rates are closer to risk free than LIBOR, which might benefit users of derivatives and loans that seek to reference a standardized and reliable short term interest rate, rather than a measure of credit risk – especially credit risk that is not their own. Both of these alternative rates also have a significantly larger transaction base (each over $200B in transactions) than LIBOR, making them more robust and resistant to manipulation.

For these reasons – the decline in underlying transactions and the poor fit of LIBOR for many of its current uses – we believe a transition to an alternative reference rate, which may involve short-term costs, is clearly in our collective interest for financial institutions, market participants, consumers, policymakers, and the general public.

While this transition will surely be difficult and complex, it is not without precedent. Some transitions have been narrower, such as the introduction of the S&P e-mini futures, the ISDA big bang standardization of credit derivative contracts, or the transition from LIBOR to OIS swaps for discounting cash flows in interest rate derivatives. Others have been economy wide – for example, the introduction of the Euro currency in Europe. Financial markets are always changing, and they show great capacity for adaptation when motivations are strong.

Moreover, history teaches us that acting collectively will reduce transition costs. Collective action will foster liquidity in products linked to the new rate, enable an active market for hedging related risks, and harness network effects to our advantage. Similar efforts toward a transition away from IBORs are currently ongoing in other jurisdictions around the world, and they face many of the same challenges.

I understand the temptation to ignore this issue for the time being and continue with your day-to-day business. While LIBOR risks may not feel urgent now, the best time to transition is *before* any problems with LIBOR reach a critical point. A disorderly transition, especially if it happened during a period of broadly elevated stress, would surely be more costly and disruptive for everyone.

To close, let me reiterate that my most important message today is the need for us to engage together in the process of considering alternatives to LIBOR and designing sensible transition plans. Success or failure of transition away from LIBOR will depend on your actions, both in engagement with the planning as well as the ultimate take-up of new alternative rate products. I encourage you to have frank conversations internally at your firms about your use of LIBOR, the potential risks, and how you might prepare for a transition to alternatives. The ARRC needs your specific feedback on questions posed by its Interim Report and Consultation, which was released earlier this year. A public roundtable was held on these issues in June, and we will continue to seek your perspective as this process continues.

Thank you for your attention.

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