**The reform of the IBOR rates**

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The overhaul or even the abolition of the IBOR stems from a G20 approach, relayed by the Financial Stability Board (FSB) and the FSA (Financial Services Authority) and various market or regulation entities concerned by what can be qualified as an earthquake. Earthquake because the outstanding amount of "Libor" indexed transactions exceeded 2 years of world GDP. Earthquake the epicenter of which was fortunately far from continental Europe, because the European Monetary Union, under the impetus of the European Commission, managed to preserve the Euribor which was declared compliant with the requirements of BMR[[1]](#footnote-1) after it was reformed in depth to include references to real transactions in its calculation

IBOR were supposed to measure cost of borrowings between banks, but the quality of the measure has deteriorated since the Lehmann crisis (2008) for three reasons:

* banks are reluctant to lend to each other for more than one day: they now lend their excess liquidity to central banks and the market operates in a hub-and-spoke mode
* regulators (central banks) have added the liquidity management to the supervision of financial institutions, forcing them to hold considerable amounts of paper
* the IBORs were all established on a declarative basis with a risk of conflict of interest for a bank belonging to a panel with positions on the index it was declaring. This risk has materialized in few occasions, resulting in considerable financial penalties and discouraging other banks from continuing to participate in these panels.

The deterioration in the relevance of the indices has been gradually amplified:

* for the Ibor by the defections of contributors refusing the risk of remaining in a panel
* for overnight rates due to the unprecedented shrinking of the volume of reference transactions.

Under these conditions, regulators and/or central banks have opted for drastic solutions:

* we are now only based on real transactions (secured or not) considered risk-free (Risk Free Rate)
* by retaining in the panels and calculation basis a scope of transactions extended to money market financial agents who do not necessarily have a banking license.

The overnight rates (Eonia, Fed Funds, Sonia...) have been reformed or even replaced in €STR for THE EUR and SOFR for the USD.  One of the disadvantages is that these rates are published the day after the reference day. As far as period rates are concerned, international IBOR have disappeared, but some domestic rates have been reformed and preserved, notably Euribor.

To the question of what was the cost of borrowing (or refinancing) over a given period (e.g., 3 months), we had so far three answers:

* the Ibor index known at the beginning of the period
* the average of the overnight rates, known at the end of the period (example SOFR 3M)
* the expectation of this average being quoted on the short swap market, known at the beginning of the period (Example Term SOFR 3M)

For currencies whose IBOR has disappeared, solutions 2 and 3 remain. Regulators prefer solution N2, but it has the disadvantage for operators of being known only a posteriori, which is not compatible with computer processing chains floating rate retail or wholesale assets or liabilities. The markets are therefore moving towards overnight rates (or their compound averages over the period) for derivatives, especially futures, and, for cash, towards short dated swap fixings (actually Contant Maturity Swaps).

As regards overnight rates averages, one might think that we have recreated a short-term curve, but this is not the case: we have only one rate each day , which is the one of the day before, and this rate cannot be very different from the rate at which the central bank takes back liquidity (the low milestone). The clearance of the indices has therefore been done at the cost of a radical impoverishment: we still have an indication of the slope of the curve with short dated swaps, but we have lost all information regarding liquidity.

No one can any longer conclude a new LIBOR indexed contract, but we must manage the old contracts whose indexation has not been amended. This is why "Fall-Back" indices are published, known at the end of the period, and equal to the average of the overnight rates over the past period plus a "spread adjustment". The spread adjustments are calculated so that that the average of the IBOR equals the average of their fall-back over a period of 5 years preceding March 5, 2021, date of the decision to stop the publication IBOR. IBOR-indexed derivatives (swaps and futures) treat exactly as their replacements plus the spread adjustment: there is therefore no value in amending existing operations. This is not true for the USD where the Libor still has 18 months of autonomy as compared to its fall back: the convergence between Libor operations and new operations with spread adjustment limited to transactions with a forward start beyond June 30, 2023.

Practically, thebuilding of yield curves must be based on new data (short swaps, future o/n rates, swaps vs o/n). The management of fixing is modified in that it occurs at the end of the period, and with a play on the dates, as otherwise the last element of the average would be known two days after the deadline for calculating flows. The operations involved are quite heavy, but it is an obligation for everyone to manage the "legacy" by making an inventory of all the operations concerned.

1. Benchmarks Regulation Regulation (EU) 2016/1011 [↑](#footnote-ref-1)