John C Williams: 901 days

Remarks by Mr John C Williams, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Securities Industry and Financial Markets Association (SIFMA), New York City, 15 July 2019.

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As prepared for delivery

Thank you for the kind introduction and the opportunity to speak this morning. It's a particular pleasure to be sharing the stage with Andrew Bailey, who has played such an important role in leading efforts on establishing robust references rates to replace the London Interbank Offered Rate (LIBOR). This critical undertaking traverses markets and transcends jurisdictions, making international cooperation and coordination essential for success.

Before I go any further, I need to give the standard Fed disclaimer that the views I express today are mine alone and do not necessarily reflect those of the Federal Open Market Committee or others in the Federal Reserve System.

Where Have We Come From?

Today I'm going to talk about the progress we've made, and the path that lies ahead. But first, given that 12 years have passed since LIBOR first became an acute area of concern, it's important to remember why replacing it is so critical.

LIBOR is based on submissions from individual banks. The volume of actual transactions that term LIBOR is based on is very small—totaling around $500 million on a typical day. To most people, $500 million may sound like a lot, but given that $200 trillion of financial contracts reference U.S. dollar LIBOR, it's really a drop in the ocean.[1]

As a result, submissions are largely based on judgment, as opposed to real numbers. When the LIBOR scandal erupted, it became clear that there had been fraud and collusion, both within and across financial services firms, in the pursuit of profit.

The reliance on expert judgment, rather than actual data, makes the rate too vulnerable to manipulation. It's readily apparent to all those in the industry—both firms and regulators—that LIBOR is fundamentally broken.

Consequently, banks are increasingly reluctant to provide LIBOR submissions, adding to the level of risk around using the rate. The U.K. Financial Conduct Authority (FCA) has reached an agreement with banks to keep submitting rates through the end of 2021, but in 2022 the existence of LIBOR will no longer be guaranteed. In other words, LIBOR's survival is assured for only another 901 days.

Those in the market know the full scale of the risks this creates for the financial system. LIBOR isn't just the rate that banks use to borrow from one another—it's also the underlying rate on numerous derivatives and loan contracts. The $200 trillion figure I mentioned earlier is the approximate total exposure to U.S. dollar LIBOR. That's about 10 times U.S. gross domestic product.

None of what I am telling you is new, but it's worth reminding ourselves just how significant reference rates are to the functioning of financial markets, both in the United States and around the world. There's broad recognition that exposure to LIBOR is a leading risk to financial stability.[2] We need to treat it as such.

Progress Has Been Made

And, to date, significant progress *has* been made, moving us toward a safe and sound reference rates regime. What's more, there's been notable momentum in recent weeks.

But first, let's take a look back at some of the more significant accomplishments.

Back in 2014, the New York Fed and the Board of Governors convened the Alternative Reference Rates Committee (ARRC), which is made up of market participants. In an important milestone, the ARRC selected the Secured Overnight Financing Rate (SOFR) as its preferred alternative to U.S. dollar LIBOR in 2017.

Since April 2018, the New York Fed has produced SOFR every day. It is based on much higher volumes than LIBOR, and compliant with the Principles for Financial Benchmarks set forth by the International Organization of Securities Commissions (IOSCO).[3] SOFR is based on transactions—not judgment—making it much more robust.

All of this points to the good work that can happen when the private and official sectors come together.

Now, there has been some criticism leveled at SOFR, most notably the lack of a term rate, and not enough liquidity in the market.

But liquidity has begun to develop in derivatives and cash markets. And, earlier this year Federal Reserve Board economists published research demonstrating how forward-looking term rates can be derived from SOFR futures and swaps markets.

However, we are still some time off from a point at which a robust, IOSCO-compliant term rate can be created, and use of such a term rate should be limited to certain segments of the loan market and to fallbacks for new contracts. I want to emphasize that the industry must not wait for a SOFR term rate to transition away from LIBOR.

In my view, the biggest challenge isn't liquidity or the creation of a term rate, it's a willingness on the part of the market to stop using LIBOR.

We need a mindset shift where firms realize that every new U.S. dollar LIBOR contract written digs a deeper hole that will be harder to climb out of.

If companies *are* going to use LIBOR, they need to start including robust fallback language in the contract, so that if LIBOR ceases to exist, chaos does not ensue.

This is an area of recent progress I mentioned earlier. The International Swaps and Derivatives Association (ISDA) has led great work on the development of contingencies for some derivatives products for the scenario where U.S. dollar LIBOR ceases to exist. The public consultation on fallback language for some non-U.S. dollar derivatives contracts took place last year. The corresponding consultation for U.S. dollar and some other non-U.S. dollar derivatives contracts closed just last week, and I look forward to hearing the results and next steps.

Universal changes to derivatives contracts will take out about 95 percent of the exposure—the $200 trillion number. If the market signs up to the ISDA protocol when it's published early next year, it will be a huge step in the right direction.

In addition, the ARRC has released four sets of recommended fallback language for different types of cash products. This fallback language clearly stipulates trigger events, replacement rates, and spread adjustments, and the triggers are close to those that ISDA has consulted on for derivatives.

And on Friday, the Securities and Exchange Commission (SEC) staff issued a statement highlighting risks and disclosures for market participants to evaluate proactively as they transition away from LIBOR.

While derivatives and institutional cash markets make up the bulk of LIBOR-based contracts, consumer products are a critical area where the industry needs to focus. Ensuring a fair transition away from LIBOR is going to be particularly challenging, and it's important consumers understand what the changes being made mean in real terms.

Last week the ARRC published potential paths forward for adjustable-rate mortgages (ARMs). These include a set of guiding principles for ARMs and other consumer products, draft fallback language for new ARMs referencing U.S. dollar LIBOR, and a framework for use of SOFR in new ARMs.

Much progress has been made, but there is still much to do. The ARRC transition plan is well underway, but we need to see certain developments in the U.S. financial industry for a smooth transition.

Milestones for the future include deeper liquidity in SOFR derivatives markets, greater issuance of SOFR-linked cash products, a reduction in the issuance of LIBOR-linked cash products, and the closing out of legacy positions on cash products, to name a few.

These all require the partnership and perseverance of the market.

2022 Is Just Around the Corner

2022 feels like it's a long way away, but believe it or not 901 days can disappear, almost in an instant.

And I don't always sense urgency among market participants on this issue. Tellingly, contracts referencing U.S. dollar LIBOR, without robust fallback language, continue to be written.

My message: don't wait for term rates to get your house in order. Engage with this issue now and understand what it means for your operations. Recognize where your exposure lies and deal with the contracts that mature after 2021 that lack robust fallback language.

This is a problem you have the opportunity to get ahead of now. Don't wait until January 1, 2022 to manage your business' transition away from LIBOR, because it's going to be too late.

Conclusion

I'll conclude with this: Reference rates are a complex issue, with numerous countries, a wide range of public and private entities, and trillions of dollars involved. Progress has been made, and the way forward is clear. But we are now at a critical point in the timeline. The very complexity of this issue is why the industry cannot afford to wait any longer. The clock is ticking, and there are 901 days left.

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1 Alternative Reference Rates Committee, *Second Report*, March 2018.

2 Financial Stability Oversight Council. 2018. Annual Report. Washington (revised June 20, 2019).

3 International Organization of Securities Commissions, *Principles for Financial Benchmarks, Final Report*, July 2013.