John C Williams: LIBOR - the clock is ticking

Remarks by Mr John C Williams, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the 2019 US Treasury Market Conference, Federal Reserve Bank of New York, New York City, 23 September 2019.

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As prepared for delivery

Good morning everyone and welcome to the New York Fed. It's a pleasure to be speaking at the fifth annual U.S. Treasury Market Conference.

This conference is particularly valuable because it brings together market participants and five public sector bodies—the New York Fed, the Board of Governors, the Treasury, the SEC, and the CFTC—to discuss the U.S. Treasury market.

The Treasury market is arguably the most important market in the world, and today is a unique opportunity to discuss some of the big topics in front of us. Increasing transparency, preparing for future risks, and taking advantage of innovation in this market are vital areas of discussion.

This morning, I'll begin with some observations on recent volatility in money markets and the Fed's approach to support stability in this critical part of the financial system as we carry out the FOMC's monetary policy decisions.

I'll then pivot to a different but related topic: the transition away from LIBOR. I *think* I can get away with it because this conference's five sponsoring agencies, which first came together following the "flash rally" in 2014, also all play a vital role in facilitating the industry's move to more robust reference rates. Crucially, they are ex officio members of the Alternative Reference Rates Committee (ARRC), the private sector group convened to guide the transition away from LIBOR. And of course the Secured Overnight Financing Rate (SOFR), the ARRC's selected replacement for U.S. dollar LIBOR, reflects transactions that finance U.S. Treasury securities.

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.

Market Conditions

I'll start with recent developments in money markets. Conditions in funding markets became highly volatile early last week, with secured lending rates moving higher on Monday and rising sharply on Tuesday. We had expected a number of factors—including quarterly corporate tax payments and the settlement of Treasury auctions—to put upward pressure on funding rates. However, the size of the reaction in repo rates, the spillover to unsecured markets such as federal funds, and the emergence of strains in market functioning were outside of recent experience. For example, in April and June of this year, sizable payment flows led to relatively muted movements in secured lending rates and small movements in unsecured rates.

As had been done ahead of prior dates with anticipated significant funding pressures, on Friday, September 13, the Markets team at the New York Fed, and others in the Federal Reserve System put in place a plan for increased monitoring of money markets. This included more frequent reporting on transactions, data, and information from market participants on Monday.

Although conditions remained calm on that Friday, the simultaneous increase and widening dispersion in repo rates and, importantly, federal funds rates on Monday indicated that markets were not effectively distributing liquidity across the system. The New York Fed's Markets team built a timeline and implementation plan in case the Open Market Desk at the New York Fed (Desk) would need to operate on Tuesday. Early Tuesday morning, it became clear that this situation had persisted and had the potential to become more acute.

In response to these developments, and in keeping with the FOMC's standing directive to the Desk to conduct open market operations as necessary to keep the federal funds rate within the target range, on Tuesday morning the Desk announced and conducted a repo operation. Although such operations were common before the financial crisis, this was the first non-test repo operation in many years. This was followed by repo operations each day since.

These actions had the desired effect of reducing strains in markets, narrowing the dispersion of rates, and lowering secured and unsecured rates to more normal levels relative to other benchmarks.

The experience of the past week drew attention to the possibility of the development of strains in funding markets around the upcoming end of the quarter. This past Friday we announced a plan of continued daily overnight repo operations through October 10, accompanied by three two-week term repo operations that span the month end.[1] The goal of these actions is the same as for recent open market operations: foster conditions in money markets to keep the federal funds rate within the target range.

This episode reminds us all of the importance of having well- functioning markets and the vital role that the Federal Reserve plays in supplying liquidity to the system when markets are under stress. We were prepared for such an event, acted quickly and appropriately, and our actions were successful. Friday's announcement on open market operations to address potential quarter-end funding pressures on interest rates followed this same approach: quickly diagnose the problem, develop the right action plan, and execute that plan.

At the same time, it is equally important that we examine these recent market dynamics and their implications for the liquidity needs in relation to the overall amount of reserves held at the Federal Reserve. We will continue to monitor and analyze developments closely. As Federal Reserve Chair Powell stated in his most recent press conference, the FOMC will assess the implications for the appropriate level of reserves and time to resume organic growth of the Federal Reserve's balance sheet consistent with the successful execution of the FOMC's ample reserves framework.[2]

That's enough on recent events for now. I'll turn to another very important issue, reference rate reform.

LIBOR Won't Last Forever

Some say only two things in life are guaranteed: death and taxes. But I say there are actually three: death, taxes, and the end of LIBOR.

Everyone in the financial services industry needs to be aware that the date when the existence of LIBOR can no longer be guaranteed is fast approaching.

I titled remarks I gave on this subject earlier in the year "901 Days" to remind everyone just how little time both the public sector and market participants have to prepare for a world without LIBOR.[3]

We are now 831 days away from that world, and while some institutions are making good progress, others are sticking their metaphorical heads in the sand, hoping the issue will go away.

Even more concerning are those wearing rose-tinted glasses, getting nostalgic about LIBOR and hoping for an extension to the deadline or a reincarnation of the rate. I cannot emphasize enough that the clock is ticking and everyone needs to get their firms ready for January 1, 2022.

A look at the numbers, and recent history, reveals the need for urgency. There are $200 trillion of financial contracts referencing U.S. dollar LIBOR.[4] But the volume of actual transactions that term LIBOR is based on is very small. When individual banks make LIBOR submissions they are largely based on judgment, not real transactions. This makes the rate vulnerable to manipulation, and banks are increasingly reluctant to provide submissions, adding yet further risk around using the rate.

The U.K. Financial Conduct Authority (FCA) has reached an agreement with banks to keep submitting rates until the end of 2021, but beyond that date the existence of LIBOR is not guaranteed.[5] The FCA has made it clear that it expects at least some banks to leave the LIBOR panels soon after 2021, making LIBOR even less representative than it is now, and that it would need to judge whether LIBOR was still representative at that stage.[6]

Headway Is Being Made

While the clock is inevitably ticking, progress is being made.

In 2017, the ARRC selected SOFR as its preferred alternative to U.S. dollar LIBOR.[7]

Since April 2018, the New York Fed has produced SOFR every business day. It's based on an important underlying market with much higher volumes than LIBOR, and is compliant with the Principles for Financial Benchmarks set forth by the International Organization of Securities Commissions (IOSCO).[8]

The International Swaps and Derivatives Association (ISDA) has led really important work on the development of contingencies for some derivatives products for the scenario where LIBOR ceases to exist.[9]

A key question is what will happen if the FCA finds LIBOR to no longer be representative. Two large central counterparties have already indicated that they would expect to move the LIBOR trades they clear to SOFR if this occurred. The Financial Stability Board's Official Sector Steering Group (OSSG) has indicated its support for ISDA to include such a trigger to avoid fragmentation between cleared and uncleared derivatives.[10]

Derivatives contracts account for 95 percent of the exposure to U.S. dollar LIBOR, so universal changes to these contracts would be a significant leap forward. If the market signs up to the ISDA protocol when it's published, it will be a considerable milestone and will go a long way toward reducing risks to firms, markets, and the financial system.

In addition, the ARRC has released four sets of recommended fallback language for different types of cash products and has published potential paths forward for adjustable-rate mortgages (ARMs).[11] While mortgages are a small part of the overall exposure, it's vitally important that consumers understand what the changes being made mean in real terms.

Last week, the Federal Reserve Board, the FDIC, the OCC, and other agencies released a proposal on adjusting margin requirements for covered swap entities that, among other things, are meant to remove unintended hurdles to signing the ISDA protocol and moving away from LIBOR.[12] The Financial Accounting Standards Board has similarly released an exposure draft with proposals to smooth the transition from an accounting perspective.[13] Finally, earlier this year, the SEC staff issued a statement highlighting risks and disclosures for market participants to evaluate proactively as they transition away from LIBOR.[14]

The Challenges Ahead

Progress has been made, but there's still much to do.

SOFR is sometimes criticized for the lack of a term rate, but my message is don't wait for a term rate to get your house in order. Don't use that as an excuse to halt the vital work of understanding where your exposure to LIBOR lies and how to prepare your business. The OSSG has produced a document explaining how market participants can use overnight risk-free rates, as opposed to waiting for term rates.[15] In addition, the New York Fed is preparing average SOFR rates and a SOFR index, with the goal of publishing them daily by the middle of next year.

Contracts that reference U.S. dollar LIBOR continue to be written, which only serves to increase the level of systemic risk. In rare cases where for some reason LIBOR must be referenced, robust fallback language that accounts for a future without LIBOR needs to be included. I also strongly encourage market participants to address legacy LIBOR-linked contracts. There's no one-size-fits-all approach for closing out or converting existing LIBOR positions so market participants need to get ahead of this issue.

We know this is difficult and complex work. At the New York Fed, we're working to identify where we have potential exposure to LIBOR and other non-IOSCO-compliant reference rates. We have teams examining monetary policy operations, foreign reserve management activities, and trading agreements with counterparties.

We want to hear your voice so we can incorporate your feedback and facilitate the development of the tools you need to ensure an orderly transition. Engage with the official sector about how LIBOR affects your firm and your challenges in this transition. And note that just last week, the ARRC published a checklist designed to support market participants with the adoption of SOFR.[16]

Implementation will be complex: financial contracts need to be scrutinized, operations need to be evaluated, and technology needs to be updated. The work involves numerous jurisdictions and multiple asset classes, and will require changes from how business is conducted to how systems are built. These things take time, and time is running out.

Conclusion

The LIBOR transition is a serious issue the industry needs to address. Both the official sector and market participants have made enormous progress, but we need to see much broader and consistent preparation for the transition.

If your firm is one of those hoping the problem will go away, or feeling nostalgic and counting on an extension to the deadline, take this message back: The clock is ticking, LIBOR's days are numbered, and we all need to play our part in preparing the industry for January 1, 2022.

Thank you, and I hope you enjoy today's conference.

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1 Federal Reserve Bank of New York, Statement Regarding Repurchase Operations, September 20, 2019

2 For recent statements regarding the FOMC's longer-run monetary policy implementation framework and balance sheet normalization, see FOMC Communications Related to Policy Normalization.

3 John C. Williams, 901 Days, Remarks at the Securities Industry and Financial Markets Association, New York, July 15, 2019.

4 Alternative Reference Rates Committee, Second Report, March 2018.

5 Financial Conduct Authority, FCA Statement on LIBOR Panels, November 24, 2017.

[6] Andrew Bailey, LIBOR: Preparing for the End. Speech at Securities Industry and Financial Market Association LIBOR Transition Briefing, July 15, 2019.

[7] Alternative Reference Rate Committee, The ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate, June 22, 2017.

[8] International Organization of Securities Commissions, Principles for Financial Benchmarks, Final Report, July 2013.

[9] International Swaps and Derivatives Association, Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA Definitions, May 16, 2019.

[10] See the letter from the OSSG to the ISDA dated March 12, 2019.

[11] See Alternative Reference Rate Committee, Fallback Contract Language.

[12] See Margin and Capital Requirements for Covered Swap Entities.

[13] See FASB Proposes Guidance to Assist in Transition Away from Interbank Offered Rates to New Reference Rates, Financial Accounting Standards Board news release, September 5, 2019.

[14] U.S. Securities and Exchange Commission, Staff Statement on LIBOR Transition, July 12, 2019.

[15] Financial Stability Board, Overnight Risk-Free Rates: A User's Guide, June 4, 2019.

[16] Alternative Reference Rates Committee, Practical Implementation Checklist for SOFR Adoption, September 2019.