Rates

A Guide to the World's New Benchmarks After Libor

Here's how to make sense of the dizzying array of acronyms that have sprung up in major markets.

By Boris Korby, William Shaw, and Alex Harris
August 11, 2020, 3:00 AM EDT

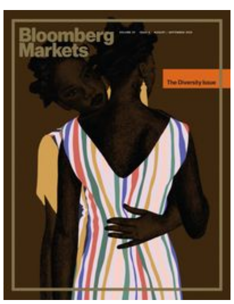
In this article

EUR
Euro Spot
1.1763 EUR
▲ +0.0025 +0.2130%

GBP
British Pound Spot
1.3086 GBP
▲ +0.0013 +0.0994%

JPY
Japanese Yen Spot
106.5700 JPY
▲ +0.6100 +0.5757%

8064646Z
JAPANESE BANKERS ASSOCIATION
Private Company



From the Aug./Sept. issue of *Bloomberg Markets*. *Illustrator: Tiffany Alfonseca*

For about 50 years, the London interbank offered rate has helped determine the cost of borrowing around the world, from student loans and mortgages to interest-rate swaps and collateralized loan obligations.

Libor, derived from a daily survey of bankers who estimate how much they would charge each other to borrow, was simple, effective, ubiquitous, and seemingly reliable.

As markets evolved, the trading that helped inform those estimates dried up. In the wake of the 2008 financial crisis, regulators discovered that the banks trusted to set the rates underpinning hundreds of trillions of dollars of financial assets had been manipulating them to their advantage.

For the past three years, policymakers around the globe have been developing new benchmarks to replace Libor by the end of 2021. The challenge has been to maintain Libor's accessibility and functionality with a replacement that's more trustworthy. That's easier said than done, and some countries and regions have made more progress than others.

U.S.

The Federal Reserve is championing the Secured Overnight Financing Rate to replace dollar Libor, which underpins roughly $200 trillion of securities.

SOFR is different from Libor in three key respects: It's based on real transactions, not just bank quotes; it provides only an overnight rate, whereas Libor offers rates for seven maturities ranging from one day to one year; and it's a secured rate, derived from repurchase agreement transactions that are collateralized by U.S. Treasuries.

Regulators prefer SOFR because a vast amount of trading underpins the benchmark—more than $1 trillion on most days, vs. an estimated $500 million for three-month dollar Libor. That makes it a truer reflection of the cost of capital and less susceptible to corruption.

Still, the transition has been uneven. Issuance of SOFR-linked bonds continues to increase, yet the leveraged loan and CLO markets have been slow to shift from Libor, citing the lack of a forward-looking term structure that extends beyond SOFR's overnight tenor, a common refrain globally. Greater trading volume in monthly and quarterly SOFR futures is expected to eventually facilitate the creation of additional tenors, producing a curve that reflects expectations for where the rate will be in the future.

Another concern is SOFR's susceptibility to periodic volatility in the market for repurchase agreements that determine the benchmark's setting. Its lack of a credit component is also a hurdle to wider adoption, some say. Given that Libor is based on the cost of lending between banks, it also reflects counterparty risk, especially when credit conditions worsen. This feature serves an important market function in hedging and securities pricing.

SOFR is also facing challengers that offer some of the features that it lacks.

The Bank Yield Index was introduced by Libor's overseer, the ICE Benchmark Administration, in January 2019. The new gauge, developed specifically as a potential replacement for lending activity tied to Libor, has multiple tenors as well as the credit component SOFR lacks. Another alternative, Ameribor, is calculated from the actual borrowing costs between the mostly small and midsize banks that are members of the American Financial Exchange. While the Bank Yield Index isn't set to launch until later this year, Ameribor futures are already trading on the Cboe Futures Exchange.

Both SOFR and Sonia dropped and then flatlined when the pandemic hit markets this year. By contrast, U.S. and U.K. Libor—the benchmarks they're slated to replace—were more turbulent.

Euro zone

Euribor, a Libor-like benchmark underpinning more than €180 trillion ($211 trillion) in assets, and the Euro Overnight Index Average (Eonia), its short-term equivalent, have long dwarfed euro Libor as the dominant reference rates in the euro zone.

The way Euribor is calculated has changed in recent years, giving policymakers comfort that it can continue beyond 2021. Its so-called waterfall methodology prioritizes bank contributions based on actual transactions over modeled estimates or panel judgments, while a handful of less liquid tenors have been scrapped.

Regulators, on the other hand, are ditching Eonia, which had few underlying trades that were dominated by a handful of contributors, and adopting the Euro Short-Term Rate, or ESTR.

ESTR draws on money-market transactions that show the overnight unsecured borrowing costs of euro-area lenders. It's underpinned by an average of about 500 daily deals totaling roughly €40 billion, according to recent figures compiled by the European Central Bank, and has a broad range of participants that can include pension funds and insurance companies.

U.K.

The U.K.'s Libor replacement, the Sterling Overnight Index Average, has been around since 1997. Sonia, as it's known, has been overseen by the Bank of England since 2016 and made its debut in a reformed version in 2018.

Like ESTR, Sonia measures the rate paid on unsecured overnight funds. The reformed gauge includes transactions negotiated bilaterally between banks as well as broker-intermediated loans. Other modifications included adjustments to the averaging methodology and a new publication time to give the BOE more time to process transactions. It's used to value about £30 trillion ($39 trillion) of trades each year, according to the BOE.

Sterling-denominated derivatives markets are shifting to Sonia. The share of pound-related swaps linked to Sonia is now roughly in line with those tied to Libor. Floating-rate bonds that mature later than 2021 have all but ceased to be tied to Libor.

Issuers have also begun to use Sonia to set prices on securitized debt, and the first syndicated loan tied to Sonia was issued in March.

British regulators are developing a Sonia term rate as well as pushing lenders and borrowers to amend Libor-based contracts to ensure a smooth transition after it's phased out.

Switzerland

Switzerland has also leaned on a benchmark born before the Libor rigging scandal.

Saron, the Swiss Average Rate Overnight, is similar to SOFR in that it's based on overnight trades, but in the Swiss franc-denominated repurchase agreement market. Saron is based specifically on transactions between financial institutions. While banks are already selling Saron-based mortgages, other credit products are still overwhelmingly priced off of Libor.

Until 2019, the Swiss National Bank used Libor to guide the country's monetary policy. The central bank switched last June to a new benchmark–the SNB policy rate. The bank now implements monetary policy by managing liquidity in Swiss money markets to steer Saron and keep it in line with its benchmark, which at -0.75% is the lowest in the world.

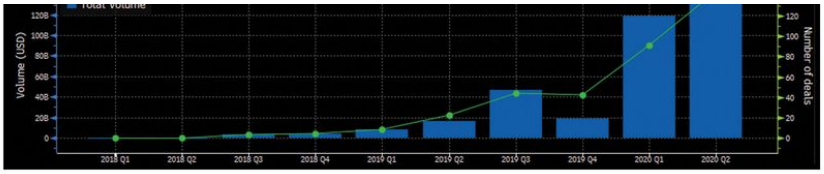
Japan

The central bank is leaning on two alternatives to yen Libor, Tibor and Tonar, as it looks to transition about $30 trillion of assets referencing the beleaguered benchmark.

Tibor, the Tokyo Interbank Offered Rate, is a version of Libor–with its own rigging scandal a decade ago–that's overseen by the Japanese Bankers Association Tibor Administration. The group implemented a series of reforms in 2017–including the introduction of a new methodology that relies on actual transaction data or, if that's not available, refers to similar interbank market rates–to bolster the reliability and transparency of the unsecured lending rate.

Tonar, the Tokyo Overnight Average Rate, is Japan's short-term alternative based on transactions in the uncollateralized overnight borrowing market. Regulators are seeking to develop a term structure based on market data for overnight index swaps, which use Tonar as the floating leg.

Quick Corp., an affiliate of Nikkei Inc., began to publish prototype reference rates in May to help lay the groundwork for additional terms. A functioning curve is expected no later than mid-2021, Masayoshi Amamiya, deputy governor of the BOJ, said in a speech earlier this year.



The League Tables (LEAG) function on the Bloomberg terminal tracks issuance in Libor alternatives.

Singapore, Australia, Hong Kong

Libor is calculated for just five major currencies—the dollar, euro, pound, Swiss franc, and yen. Still, other countries are reforming their own Libor-like reference rates.

Financial-services companies in Singapore are set to adopt the Singapore Overnight Rate Average, which is replacing the Libor-based Singapore-Dollar Swap Offer Rate, that underpins some S$3.5 trillion ($2.5 trillion) of derivative products. The new benchmark, known as SORA, is based on an average rate of unsecured overnight interbank Singapore dollar transactions brokered onshore, whereas the SOR is computed from borrowing greenbacks and swapping them into the local currency.

There are signs the transition is well under way: Global clearinghouse LCH cleared the first local currency interest-rate swaps benchmarked to SORA in May.

Down under, the Libor rate for Australian dollars has been discontinued and replaced by the bank bill swap rate, commonly known as BBSW, which is referenced in about A$18 trillion ($13 trillion) of transactions. The critical difference is that the BBSW is based on actual transactions in the bank bill market.

The rate was subject to attempted manipulation in recent years, which prompted reforms in 2018 when a new regulatory framework for the financial benchmark was installed. The reforms included the adoption of a volume-weighted average price methodology.

The Australian Overnight Index Average, or Aonia, is also gaining traction, with the first floating-rate note tied to the benchmark pricing last year. It's based on the rate at which unsecured funds are lent in the domestic interbank market.

The Hong Kong Dollar Overnight Index Average, or Honia, has been proposed by the Treasury Markets Association as an alternative to the local Hong Kong Interbank Offered Rate, known as Hibor.

Honia, like other risk-free rates, is based on unsecured lending transactions in the interbank market—and is thus considered a more reliable benchmark. Still, the Hong Kong Monetary Authority has said it plans to adopt a multirate approach where Honia and Hibor exist in tandem.

Korby is a Bloomberg News senior editor in Seattle on the credit team. Shaw is *an editor on the foreign exchange and rates team in London, and Harris reports on FX and rates in New York.*

– With assistance by Masaki Kondo, Stephen Spratt, Ruth Carson, and Tian Chen