BANK OF ENGLAND

The Bank's risk management approach to collateral referencing LIBOR for use in the Sterling Monetary Framework – Summary of responses

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On 27 June 2019, the Bank published a Discussion Paper seeking initial feedback on its approach to the risk management of collateral referencing LIBOR for use in the Sterling Monetary Framework (SMF) (the LIBOR DP)[1]. 20 responses were received from banks and building societies, of a range of size and business model – all of which were members of the SMF, although the discussion was open to the market more widely.

Key themes from these responses are discussed below.

Whilst acknowledging the focus of the LIBOR DP was how the Bank could manage the risks posed to public money on its own balance sheet, respondents generally supported a policy that would also have the broader benefit of increasing the pace of transition and incentivise issuers to take timely action with respect to legacy LIBOR assets. However, respondents suggested that, in doing this, the Bank should adopt a policy allowing appropriate time for implementation, to minimise the risk of causing market disruption or presenting challenges to SMF participants who may see a particularly sizeable reduction in SMF eligible collateral.

One option presented in the LIBOR DP (Option C) was for the Bank to apply a one-off additional haircut and/or a haircut that increased over time to all collateral that references LIBOR and matures beyond end-2021. Respondents favoured this option as being the most flexible and balanced proposal, limiting event risk that might lead to market dislocation, whilst still promoting LIBOR transition. Views differed about the extent to which the option would incentivise issuers to amend the terms of legacy LIBOR instruments maturing after 2021. But this option was considered by respondents to have a less disruptive impact on firms' ability to access the SMF when compared to a broad brush ban – and would continue to give some credit to legacy assets for a transition period. Several respondents specifically cited a preference for gradually increasing haircuts over time to avoid cliff edges, particularly if the timing of progressive haircut increases corresponded with key LIBOR transition events.

The LIBOR DP also presented an option whereby, at some future point in the transition period, the Bank would announce that all collateral referencing LIBOR would become ineligible, unless mitigated by appropriate fallback language or other market solutions (Option A). Concerns raised by respondents with regards to this option focused on the potential for a large reduction in SMF eligible collateral and the

[1]https://www.bankofengland.co.uk/-/media/boe/files/paper/2019/the-boes-risk-management-approach-to-collateral-referencing-libor-for-use-in-the-smf.pdf

possibility of significant market disruption and illiquidity if the lead time provided was insufficient. Some respondents also noted that a lack of market consensus in a number of areas might make it difficult for some firms to transition particular assets at a given point in time.

Similar concerns were also raised in relation to Option B, which proposed that the Bank make LIBOR linked collateral issued/originated after a certain date ineligible, unless mitigated by appropriate fallback language or other market solutions. The choice of cut-off date was highlighted by respondents as the key driver of the scale of impact. Options cited by respondents included: a backward looking cut-off date corresponding to previous regulatory announcements; or a forward-looking date at which viable mitigants had been made available or to a date that could be widely recognised as when the market had moved to SONIA. But respondents noted difficulties in selecting between these and other options, particularly given remaining uncertainties over the phasing of LIBOR transition.

In relation to Option A and B, several respondents highlighted the difficulty in determining the suitability of appropriate fallback language, particularly as the market was still finding common consensus for some instrument types.

As a general observation, respondents requested that a reasonable lead time be provided for any change in approach by the Bank, in order to ease market disruption and allow SMF participants sufficient time to adapt and replace and/or transition impacted collateral.