Consultation on Term SONIA Reference Rates

UK Finance response to Bank of England Working Group on Sterling Risk-Free Reference Rates Consultation

26 October 2018

Introduction

UK Finance is a trade association formed in July 2017 to represent the finance and banking industry operating in the UK. It represents around 300 firms in the UK providing credit, banking, markets and payment-related services. The new organisation brings together most of the activities previously carried out by the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association.

In addition to representing residential mortgage lenders for home purchase and buy-to-let, UK Finance members also lend to support the social housing and registered social landlord sectors across the UK nations.

We welcome the opportunity to provide this response to the current Consultation on Term SONIA Reference Rates.

We have responded to aspects of the consultation that are most relevant to mortgage lenders and their current interests.

General comments

Our main motivation in responding to this consultation is to clarify that the mortgage industry currently uses term reference rates in a variety of applications and that, for the vast majority of these contracts, it would not be appropriate or practicable to simply substitute LIBOR for the Bank of England base rate, as is suggested in the consultation.

Furthermore, it is not the case that only a niche selection of buy-to-let (BTL) lenders hold contracts linked to LIBOR. A variety of mortgage lenders active in BTL lending, residential lending, commercial lending, and lending to housing associations currently use LIBOR TRRs in mortgage contracts and in the contracts which govern their funding, hedging, and securitisation activities.

We estimate that our membership includes at least 23 lender brands which use term reference rates in their variable rate mortgage contracts. This is a conservative estimate, and the actual number of firms is likely much higher. Collectively these lenders hold approximately £141 bn in their mortgage books, although it is unclear at this point how much of this lending is on a LIBOR-linked variable rate. Some of these lenders are continuing to write new loans linked to LIBOR. These lenders are not concentrated in one sector; they include banks, non-banks, building societies, and specialist lenders who hold both buy-to-let and residential loans linked to LIBOR.

We do not yet have a quantitative estimate of the extent to which the mortgage industry is exposed to LIBOR from the funding, hedging, and securitisation aspects. We are currently surveying our members to assess the scale of this exposure and expect to have a better understanding of this exposure by end 2018.

Answers to consultation questions

Question 1: Would the availability of robust TSRRs facilitate transition to SONIA for end users in loan and debt capital markets? Are there other use cases which should be considered?

Although mortgages are listed in the consultation as users requiring a TRR alternative to LIBOR, we believe the strength of demand from the mortgage industry is significantly underestimated as the total balance of outstanding LIBOR linked mortgages is likely to be far in excess of the £1bn threshold indicated on page 20 of the consultation. We believe this is due to a lack of understanding of the pervasiveness of LIBOR not only in mortgage contracts but in the business models of lenders. There are several reasons why LIBOR may be embedded in lenders' business models:

1. **Rate matching in funding**: Typically, if a mortgage contract is on a LIBOR-linked variable rate, it is because the lender's funding contract is also tied to LIBOR. Regardless of what alternative rate replaces LIBOR in funding contracts, it is crucial that associated mortgages are linked to the same reference rate to avoid a mismatch. For this to be practicable, the alternative rate should be known at the start of an interest period and should reflect forward interest rate expectations over the period.

   If lenders were to have mortgage contracts linked to the BoE base rate while their funding was linked to a 3-month SONIA, this would create a risk of significant mismatch which would have capital as well as profit and loss implications. Additionally, BoE Base Rate is an overnight rate and does not reflect the term so is not an appropriate substitute.

   Matching both contracts to the same rate which is known at the start of the period creates certainty for both the customers and lender, which allows the mortgage and funding markets to work smoothly and efficiently with each other.

2. **Rate matching of securitisations**: Likewise, for lenders who use securitisations using a TRR allows for a match between assets and liabilities in the securitisation.

3. **Transparency and certainty**: A term reference rate which is set independently of the lender provides transparency for borrowers. When the term rate is known with certainty at the outset of the period, this allows the borrower and lender to accurately project their outgoings and receipts.

   Lenders are aware there is a pertinent issue of how (and when) to transition legacy mortgage borrowers from a LIBOR reference rate to a new TSRR when LIBOR is no longer available. To avoid potential consumer harm or significant payment shock to legacy borrowers, an obvious sensitivity is that an appropriate TSRR should broadly align with the long-run trends around the level and volatility of LIBOR to be justifiable from both a regulatory and contractual perspective.

The mortgage industry would therefore require any risk-free TRR intended to be a substitute for LIBOR to meet these requirements to avoid a major disruption of many firms' business models and to avoid consumer harm.

We do not have adequate expertise to comment on whether price discovery is feasible from either the short-dated SONIA OIS market or the SONIA futures market, or on the appropriate data sources for TSRRs.

Question 8: Do you see benefit in early publication of 'prototype' TSRRs based on currently available data sources?

Yes – this would significantly assist with the impact assessment of any replacement TSRR on certain mortgage lenders' debt arrangements and, more importantly, mortgage borrowers that would need to be moved to an appropriate TSRR once LIBOR ceases to be available.

Question 9: Do you agree that the definition of TSRR benchmarks should allow data sources to evolve (for example, to include inputs from listed futures) to reflect potential future changes in market structure?

We have reservations if this approach would be appropriate for mortgage borrowers – any replacement TSRR applied will need to be clear, fair and not misleading from a borrower's perspective. Subsequent changes to the basis for setting a benchmark may require on-going amendments to contractual documentation and communication to these borrowers. This burden would fall disproportionately on lenders and may conflict with applicable regulatory obligations.

If data sources are allowed to evolve, there is a potential risk that confidence in the benchmark setting may ultimately be undermined. Preferably, all applicable data sources should therefore be identified and included upfront in the definition of the TSRR benchmarks.

Question 10: Do you have any additional views on the potential use cases, data sources and calculation methodologies, and risks associated with TSRRs?

Whilst the availability of robust TSRRs would facilitate a transition to SONIA for end users of loan and debt capital markets, we would encourage the Bank of England Working Group on Sterling Risk-Free Reference Rates to better understand the nuances that impact the mortgage market, particularly those faced by non-bank lenders which primarily finance themselves using LIBOR-linked debt and advance LIBOR mortgages. Factors to consider include:

- How do these lenders transition from advancing LIBOR mortgages without having any certainty regarding the likely replacement rate for its debt arrangements?
- What if the practice in the loan and debt capital markets takes time to develop and is not sufficiently advanced by 2020/2021 to provide a clear direction to lenders that would then enable an orderly mortgage rate transition?

There is a need for an appropriate mortgage rate to replace LIBOR, but the suitability of any proposed TSRR will need to be analysed and understood from a borrower's perspective.

Contact

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