April 2020

Preparation for LIBOR transition 'Dear CEO' letter feedback

Key findings

In May 2019, the Australian Securities and Investments Commission (ASIC) wrote to the CEOs of selected major Australian financial institutions – supported by the Australian Prudential Regulation Authority (APRA), and the Reserve Bank of Australia (RBA) – requesting information to better understand how these institutions are preparing for the end of LIBOR.

Institutions responded to the letter in July 2019, providing ASIC, APRA and the RBA with information on their transition preparation. We appreciate the time and effort respondents have taken to address this important issue, as well as the level of cooperation shown.

Responses confirmed that the overall impact of LIBOR in Australia is substantial. The aggregate notional LIBOR exposure of respondents is approximately A$10 trillion, with 40% of that expected to mature after the end of 2021(when the continuation of LIBOR will no longer be supported by the UK Financial Conduct Authority). Responses also indicated that due to liquidity concerns in alternative reference rates (ARRs), entities are continuing to write LIBOR-linked contracts.

Details of the responses reflected various levels of preparedness between different segments of the industry. While some respondents demonstrated that significant planning was under way for LIBOR transition, in other cases this work was yet to commence in earnest. Given that LIBOR will not be supported beyond 2021, and the scale of work involved in transitioning to alternative benchmarks, prompt action is imperative. If, by the end of 2021, institutions have not transitioned to alternative reference rates or put robust fall-back provisions in place for legacy contracts, significant reputational, operational and legal risks to financial institutions could be realised, risking disruptions in financial markets.

The selected institutions have been provided with individual feedback from ASIC and APRA, as the relevant supervisory authorities, on their transition preparations. This feedback includes ASIC's and APRA's general assessment of the transition preparations, related recommendations, and a plan for ongoing engagement on these issues. Actions taken by the better-prepared respondents are outlined in the section on best practice below. Institutions should consider the recommendations provided as non-exhaustive feedback on aspects of LIBOR transition that were raised in the letter.

Respondents cited various key dependencies to the success of the transition, many of which relate to the outcome of industry consultations and work of various international working groups, as well as the evolving liquidity of the alternative reference rate markets. ASIC and APRA have taken this into consideration in the review process and acknowledge these external dependencies.

Best practice

The list below provides some examples of what APRA and ASIC consider to be standards of 'best practice' for prudential and conduct risk mitigation measures. Respondents that are better prepared for LIBOR transition demonstrated these standards. All institutions should consider how these measures may be relevant to their LIBOR transition planning, taking into account the nature, scale and complexity of their activities, and the extent of their LIBOR exposures.

Measures:

a. Formalise a transition program that identifies risks, mitigation strategies, and timelines. The well progressed programs have a strong governance framework, including the appointment of an appropriate senior manager accountable for program delivery and effective oversight.

b. Conduct a comprehensive assessment of how LIBOR affects an institution’s business and quantify LIBOR-related risks. The ability to easily repeat the identification process will assist institutions in monitoring their LIBOR exposure over time. It is also important to limit any addition to post-2021 LIBOR exposure. Writing new LIBOR-based contracts expiring post-2021 should be carefully justified and closely monitored.

c. Focus on client outreach and communication programmes to ensure clients are aware of the transition risks. Communication should be clear on what LIBOR transition means for clients in practical terms and tailored to the sophistication of respective client segments.

d. Participate in industry forums and keep abreast of market developments and co-ordinated actions being taken within the industry. Well progressed institutions maintained up-to-date information on market accepted protocols and upcoming key events. Various industry consultations and guidance on good practice, including results for pre-cessation fall-backs by the International Swaps and Derivatives Association (ISDA), are expected to be finalised in 2020. Institutions are encouraged to adopt these recommendations.

e. Seek legal advice on contract amendment and fall-back provisions. Starting this process early is the most prudent approach.

f. Assess readiness of IT systems and infrastructure and ensure they can process contracts that reference overnight rates. Institutions are encouraged to explore how they can transact in various ARRs if they have not already done so. Plans to update and test these systems as transition progresses should also be prioritised.

g. Plan for both base and alternative scenarios, including the adoption of various ARRs. Conduct scenario analysis under the base assumption that no additional transition time would materialise is the most prudent approach. Term rate expectation should also be managed. Although there are multiple benchmark administrators currently developing term rates based on ARRs, institutions should be prepared for a range of scenarios, including one whereby no term rates will be available post-LIBOR cessation.

h. Initiate LIBOR transition training programmes for relevant stakeholders, including staff members, Boards and senior management. Institutions should prioritise client-facing stakeholders and ensure they are familiar with the language used in benchmarks reform, including the range of possible alternative reference rates.

i. Consider conduct related issues associated with the transition, including the potential for conflict of interest, fair treatment of clients, and asymmetry of information. ASIC intends to release additional conduct related information and industry guidance on LIBOR transition in 2020.

j. Ensure there is adequate due diligence, risk assessment, and contingency planning in relation to third-party service providers in the context of LIBOR transition. The responsibility of transition success should be shared between institutions and their service providers. It is important for institutions to do everything they can to ensure they have obtained the best available option.

Next steps

Public outreach

In line with initiatives and workstreams of international industry bodies such as the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board's Official Sector Steering Group (OSSG), APRA, ASIC, and the RBA will continue to speak and engage publicly to increase general awareness of the need to plan for LIBOR transition and to encourage institutions to start the transition early.

This engagement aims to mitigate potential stability risks to the wider market by reaching a broad range of institutions to include those that have not yet been engaged on the issues.

Industry developments

ASIC and APRA will monitor industry developments and, where appropriate, engage with relevant stakeholders to seek assurance that these outcomes are being adequately addressed. It is recognised that disruptions from the COVID-19 outbreak may affect the timing of some aspects of institutions' transition plans.

Feedback welcome

ASIC, APRA, and the RBA would like to reiterate the importance of planning and acting now to deal with the end of LIBOR. There are significant challenges and risks ahead, and it is crucial that institutions in Australia are well-prepared to ensure a smooth transition.

We appreciate all respondents' cooperation on this matter and the time and effort taken to respond to the letter. Should you have further questions or feedback, please do not hesitate to contact the ASIC Benchmarks team at Benchmark.Reform@asic.gov.au.