BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

FCA FINANCIAL CONDUCT AUTHORITY

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26 March 2021

Dear CEO,

Transition from LIBOR to Risk Free Rates

We have written to you previously[1] about the preparations you should be making for the cessation of LIBOR. Now that cessation dates for all panel bank LIBOR settings have been confirmed,[2] we have entered the final and critical phase of the transition from LIBOR to Risk Free Rates (RFR). It is imperative that the industry continues to build on work undertaken to date, and in some areas, accelerates efforts.

We expect all firms to meet the milestones of the Working Group on Sterling Risk Free Reference Rates (RFRWG)[3] and the targets of other working groups and relevant supervisory authorities as appropriate. The annex to this letter sets out a list of priority areas where further action by firms is necessary to prepare for the cessation of LIBOR. This list is not exhaustive and the onus is on firms and responsible Senior Manager Function (SMF) holder(s) to determine the specific actions necessary to mitigate the risks to safety and soundness arising from their firm's exposures to LIBOR, to ensure good client outcomes and to preserve market integrity.

We have written separately today to the named SMF responsible for oversight of transition at the PRA and FCA firms with the largest and most complex LIBOR exposures to outline the steps we expect them to take in the remaining time available. The responsible SMFs should satisfy themselves that all appropriate actions are being taken to ensure an orderly transition. As a key regulatory priority, we expect that this transition forms part of the performance criteria for determining their variable remuneration.

As we enter the final phase of LIBOR transition, the PRA and FCA are intensifying our supervisory focus on firms' management and oversight of the risks associated with transition. We will use firm meetings, relevant management information and the LIBOR and RFR exposure data we collect to assess your transition progress. As previously indicated, we are keeping a range of supervisory tools under review for use where we see either insufficient progress, or incidents of poor risk management or governance of transition, including relative to the expectations set out in the annex to this letter.

Thank you for your firm's constructive engagement on the transition from LIBOR to date. We look forward to this dialogue continuing as part of our supervisory engagement on this important priority over the coming months.

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1 2018 letter:https://www.bankofengland.co.uk/prudential-regulation/letter/2018/firms-preparations-for-transition-from-libor-to-risk-free-rates; subsequent feedback statement of June 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/firms-preparations-for-transition-from-libor-to-risk-free-rates; January 2020 letter: https://www.bankofengland.co.uk/prudential-regulation/letter/2020/next-steps-on-libor-transition.

2 https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf.

3 https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor/working-group-on-sterling-risk-free-reference-rates.

Yours sincerely

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Annex

1. Cessation of new sterling LIBOR business milestones

The end Q1 milestones of the RFRWG are now imminent. From Thursday 1 April 2021 we do not expect to see incremental sterling LIBOR loan, bond, securitisation or linear derivatives business being written by PRA and FCA regulated firms and groups, unless specifically permitted within the RFRWG milestones.

Firms should have robust processes in place to ensure that all new sterling LIBOR business is closely controlled and the use of the linear derivative risk management exemption is consistent with its express purpose of facilitating the risk management of existing positions.[4] Any incident of sterling LIBOR-referencing loan, bond or securitisation issuance from Thursday 1 April onwards that expires beyond end-2021 would potentially be viewed as indicative of poor risk management and poor governance of transition. In a situation where end-user readiness for use of RFR-based alternatives is not yet in place, we note that alternative funding solutions exist which would be consistent with the milestones of the RFRWG, such as the use of a fixed rate, an alternative floating rate or a short-term LIBOR linked facility that expires before the end of 2021.

a. Cessation of new LIBOR-referencing syndicated lending

Progress in transitioning new sterling syndicated lending business away from LIBOR has lagged other segments of the cash markets. We are concerned that a number of individual firms within syndicates may have been undermining efforts of the wider market to transition. These firms should not be allowed to act as a brake on transition. The Lead Arranger(s) should take the principal role in ensuring that all syndicate commitments entered into after Thursday 1 April 2021 do not reference sterling LIBOR. If necessary, syndicate members that are not ready or willing to commit on alternative rates from Thursday 1 April onwards should not be included in that syndicate. Any new sterling LIBOR syndicated lending commitment after the end-Q1 milestone would be viewed as a collective failing of all the banks in the syndicate.

More widely, we encourage Lead Arrangers to take a similar role in spearheading efforts to transition non-sterling and multi-currency syndicated lending away from LIBOR now, even where industry milestones differ from those of sterling, to ensure better risk management outcomes for themselves and their clients.

2. Systems readiness for LIBOR cessation

We expect firms to prioritise resources to expedite the delivery of strategic front-to-back technology solutions for RFR to the greatest extent possible. Where a firm is temporarily reliant on a tactical solution, this should be robust, not place undue constraints on RFR volumes and be subject to appropriate controls. The operational resiliency implications of reliance on tactical solutions should be controlled and managed within an explicit and defined firm risk appetite. Firms should also ensure that systems and processes are ready to robustly manage reliance on fall-backs post-cessation and that the firm's risk management takes full account of this reliance.

3. Active transition of legacy LIBOR exposures

We expect firms to intensify efforts to execute plans to transition the stock of legacy LIBOR-linked contracts ahead of confirmed cessation dates of panel bank LIBOR, wherever it is feasible to do so. All legacy sterling LIBOR contracts should, wherever possible, have been amended by end Q3 2021 to include at least a contractually robust fall-back that takes effect upon an appropriate event, or, preferably, an agreed conversion to a robust alternative reference rate.[5] Actions with respect to non-sterling exposures should be consistent with the relevant timelines for that currency.

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[4] Path to ending new use of sterling LIBOR-linked derivatives: https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor/working-group-on-sterling-risk-free-reference-rates.

[5] See also the Q&A published by the FCA on replacing LIBOR with alternative rates in existing contracts: https://www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition.

As set out by Andrew Bailey last July,[6] 'it remains in the interests of financial markets and their customers that the pool of contracts referencing LIBOR is shrunk to an irreducible minimum ahead of LIBOR's expected cessation, leaving behind only those contracts that genuinely have no or inappropriate alternatives and no realistic ability to be renegotiated or amended'. In instances where legislative solutions are not expected to be provided to support tough legacy exposures, firms should have robust plans in place to ensure all relevant LIBOR-referencing exposures are addressed. As the time for remaining action is short and reducing in every LIBOR currency, action needs to be front-loaded to deliver demonstrable progress against a risk-based prioritisation of contracts.

a. Legacy syndicated commitments

Progress to date in actively transitioning legacy LIBOR-referencing syndicated lending facilities has been slow and, in common with new syndicated lending business, has lagged progress in other areas. We expect the Lead Arranger(s) and/or Agents(s) of legacy LIBOR syndicated facilities to proactively take steps to initiate the transition of syndicated facilities on a timeline consistent with meeting the milestones of the RFRWG and other working groups globally. The number and scale of outstanding LIBOR-referencing syndicated exposures and the challenges associated with migration of syndicated lending highlight the need for urgent action by all parties to the loan. In any case where Lead Arranger/Agent engagement to date has been insufficient, member banks should now be taking steps to progress solutions for these exposures.

b. Legacy derivatives

While the ISDA protocol provides a fall-back designed to enable derivative contracts to continue to function post cessation, firms should be prepared to demonstrate the steps they have taken to identify where an active transition would be more appropriate and how any residual risks from reliance on fall-backs will be managed. Mitigation of these risks requires proactive, timely and meaningful engagement with clients.

4. Conduct risk mitigation

Firms are expected to continue their focus on identifying and mitigating conduct risks and to treat clients fairly during LIBOR transition. As active transition intensifies, firms are expected to sharpen their efforts to traceably identify and address risks. Where counterparties are retail consumers or small and medium sized enterprises (SMEs), these risks may be particularly acute. As set out in the FCA's LIBOR conduct Q&A,[7] firms should keep their customers appropriately informed about the impact of LIBOR cessation on existing and new financial products and services they offer or distribute. Information to clients should be presented in good time to allow customers to make informed decisions about relevant products and the risks to which they may be exposed.

Firms should monitor progress of their transition efforts, including tracking and oversight of LIBOR transition risks, through the collection and use of meaningful conduct management information and data, including client outreach and any emerging risks, and escalate issues to senior management and the Board, if appropriate.

5. Development of RFR markets

Ensuring markets are deep and liquid across RFR products well in advance of cessation dates is central to delivering a smooth transition and ensuring continuity in the supply of lending and risk management products once LIBOR ceases. Now that cessation dates for LIBOR panels are confirmed and imminent, firms should intensify efforts to transact using RFRs in order to accelerate the development of a deep and liquid product set. As part of our supervisory engagement in the coming months, we will be requesting that

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[6] https://www.bankofengland.co.uk/speech/2020/andrew-bailey-speech-as-part-webinar-hosted-by-the-boe-and-the-frb-of-ny-libor-entering-the-endgame.

[7] https://www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition.

firms make clear the efforts they are undertaking to facilitate the transition of products from LIBOR to robust alternative rates for relevant currency exposures.

a. Sterling futures and non-linear derivatives

We have observed good progress in sterling bond and securitisation markets and that the "SONIA first" convention switch in the interdealer market has successfully catalysed the movement of most sterling swaps business away from LIBOR. However, there remains much more to do to ensure that SONIA futures and options markets develop in sufficient depth to minimise the risks of LIBOR cessation to firms' non-linear exposures. Firms should take active steps to build further liquidity in these products in advance of the upcoming RFRWG milestone to cease new GBP LIBOR futures and non-linear derivatives by end-Q2 2021, other than for risk management of existing positions.

b. Non-sterling LIBOR currencies

We expect firms to work with pace and intensity to further the adoption of RFRs in all markets in which they are active. PRA and FCA firms have significant exposures to LIBOR currencies other than sterling. However, trading volumes by these firms in many targeted replacement rates remain low and the lack of development of these markets is increasingly a concern. Firms should take all action possible in the limited time remaining to minimise risks from exposures to all relevant LIBOR currencies.

Given the significant exposures of PRA and FCA regulated firms to USD LIBOR, and the risks that continued use of USD LIBOR beyond the end of the year would create, firms should ensure they cease new use of USD LIBOR as soon as practicable and no later than the end of 2021, in line with the supervisory guidance issued by US authorities.[8] Firms should take appropriate steps now to achieve this, and will be expected to demonstrate their transition progress by reference to the recommended timelines of the Alternative Reference Rates Committee (ARRC). Additionally, firms should support the transition to €STR before the discontinuation of EONIA on 3 January 2022.

6. Model changes

The PRA previously set out plans to review firms' internal model changes necessitated by the transition away from LIBOR.[9] The PRA expects to write to firms in April setting out our expectations for market risk models (Internal Model Approach (IMA)), and in June for counterparty credit risk models (Internal Model Method (IMM)). The PRA expects all formal model change applications to be submitted by end-September 2021, in order to allow sufficient time for PRA review before the end of the year.

7. Selection of appropriate alternatives to LIBOR

Transition from LIBOR is part of a global program of work supported by the Financial Stability Board to reduce vulnerabilities through addressing the core weakness of Inter Bank Offered Rates. Wherever possible firms should use the most robust alternative reference rate to LIBOR appropriate for the applicable use case. In sterling this will often be SONIA compounded in arears in line with existing market practice in derivative and bond markets and with the use cases identified in loan markets by the RFRWG.[10] In selecting benchmarks for use in their products, firms should take account of relevant industry guidelines and recommendations including the RFRWG's use cases and the work undertaken by the FICC Markets Standards Board to establish a market standard on use of term SONIA reference rates.[11] As an overarching consideration it is important that the selected replacement rate meets customers' needs, and that customers understand the properties and implications of the rates they are moving to.

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8 Board of Governors of the Federal Reserve System Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency Statement on LIBOR Transition, 30th November 2020: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf.

9 https://www.bankofengland.co.uk/prudential-regulation/letter/2019/prudential-regulatory-framework-and-libor-transition.

10 https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/use-cases-of-benchmark-rates-compounded-in-arrears-term-rate-and-further-alternatives.pdf.

11 https://fmsb.com/wp-content/uploads/2021/03/FMSB-Term-Rate-Standard_TRANSPARENCY-DRAFT_Final.pdf.