Firms’ preparations for transition from London InterBank Offered Rate (LIBOR) to risk-free rates (RFRs): Key themes, good practice, and next steps.

In September 2018, the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) wrote to CEOs of major banks and insurers supervised in the UK asking for details of the preparations and actions they are taking to manage transition from LIBOR to alternative interest rate benchmarks. The purpose of these letters was to seek assurance that firms’ senior managers and relevant governance committee(s) understand the risks associated with this transition and are taking appropriate action now so that firms have transitioned to alternative rates by the end of 2021.

These letters were sent directly to the largest banks and insurers. Firms that did not receive a direct email from their supervision team were not within the scope of that request, but face the same risks, and the same need to ensure they complete transition before end-2021.

We also published a copy of the September 2018 letter on the Bank of England and FCA websites due to the wide-ranging use of LIBOR in the market. We encouraged all firms that use and/or rely on LIBOR to read and reflect on the letter.

We have reviewed responses from those firms that were direct recipients of the original letter and provided those firms with feedback. Given the widespread use of and reliance on LIBOR that we highlighted at the time of publishing the original letter, we have decided to publish a number of observations from our work to date.

We believe that all firms need to plan for the cessation of LIBOR, and many of the observations will be relevant beyond the largest and most complex market participants that were asked to respond to the original letter. In the context of firms’ risk management, contingency planning and governance frameworks, all firms may wish to review the contents of this publication. Not all findings will be relevant for all firms. These should therefore be considered with regard to the nature, scale and complexity of a firm’s operations and its exposure to LIBOR and/or other interbank offered rates (IBORs). In the first instance, any actions should begin with a comprehensive assessment of how LIBOR interacts with a firm’s business.

**Key findings**

Having reviewed the responses, the PRA and FCA have made observations across eight key areas:

**Key finding 1: Comprehensive identification of reliance on and use of LIBOR**

Many firms undertook a comprehensive assessment of how LIBOR interacts with their business, involving a sufficiently diverse range of stakeholders to ensure identification of exposure and reliance on benchmarks. In stronger responses, this went beyond a firm’s balance sheet exposure and also assessed, for example, whether LIBOR is present in the pricing, valuation, risk management and booking infrastructure firms use. Any assessment should be proportionate to the nature, scale and complexity of firms’ exposure to LIBOR.

**Key finding 2: Quantification of LIBOR exposures**

Some firms lacked the management information to provide a clear understanding of current LIBOR exposures, including where contracts mature after 2021. Where appropriate, the PRA and FCA expect firms to consider a range of quantitative and qualitative tools and metrics to monitor their exposure to LIBOR and related risks. The metrics should be updated sufficiently regularly to support
timely decision-making by the relevant governance committee(s). Management information should be proportionate to the nature and scale of the risks you identify as a result of LIBOR transition.

**Key finding 3: Granularity of transition plans and their governance**

Clear and appropriate governance, supported by reporting to key senior managers and the relevant committee(s), on a regular basis using relevant project indicators were an important component of a strong response. Where appropriate, this would very likely include nominating a senior executive covered by the Senior Manager Regime as the responsible executive for transition. You should develop a project plan for transition, including key milestones and deadlines to ensure delivery by end-2021.

**Key finding 4: Identification and management of prudential risks associated with the transition**

Strong responses evidenced that a detailed risk assessment was completed and had been subject to appropriate review and challenge. In forming an assessment of the risks, stronger responses took a broad view and considered all risks that could be relevant to a firm’s operations. These risks had been clearly aligned to appropriate mitigating actions. Some plans prioritised targeting exposures or dependencies based on agreed parameters of risk and/or materiality (e.g. size, complexity, maturity). Where this information was not currently available, we considered if responses included details of whether firms were developing the ability to track and monitor transition risks over time.

**Key finding 5: Identification and management of conduct risks associated with the transition**

The strongest responses considered a range of conduct risks, including management of potential asymmetries of information and the potential for conflicts of interest, when forming and reviewing their transition plans. Firms should build the relevant mitigating actions to address these risks into their planning.

**Key finding 6: Scenario planning**

Stronger responses used LIBOR discontinuation at the end of 2021 as a base case scenario for the purposes of planning and managing their risks. The PRA and the FCA have indicated that firms should plan based on the likely cessation of LIBOR at the end of 2021.

**Key finding 7: The role of market participants in supporting transition**

Stronger responses demonstrated a good understanding and engagement with transition issues and evidenced an understanding of the impact of LIBOR on their business. Firms that showed an up to date understanding of relevant industry initiatives and the timeline and probability of delivery of proposed industry solutions delivered stronger responses. Firms should engage with the various industry solutions (such as responding to consultation papers from industry group and associations on LIBOR transition). More information can be found on the website of the Working Group on Sterling Risk-Free Reference Rates. Firms should consider the role they can play in driving consensus and establishing market standards but also consider what contingency plans they have in place if these solutions do not materialise.

**Key finding 8: Transacting using new risk free rates and building in fallbacks**

Stronger responses evidence firms considering opportunities to proactively transact RFRs to reduce the risks from LIBOR discontinuation, or otherwise to take steps to incorporate robust fallback language.

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1 The Working Group on Sterling Risk-Free Reference Rates was established in 2015 to implement the Financial Stability Board’s recommendation to develop alternative risk-free rates (RFRs) for use instead of Libor-style reference rates. Further information can be found at https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor.
Further supporting information from responses on each finding

1. Comprehensive identification of reliance on and use of LIBOR

Most firms recognised the need to transition away from LIBOR, as the limited market activity underlying submissions raises concerns for its sustainability. Some responses demonstrated limited understanding of the inherent weaknesses in LIBOR, instead attributing the need to transition solely to historic compliance issues. While most of the responses demonstrated a good understanding of the need to begin to move away from LIBOR and the timelines involved in transition, a small number of responses still presented transition from LIBOR as a choice rather than a necessity.

One of the key findings from responses has been that exposure to LIBOR is to be found not only deeply embedded across firms’ assets and liability structures, but also in a wide range of applications and infrastructure used for valuation, pricing, performance evaluation and risk management. Exposure to benchmarks can also be found in more idiosyncratic parts of firms’ operations (e.g. ancillary contract terms). It is therefore prudent for firms to undertake a thorough stocktake to identify where and how LIBOR is relevant to their business and whether any relevant exposure to other interbank offered rates (IBORs) should be considered.

2. Quantification of LIBOR exposures

Most firms provided the requested summary assessments of LIBOR exposures, and were able to identify net and gross exposures². Firms with the most developed submissions had analysed their exposure across product lines, currencies, counterparty and notional value, and had identified the amount due to mature beyond 2021. Firms took different approaches to considering whether to include exposure to (non-LIBOR) IBORs e.g. EURIBOR, EONIA, TIBOR. Where these were included firms generally used a longer transition period than for LIBOR.

Most firms had to extract exposure information manually, requiring considerable time and effort and indicating varying degrees of robustness in these numbers. The strongest responses included details of how transition plans were developing to allow firms systematically to extract this data set on a regular basis. Robust reporting allowed firms to target resource and monitor if actions were having an impact on the level of LIBOR risk they were continuing to run. It also allowed quantitative targets to be set to demonstrate progress in actively reducing exposure and identify if new LIBOR exposure beyond 2021 was being generated.

The scope of consolidation varied across responses. The strongest responses demonstrated an understanding of both group (consolidated) and entity level exposures as well as where LIBOR was embedded in intragroup facilities or used in shared infrastructure and/or applications.

A number of responses indicated that firms expected LIBOR exposure to increase in the short-term without providing sufficient explanation of how this was consistent with prudent management of the risks and the design principles of the scenarios relevant firms were using.

3. Granularity of transition plans and their governance

There was significant divergence in the governance structures described in firms’ responses, most notably influenced by the scale and type of firm responding e.g. domestic vs. international. However, almost all firms identified appropriate UK Board-level, or equivalent, senior managers to oversee the progress of the LIBOR to RFR transition. The appointment of an appropriate senior manager supported firms in ensuring co-ordination across different stakeholders within a firm ensuring sufficient resource was made available to support transition. The strongest responses provided clarity on the senior manager’s role in transition work, including setting out relevant

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² Exposure is the overall contract value that references LIBOR or other IBOR’s. Firms that have large exposure to LIBOR without adequate fallback plans may face, or cause, greater risks if they do not take steps to transition.
reporting lines and what management information they received to demonstrate effective oversight of transition.

The project plans received were of varying degrees of granularity. Firms with the most developed plans provided specific and detailed timelines built around a base case scenario aligned to the expected cessation of LIBOR by end-2021. These responses incorporated mitigating actions set out in a clear timeline. Additionally, these responses provided details of the key performance indicators of whether work was on track against identified milestones.

Only a small number of responses demonstrated detailed resourcing work had been undertaken to assess the level of support transition work required e.g. identifying and ring-fencing a dedicated team of staff to support transition with allocated budget.

The frequency and seniority with which formal updates were provided also varied across firms. Stronger responses set out the role of each committee involved in the RFR transition with clear escalation paths ensuring regular progress updates were provided to the project’s sponsoring executive and relevant governing committee(s).

4. Identification and management of prudential risks associated with the transition

Firms identified a broad range of potential risks from transition and associated mitigants in the information provided. Stronger responses clearly recognised the risk of LIBOR discontinuation and demonstrated commitment to reducing the risk of a ‘cliff-edge’ at end-2021. These plans showed firms taking opportunities to transfer exposures to new RFRs prior to 2021 (where prudent), having undertaken appropriate internal due diligence/product approval processes and ensured relevant infrastructure and applications were updated. Responses that demonstrated use of management information to prioritise addressing exposures based on agreed measures of risk and/or materiality (e.g. size, complexity, maturity) and set out plans to develop toolkits to track and monitor risks were generally considered to be more comprehensive.

Some assessments focussed disproportionately on the risk to transitioning contracts, with limited consideration of strategic balance sheet risks. The strongest responses provided a full assessment of all risks relevant to the firm’s operations e.g. FX-related risk, basis risk, operational risk, credit risk and liquidity risk.

5. Identification and management of conduct risks associated with the transition

The majority of firms were able to identify conduct risks including those associated with conflicts of interest and market abuse. Firms identified the need for management of potential asymmetries of information when dealing with customers and clients. Looking ahead, some firms also identified needs to protect against conduct risk in contributing to benchmarks, including in potentially less liquid LIBOR markets. To mitigate this, firms discussed introducing targeted controls, for instance enhanced surveillance and awareness training for traders and second line staff.

Strong responses indicated firms are developing and executing comprehensive internal and external communication strategies to promote education on transition amongst key stakeholders and are reviewing their governance procedures to cater for RFR products. Less strong responses lacked recognition of potential conflicts that could, for example, result in clients and third parties being misinformed and/or disadvantaged and did not acknowledge potential risks from market manipulation or insider trading. For instance, some insurers failed to consider the potential customer impacts resulting from the indirect effects of the transition (e.g. the effect on Solvency II surplus or reinsurance treaties); or product specific conduct risks (e.g. how any potential changes in investment strategy or cost allocation resulting from transition might impact insurers’ with-profits customers).

6. Scenario planning

Most firms used a base case scenario of LIBOR cessation at the end of 2021. Due to the deeply embedded nature of LIBOR, most firms recognised the importance of building increasing
momentum on transition before its expected discontinuation. However, a small number of responses based their transition planning on the assumption that incremental extended transition arrangements would materialise for LIBOR and paced their planning assumption and actions on this basis.

7. The role of market participants in supporting transition

Firms’ responses demonstrated a wide range of understanding of, and engagement with, the various initiatives being led by market participants, trade associations and regulators. This included developments in the selection and use of new alternative risk-free rates e.g. SONIA (GBP), SOFR (USD), SARON (CHF), €STR (EUR) and TONA (JPY). The most comprehensive responses showed clear evidence of involvement of a range of staff from across the firm, both in putting together the response to the Dear CEO letter and in involvement in relevant industry initiatives.

Strong responses acknowledged the importance of ensuring that transition programs maintain up to date information on relevant industry initiatives (e.g. International Swaps and Derivatives Association work on derivative fallbacks) as well as the need to understand the timeline and probability of delivery of proposed industry solutions for prudent management of risks around transition. Delaying decisions based on placing reliance on solutions with an uncertain delivery date (e.g. production of a forward-looking term rate), may be imprudent especially where alternative solutions are available.

Many responses flagged the need for market consensus and regulatory intervention as key dependencies inhibiting transition plans. Some firms have therefore adopted a ‘wait and see’ approach. While we recognise some of these dependencies, we would urge firms proactively to consider not just how they engage with these initiatives and the role they have in helping deliver consensus but also what contingency plans they have in place if these solutions do not materialise or where the proposed use case is quite limited.

For insurers, the Solvency II discount curves for major currencies are currently LIBOR-based. We are aware that insurers need clarity about when and how these discount curves will transition to replacement risk-free rates. We understand the challenges this poses to insurers, and we are working constructively with EIOPA and others to address these issues.

8. Transacting using new risk free rates and building in fallbacks

Many of the responses demonstrated that firms had begun proactively to transact alternative RFRs to some extent. This supported progress in reducing exposure to LIBOR and added credibility to forward plans to reduce exposure. A significant number of responses did not provide sufficient detail on plans to support transacting alternatives e.g. plans to update and test systems to execute, price and value new RFRs and the relevant governance process for new products.

A number of firms’ responses placed considerable reliance on the development of ‘market’ solutions to overcome potential barriers to transition e.g. relying on the development of a forward-looking term rate, waiting for market liquidity to build up in new RFR products. It wasn’t always clear that these same firms were actively contributing to the development of these market solutions, for example being willing to commit to provide firm tradeable quotes to support the development of an IOSCO compliant forward-looking term rate, making a market in new RFR derivatives, developing alternative RFR-linked products e.g. SONIA linked loans. The strongest responses demonstrated engagement and commitment to transacting new RFRs that was consistent across a firm’s business and client base.

Where firms are not yet ready to transact RFRs, most indicated they have begun updating fallback language in new LIBOR issuances. Compliance and Legal functions were key members of project teams behind stronger responses. These same firms also showed active understanding of the work of various market participant groups and trade associations regarding fallbacks.

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