IBOR Transition Guide for Asia

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Asia Securities Industry & Finance Markets Association (ASIFMA)

ASIFMA is an independent, regional trade association with over 130 member firms comprising a diverse range of leading financial institutions from both the buy and sell side including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative and competitive Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the US and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

The Asia Pacific Loan Market Association (APLMA)

The Asia Pacific Loan Market Association (APLMA) is a professional (not-for-profit) trade association which represents the interests of institutions active in the syndicated loan markets around Asia-Pacific region. Its primary objective is to promote growth and liquidity in the syndicated loan markets (both primary and secondary), which it endeavours to do by: advocating best market standards and practices; maintaining a suite of highly professional standard documents; engaging with regulators on key matters affecting the markets; organising conferences and knowledge-sharing events in member countries; and providing networking platform for members across the region.

International Capital Market Association (ICMA)

ICMA is the trade association for the international capital market with around 600 member firms from more than 60 countries, including banks, issuers, asset managers, infrastructure providers and law firms. It performs a crucial central role in the market by providing industry-driven standards and recommendations for issuance, trading and settlement in international fixed income and related instruments. ICMA liaises closely with regulatory and governmental authorities, both at the national and supranational level, to help to ensure that financial regulation promotes the efficiency and cost effectiveness of the capital market.

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International Swaps and Derivatives Association (ISDA)

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 75 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

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Introduction

This Paper provides an overview of the key implementation issues to be considered by Financial Institutions (FIs) in Asia preparing for the transition from the London Interbank Offered Rate (LIBOR) in all its tenors and currencies to Alternative Reference Rates (ARRs) by the end of 2021 (LIBOR Transition). Specifically, it includes a practical implementation checklist which FIs may use as a reference.

The objective of this Paper, including the practical implementation checklist, is to assist each FI to take into account issues that are relevant in implementing its individual transition plan. In practice, each FI's LIBOR transition process will differ. FIs should not treat this Paper as comprehensive or as uniformly applicable to each FI's individual circumstances.

LIBOR

LIBOR is currently produced in seven tenors (overnight/spot next, one week, one month, two months, three months, six months and 12 months) across five currencies (USD, Euro, CHF, JPY and GBP). It is based on submissions provided by a panel of 20 banks. These submissions are intended to reflect the interest rate at which banks could borrow money on unsecured terms in wholesale markets. LIBOR is administered by ICE benchmark administration (IBA), which is regulated by the UK's Financial Conduct Authority (FCA).

LIBOR, along with other interest rate benchmarks based on bank borrowing costs around the world (collectively known as IBORs), has served as a fundamental building block in the global financial markets since the 1980s. In some countries, the calculation of the local IBOR uses LIBOR as an input. Consequently, the discontinuance of LIBOR directly impacts the future sustainability of these rates. Other IBOR rates, such as Hong Kong's HIBOR, are calculated independently.

LIBOR is widely used in a variety of loans and financial instruments, including consumer and syndicated loans, structured products, securitisations, short term instruments, bonds such as floating rate notes, over-the-counter derivatives and exchange-traded derivatives, as well as in corporate contracts, accounting, tax, and valuation methods.

The Limitations of LIBOR

The global financial crisis in 2008 exposed several crucial limitations and weaknesses inherent to LIBOR. The key limitations can be summarized as follows:

- **Susceptibility to manipulation –** the LIBOR rate setting system was tainted by rate-rigging scandals where panel bank submissions were alleged to have been inaccurate or manipulated to project market strength and for other proprietary purposes. This led to loss of market trust, criminal prosecution and billions of dollars in fines and settlements paid by panel banks. Following the 2012 Wheatley Review, a number of reforms were introduced aimed at reducing subjective input and making LIBOR a more transaction-based benchmark. IBA became LIBOR's administrator, and the FCA the supervisory authority for IBA.

- **Illiquidity of the underlying market –** notwithstanding the reforms introduced, the number of transactions in the short-term wholesale funding markets have fallen significantly over time, as financial institutions became more reluctant to lend on an unsecured basis for terms longer than overnight. The low volume of transactions increases LIBOR's vulnerability to short-term market illiquidity and amplification of price moves. This represents a potentially serious source of vulnerability and systemic risk. At the same time, banks are reluctant to assume the legal risks associated with submitting quotes based on very shallow markets.

- **Challenge to LIBOR as a 'risk-free' rate** –financial transactions are better suited to reference rates that are closer to risk-free. Identifying and adopting such rates has been one of the key objectives of the global agenda of interest rate benchmark reform.

The End of LIBOR

The reasons noted above ultimately led the FCA to announce in July 2017 that the continued publication of LIBOR could not be guaranteed beyond the end of 2021. To ensure an orderly transition away from LIBOR, the FCA obtained agreement from submitting panel banks to voluntarily continue submissions for LIBOR until the end of 2021.

Working groups in the respective LIBOR jurisdictions have worked to propose and develop ARRs. Additionally, countries with national benchmark rates using LIBOR as an input are evaluating the impacts of the transition and potential alternatives.

The FCA and supervisory authorities across the globe have emphasized the fundamentally "market-led" nature of the initiative, and have continued to encourage financial market participants to make timely preparations for the discontinuation of LIBOR. Furthermore, in a statement on April 29, 2020, the FCA acknowledged the impact of COVID-19, recognizing that the disruption to the markets will inevitably cause focus to move away from LIBOR transition, but reiterated that the final deadline of the transition remains unchanged.

Replacing LIBOR

In order to achieve the FCA's target of replacing LIBOR, ARRs have been identified for each of the five LIBOR currencies.

Alternative Reference Rates

ARRs are interest rates to be used for replacing LIBOR as the primary benchmark measure and benefit from regulatory endorsement. The need for expert judgement is minimised by basing the ARRs on robust underlying transactional data.

LIBOR Replacement ARRs

Currency	Selected Rate	Working Group	Administrator	Type
Pound Sterling, GBP	Sterling Overnight Index Average (SONIA)	Working Group on Sterling Risk-Free Reference Rates	Bank of England (BoE)	Unsecured
US Dollar, USD	Secured Overnight Financing Rate (SOFR)	Alternative Reference Rates Committee (ARRC)	Federal Reserve Bank of New York	Secured
Euro, EUR	Euro Short-Term Rate (€STR)	Working Group on Risk-Free Rates	European Central Bank (ECB)	Unsecured
Swiss Franc, CHF	Swiss Average Rate Overnight (SARON)	National Working Group on CHF Reference Rates	SIX Swiss Exchange	Secured
Japanese Yen, JPY	Tokyo Overnight Average Rate (TONAR)	Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks	Bank of Japan (BoJ)	Unsecured

Strengths of ARRs

- **Increased robustness –** all of the selected ARRs are overnight rates, based on actual transactions in a liquid underlying market. This is considered to be more robust and less prone to manipulation, given the volume of observable data, and eliminates the need to determine rates using expert judgement. Financial instruments that reference these rates rarely reference the overnight rate itself, but instead typically reference a backward looking compounded average of the overnight rates published during the relevant period.
- **Elimination of credit risk –** ARRs eliminate the element of credit risk inherent in LIBOR and allow market participants to take or hedge risk related to monetary policy rates without unintentionally introducing a variable credit component.

Key considerations associated with transition to ARRs

New products

- **Term structure –** LIBOR is forward-looking in nature, and published in seven tenors, whereas ARRs are currently only available as overnight rates. While ARRs compounded in arrears are expected to be the primary vehicle for replacing LIBOR, it is possible that in some jurisdictions forward-looking term rates derived from transactions referencing the ARRs ('forward looking term rates') may be developed. It is anticipated that the use of forward looking term rates will be limited and regulators have urged market participants not to delay transition in the hope that forward looking term rates will be available to them.

- **Risk premium** – LIBOR includes an element reflective of the funding costs of banks, which is not present in ARRs, thus for existing products to fall back to replacement rates, a spread adjustment must also be considered. If these existing transactions are voluntarily amended, counterparties could use a spread adjustment or a one-time negotiated amount. International Swaps and Derivatives Association (ISDA) has produced a methodology (the ISDA Methodology) for a spread adjustment in derivatives fallbacks (although, importantly, this spread adjustment is only meant for fallbacks in derivatives and must be considered separately by the relevant parties for use in other products and for use in any voluntary transition efforts).[1] The Alternative Reference Rates Committee (ARRC) in the US and the Working Group on Sterling Risk-Free Reference Rates in the UK have also carried out market-wide consultations on the appropriate spread adjustment for bond fallbacks, the results of which align with the new ISDA Methodology.

Fallback language in new IBOR contracts

- **Fallback language** – While FIs should be making every effort to reduce the number of new contracts issued that extend beyond the end of 2021 and reference LIBOR, to the extent there are such new contracts referencing LIBOR, FIs will need to include amended fallback terms or alternative provisions that take into consideration the permanent cessation of the referenced rate. Fallbacks may differ across different financial product types and asset classes. Therefore, there may be a potential mismatch in product replacement rates across portfolios. Appropriate fallback language is being developed by working groups and industry bodies such as ISDA, and Asia Pacific Loan Market Association (APLMA) and is already market standard in the international bond market.

Legacy products

- FIs will need to consider carefully how to transition legacy LIBOR products to ARRs. Some practical considerations are set out in the practical implementation checklist below.

Other considerations

- **Market factors –** Sufficient market volume and liquidity in ARR-based instruments are required for a successful transition. ARRs are used increasingly across all markets: the issuance of new, public, sterling LIBOR floating rate notes with a maturity beyond the end of 2021 has all but ceased, and the FCA and BoE have encouraged firms to make SONIA the primary interest rate benchmark in sterling markets. However, the pace and schedule of the transition, as well as rate of market adoption is different for different jurisdictions and also varies by asset class.

- **Accounting / tax / IT infrastructure considerations –** There may also be accounting, tax and infrastructure considerations associated with transitioning to ARRs, which FIs will need to consider.

[1] More information about the consultations that resulted in this spread adjustment and its methodology are available in Sections 2 and 3 of the Benchmark Hub on ISDA's website, available at https://www.isda.org/2020/05/11/benchmark-reform-and-transition-from-libor/.

Consequences for other IBORs

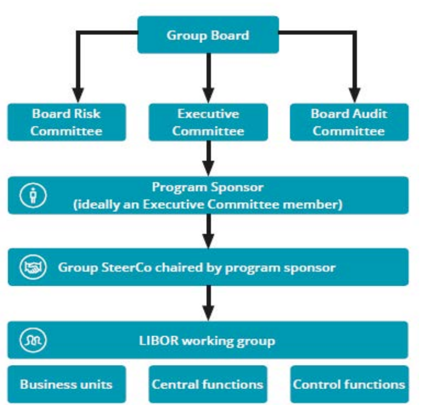
A number of key Asian benchmarks are synthetic benchmarks derived by applying a forward FX curve to the USD LIBOR curve. When USD LIBOR is no longer available after the end of 2021, the sustainability of these benchmarks is in doubt.

Key benchmarks are: **SOR** (Singapore); **THBFIX** (Thailand); **MIFOR** (India) and **PHIREF** (Philippines).

Planning for the cessation of LIBOR is underway by the respective administrators of these benchmarks. Some have replacement rates for new transactions identified and transition timelines in place (**SOR** and **THBFIX**), whereas others are yet to identify the replacement rates. As a result, any organization planning for the cessation of LIBOR should also consider its exposure to any of these four affected IBORs.

Practical Implementation Checklist

Drawing upon a combination of practical experience from organizations that have initiated transition programs, as well as emerging guidance from the regulatory community, FIs can make reference to the following key considerations when performing their own assessment of the impact from benchmark rate reforms:

Steps	Key Considerations
1.Program Governance	• Appoint senior executives to direct the overall IBOR Transition Program. • Establish a governance framework over impacted business lines and functions. • Identify key stakeholders, project leaders and supporting staff to oversee and execute the transition. • Create an IBOR working group to monitor market and regulatory developments, assist senior executives to implement the IBOR transition program and provide regular internal communications to all relevant stakeholders. *IBOR Transition Program Governance Structure (For illustration purposes only)*
2.Transition Management Program	• Conduct a comprehensive impact assessment across key focus areas such as financial products, contracts, business process (including IT systems and valuation models). • Identify resources and budget needs to implement the transition program, including the assistance of external consultants, if required. • Establish a project management framework to monitor, amongst others, resources, budgets, progress of the IBOR transition program, and risks. • Consider time and resources needed to make operational changes and communicate with relevant internal stakeholders.
3.Communication Strategy	• Establish clear communication strategy to be used both internally and externally with counterparties, product issuers, regulators and industry bodies. • Develop communication materials such as learning materials, and newsletters for internal stakeholders, and provide training programs to all relevant staff.

	• Develop client communications and disclosures with input from legal, compliance and if needed, external advisors. • Provide clear messaging on transition to impacts to clients and investors.
4. Identify and Validate Exposures	• Conduct a product exposure analysis to determine all IBOR-linked products for each line of business. • Continuous monitoring of the approach for tracking these IBOR-linked products throughout the transition period. • Quantify exposures for IBOR-linked products maturing beyond year end 2021.
5.Develop Product Strategy	• Establish a clear strategy and timeline for reducing reliance on IBOR for new product issuance. • Define timelines for offering new ARR-linked products. • Define risks and new product approval requirements based on new ARRs.
6.Risk Management	• Identify key risks resulting from IBOR discontinuation including market readiness, business impacts, financial and legal risks. Key financial risks include accounting treatment and valuation. • Establish processes to measure and monitor these material risks. • Identify mitigating actions to all identified risks especially around product, operational and conduct risk. • Provide periodic update to senior management. • Update risk management framework accordingly.
7. Transition of Existing Contracts and New Contracts	• Identify all IBOR related contracts that extend beyond the end of 2021. FIs should begin referencing ARRs when entering into new contracts, as far as practicable. • For existing contracts with no fallback language or with fallback language that does not contemplate the expected permanent discontinuation of LIBOR, either begin to a) amend these contracts to incorporate appropriate fallback language or transition them directly to an ARR; or b) determine if these contracts can be renegotiated, terminated or closed out prior to the end of 2021. • For new contracts that reference affected IBORs, make every effort to incorporate alternative fallback language catering for the permanent cessation of the IBOR. • Assuming a material number of contracts do not have suitable replacement fallback language, determine size and program needed to implement fallback language as written, and begin

	planning for implementation. This should include customer notification processes. • Consider the conduct risks referred to in the section "Conduct Risk" below when amending existing client contracts.
8.Operational and Technology Readiness	• Assess where IBOR is used front-to-back across all affected business and operations. • Develop a process to incorporate new market data sources and new calculation methodologies into IT system. • Build testing plans for new product capabilities, models/validation. Ensure readiness plan will have oversight of the readiness state of material operation and technology vendors. • Begin to plan for internal testing, third party validation /readiness for transition.
9.Accounting and reporting	• Identify instruments that might be affected by accounting issues. • Identify impact on fair value accounting and impairment to profit & loss, credit allowances, and fair value hierarchy. • Identify impact and changes need to be made to current finance systems, operations, and control environment. • Update financial disclosures accordingly.
10.Taxation	• Identify and understand tax implication based on current guidance update tax documentation if needed. • Determine tax reporting requirements and consider jurisdiction affected. • Review the nature of amendments to existing contracts and review intra-group arrangements (if any).

Key Questions to Consider in LIBOR Transition

Exposure to LIBOR

- What is the FI's exposure to contracts that are linked to LIBOR?
- Can the identification and quantification of this exposure be rerun regularly and easily?
- What level of detail can be gathered?

Differences between LIBOR and ARRs

- Is the FI following progress of official sector and official ARR working group considerations on how to address the economic impact of maturity differences between LIBOR (as a forward-looking term rate) and ARRs (as overnight rates that are typically traded based on a backward looking compounded in arrears calculation)?
- Is the FI following progress of trade association and official ARR working group considerations on how to address the economic impact of differences in risk components between LIBOR (which captures a certain level of credit risks) and ARRs (which are largely considered "risk-free")?

Legal & Contractual Implications

- How many contracts that are linked to LIBOR will mature beyond the end of 2021?
- How many different product types are there (e.g. loans, bonds and derivatives)?
- Are there any interdependent products (e.g. loans with linked derivative transactions)?
- Where are they retained and in what form?
- Who are the counterparties to those contracts?
- What law are those contracts governed by?
- How can those contracts be amended?

Operations & Technology

- How many systems use LIBOR?
- Do these systems need to be changed, or can they be overlaid to accommodate ARR mechanics?
- How long will it take to build and test and/or overlay these systems?
- How do these systems link into each other?

Internal Training and Client Communications

- Which internal teams should be trained on LIBOR transition?
- How will the internal teams be kept up-to-date on developments in relation to LIBOR transition?
- Who do you need to contact regarding LIBOR transition queries?
- Which internal teams will be responsible for internal training and client communication?
- What information will be provided to customers, when and who has to agree the key messaging?

- How do you train all key staff to handle internal and external queries to ensure consistency in response?

Conduct Risk

- How do you make sure you treat all customers equitably, honestly and fairly during the LIBOR transition?
- How do you ensure consistency in the treatment of different clients and different types of clients?
- How will these risks be monitored, and how will these risks be mitigated?

Consequences of Inaction

The following are a selection of the potential consequences that may arise if participants do not prepare for the transition away from LIBOR.

- Operational implications of being unable to book new rates when approached by clients to transition existing contracts
- Conduct and legal risk of continuing to sell LIBOR linked products to clients
- Uncertainty over payment obligations and even legal status of LIBOR-linked contracts
- Issues with hedge effectiveness should the organization not be ready to transition its hedging relationships
- Financial models and forecasts still based on a rate that no longer exists
- Floating rate notes potentially converting to fixed as traditional fallbacks do not envisage the permanent unavailability of a LIBOR rate
- Potential regulatory action designed to accelerate transition (capital charges linked to LIBOR exposure etc.)
- Competitive disadvantage as the institution is unable to offer new products to customers

Key Resources for Reference

- **Financial Conduct Authority:** *Conduct risk during LIBOR Transition – Questions and answers for firms about conduct risk during LIBOR transition*
- **Alternative Reference Rates Committee:** *Practical Implementation Checklist for SOFR Adoption*
- **Alternative Reference Rates Committee:** *Buy-Side/Asset Owner Checklist*
- **Alternative Reference Rates Committee:** *Recommended Best Practices for Completing the Transition from LIBOR*
- **The Working Group on Euro Risk-Free Rates:** *Checklist on the transition from EONIA to the €STR*
- **The National Working Group on Swiss Franc Reference Rates:** *Checklist: Operational Readiness*

Other relevant websites include:

- https://www.newyorkfed.org/arrc/index.html
- https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html
- https://www.snb.ch/en/ifor/finmkt/fnmkt_benchm/id/finmkt_reformrates
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