Extinction of LIBOR – Is the Australian Financial industry ready for the “big switch”?

Executive Summary

On 09th May, 2019, the Australian Securities and Investments Commission (ASIC), sought inputs from the financial market players to take stock of their readiness in incorporating replacement benchmark of LIBOR (London Interbank Offered Rate). It is estimated that LIBOR as global interest rate benchmarks are still embedded in contracts worldwide to the tune of hundreds of trillions of US Dollars. Major players that rely upon LIBOR are Banks, Asset Managers, Insurers as well as corporates around the world. The financial instruments that underpin it as underlying reference are mortgages, bonds, corporate loans and derivatives.

While volume is just one aspect, the complexity in steering away from LIBOR also lies in the fact that the benchmark, being only an underlying reference rate, makes it harder to assess with certainty the aggregated sums to which a firm is exposed to it. Although, transitions from LIBOR to transaction-based alternative reference rates have already started picking up pace in recent years, experts have expressed concerns about complete preparedness of the market, when the sun sets on the usage of the benchmark rate with the end of 2021.

In this paper, we will dive deeper into the underlying reasons that provoked the need for alternate benchmarks as well as the cause and effects of LIBOR replacement on Australian Financial Industry and how the replacement can be best carried out with minimal impact on business continuity & sustainability.

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The Ubiquitous LIBOR

It goes without saying that LIBOR by far is the world's most important interest rate benchmark and even slightest of out of ordinary rate movement can cause millions of dollars' worth of losses for the party placed on the wrong end of the movement. LIBOR has far reaching effects than usually realised as it not only impacts big players but also the end consumers (including individuals) who purchase credit products with LIBOR anchored as reference rate.

The Scandalous LIBOR

However crucial LIBOR may be, the rate took massive flak when allegations of the rate rigging turned out to be true and it was found that the panel banks tasked to set it, were involved in fixing the same for their own benefits thus causing substantial losses to their counterparts. Till date, penalties in the range of USD 10 Billion have been imposed on a number of banks found guilty of the charges.

The very process of setting up LIBOR has been questioned by many experts as the process largely hands over autonomy to the chosen few bankers (called LIBOR Panel) to set up the inter-bank lending rate leaving plenty of room for manipulation to catapult panel members to favorable positions.

It has been widely believed that during the stressed period of 2008-09, the bankers produced synthetically low LIBOR which allegedly had implicit support from the regulators and was solely done to manage market perception that was increasingly turning negative in the anticipation of depression like situation from 1930s.

Wall Street Journal in its publication dated back in 2008 amidst the global financial crisis stated that the banks have been reporting significantly lower borrowing costs for the LIBOR than what the other market measures suggest they must be. Some investigations have even suggested that the practice of fixing LIBOR higher or lower than actual to benefit a chosen few has been going on for decades ever since the widespread acceptance of LIBOR in mid-1980s.

The Reforms & Demise of LIBOR

The steps to reform LIBOR were initiated much before the Britain's FCA (Financial Conduct Authority) eventually decided to close the curtain on the rate with the year ending 2021.

In 2012, following the multitude of LIBOR scandals that rocked the world, the British Bankers' Association (BBA) proposed to transfer oversight of LIBOR to the UK regulators. As a result, FCA in 2013, took charge as supervisory authority of LIBOR and appointed the independent UK subsidiary of

ICE[1] as the Benchmark Administration (IBA). The LIBOR was henceforth renamed as ICE LIBOR from BBA LIBOR.

With the change in administration, many LIBOR reforms were introduced including derivation of submitted reference rates from actual transactions and setting up of oversight committee to challenge & question the benchmark setting. From July 2013, instead of publishing 150 rates comprising 10 currencies and 15 maturities, the LIBOR rate setting was slashed down to 35 (5x7) covering 5 [2] currencies and 7[3]maturities.

Despite the measures carried out to infuse transparency and restore faith in the process of benchmark setting, the eventual decision to pull the plug on LIBOR came in July 2017 when FCA announced that starting 2022, it would no longer monitor or seek submission of LIBOR rates from the panel banks and therefore, market participants must prepare for alternate reference rates for the purpose thereof.

Why Replace LIBOR

Contrary to the widely held notion that LIBOR has been extinguished due to irreparable damage to its credibility resulting from the unearthed scandals; the actual reasons stated by FCA points at the rapidly diminishing reliance on the benchmark for the purpose of unsecured inter-bank lending. While the rates as reference were ubiquitously underpinned in lending and derivative instruments across the globe, the actual unsecured wholesale lending contracts among banks (on the basis of which LIBOR are set) were constantly dwindling down in number at an unprecedented pace.

FCA has been witnessing the disappearance of such deals from the market to the extent that it was getting harder for the panel banks to provide their estimate off the back of such low volume of transactions without adding a pinch of their own expert judgment to brew the final LIBOR.

Such estimated benchmarks inherently carried the risk of diversions from the actual rates especially when the markets did not offer enough contracts to cross-validate the accuracy of the benchmark. Therefore, sustainability of such benchmark in the absence of the required volumes of underlying transactions had put a question mark on its relevance as well as longevity. And hence, FCA eventually decided to pull the plug on LIBOR and thereby, directed market participants to gear up for a change involving setting up of alternative reference rates.

Note that the FCA's decision does not stop the banks from submitting the rates but the relevance of the act hardly justifies the effort

[1] A US based exchange operator - Intercontinental Exchange (ICE)

[2] US dollar, Euro, British pound sterling, Japanese yen, Swiss franc

3 Overnight, 1 week, 1 month, 2 months, 3 months, 6 months 12 months

since the rates would no longer qualify as regulator supported authoritative benchmark for inter-bank lending.

It is also worth noting that most of the contracts with underpinned LIBOR are of shorter format i.e. one year or less and therefore, will wind-up well before the deadline of 2021 arrives. This is also the reason why short-term contracts underpinning LIBOR haven't really seen much dips in volume since the announcement of the benchmark discontinuation.

What Replaces LIBOR

Dropping LIBOR is only the beginning of a challenge akin to the Y2K scare that the financial industry withstood with the dawn of 21st century. The next half of the challenge is expected to hit both the industry players as well as the regulators. While the market participants have a gigantic task ahead to ensure a swift yet smooth transition to alternative rate, the regulators however, have an even more difficult job at hand to come up with a risk-free benchmark that not only carries the LIBOR-like traits but also fares better in the areas where the benchmark was found inadequate.

Regulators therefore, took it upon themselves to come up with the alternative risk-free rate that:

1. *Is derived off the back of substantial and exceedingly more active market than term LIBOR*
2. *Is derived out of transparent setting and does not put the onus of rate setting upon a handful of industry players*
3. *Not reliant on expert judgement*
4. *Not susceptible to manipulation*
5. *Last but not the least, complies with international interest rate benchmark standards[4].*

Before the FCA's decision was publicly announced in July 2017, regulators across the globe had already started working on the alternate reference rates. In April, 2017, the Risk Free Rate Working Group in UK, proposed SONIA (Sterling Overnight Index Average) as the alternative benchmark.

Although, SONIA has been around since 1997, yet, the benchmark was reformed in the wake of its elevation as the new risk-free rate benchmark to enable sterling financial markets

[4] International Organisation of Securities Commissions (IOSCO)

and has since saw multifold increase in the number of contracts that underpin SONIA as the benchmark rate. The average daily base for SONIA has been estimated to be around £40 Billion and the rate is used to value around £30 trillion of assets each year. Currently, infrastructure has been enhanced to improve the operational capability for SONIA-referencing FRNs, loans and other instruments. The Term SONIA Reference Rates (TSSRs) have also been tentatively planned to come into regular publication practice towards the end of 2019.

The US had also initiated its pursuit of an alternative reference rate even before the news of LIBOR broke-out in open. The Federal Reserve opted for SOFR (Secured Overnight Financing Rate) as its benchmark rate upon the recommendation of ARRC (Alternative Reference Rates Committee), a group of market participants convened by the regulator. The SOFR thus came to life in April 2018 and is derived from an estimated $1.1 Trillion of transactions every day, majorly comprising treasury repos.

In Eurozone, apart from the ongoing preparation to move away from Euro-LIBOR, the European Money Markets Institute (EMMI) announced in Feb 2017 that it will no longer pursue a thorough review of EONIA, the 'Euro Overnight Index Average' and will instead introduce a replacement benchmark rate: €STR (Euro Short-Term Rate). €STR will be published first in October, 2019 before coming into full force to replace EONIA on 01st Jan, 2022 – a deadline pushed back by 2 years on industry's request. Similarly, the LIBOR equivalent version, EURIBOR (Euro Interbank Offered Rate) has also been reformed to meet the regulatory requirements of BMR, the EU Benchmarks Regulation (BMR) framework that ensures the accuracy and integrity of indices used as benchmarks in financial instruments and financial contracts. However, considering the sheer volume of contracts anchored on EURIBOR, it remains to be seen what happens to the legacy contracts when the deadline of compliance arrives in Jan 2020 and the parties are yet to conform to the stringent requirements laid down by BMR.

Among other major countries, Switzerland has successfully replaced its legacy overnight rate (TOIS) with SARON (Swiss Average Rate Overnight) whereas Japan is also working towards retaining and reforming its own alternative of LIBOR-overnight called TONAR (Tokyo Overnight Average Rate).

The Australian Story

Amidst an array of scandals that hit LIBOR and raised suspicions about the credibility of rates set by panel banks, Australia, for what would be considered a 'blessing in hindsight', was the first major nation to steer away from panel based rate setting mechanism to benchmark discovery off the back of actual transactions.

As a result, the Australian IBOR, BBSW (Bank Bill Swap) panel for term rate setting was dismantled in 2013 after voluntary exit of some major banks. The then BBSW administrator, AFMA (Australian Financial Markets Association) was tasked to arrive at BBSW rate discovery process based on market activities. Since its introduction, BBSW has been further reformed from a NBBO (National Best Bid and Offer) based term rate to the rate derived from VWAP (Volume-Weighted Average Price) of bank bill transactions.

The new methodology is supported by ample transactions taking place in the Australian market and employs robust waterfall rates derivation process in which lack of sufficient underlying transaction for VWAP gives way to the NBBO rates discovery mechanism and in situation where NBBO also falls short; the deployed algorithms (as last resort) are utilised to eventually produce BBSW rate.

BBSW has been estimated to be referenced in contracts with a notional value of around A$18 trillion, including derivatives, loans and securities. BBSW also saw change in its administrator from AFMA to ASX (Australian Stock Exchange) in 2017.

Another rate that is deeply rooted in Australian financial market and is also the one that supplements BBSW is Cash Rate. The risk-free rate for Australian dollar, administered by the RBA (Reserve Bank of Australia) and calculated as the weighted average interest rate on unsecured overnight loans between banks.

Over last several years, substantial efforts have been put into making the infrastructure robust for both BBSW as well as Cash Rate and the Australian regulators have time and again reiterated that BBSW (as term rate) and Cash Rate (as overnight unsecured lending rate) can and will continue to co-exist as Interest Rate Benchmarks for the Australian dollar.

Therefore, the efficient functioning of Australian Financial market linked to both these benchmarks has the ability to become preferred choice of fallback rate for the contracts underpinning LIBOR and have expiry beyond 2021. However, there lies multiple challenges ahead for the financial industry to switch from LIBOR to other reference rates.

Replacing LIBOR – The challenges

The mystery of Risk Mark-up

Notionally, LIBOR represents the rate at which banks can borrow unsecured sums from each other for the tenor ranging from overnight to a maximum of an year. Note that no IBOR ever represents risk-free rate, instead it incorporates the element of credit risk that lender will carry against the borrowing bank (or any other entity) and hence, any alternative reference rate to replace LIBOR must be able to produce a rate that represents risk-free rate plus the (credit) risk spread.

Such setting of IBOR guarantees spike in rates if the banking industry faces turbulent times and nobody wants to lend to banks and therefore, one of the glaring issues with LIBOR setting identified during the GFC were the lower levels of published rates by the panel banks even though the perceived risk associated with lending to banks was at a much higher level.

Experts thus questioned the basis for such artificially low IBOR in the face of increased difficulties for banks to borrow from the market.

Therefore, one of the challenges that regulators are facing is to be able to infuse adequate confidence in their alternative interest setting surrounding the mark-up to be added on the provided risk-free reference rates. Risk-free reference rates have been freely available in the market (for instance, treasury or cash rates) but the indicator of mark-ups can only be derived and the only way to derive the mark-up accurately is to base it upon the actual transactions and allow the market forces to discover correct levels of risk rate to be added to the risk-free rate.

One of the benefits that the formal introduction of risk-free reference rates serves is the readily available rates for derivatives which used to underpin LIBOR which by very setting is always quoted higher than the actual risk-free rate.

The Fall-Back Provisioning

Another major challenge which can easily be considered as the next stage after successful discovery of mark-up is the seamless porting of existing LIBOR anchored contracts into the ones underpinning the alternative reference rates.

Generally speaking, such contracts do include fallback provision in the event that the benchmark LIBOR is not available due to some temporary glitch; however, none of the contracts at the time of writing envisaged the situation where LIBOR cease to exist for good!

Regulators across the globe alongside market facilitators, such as ISDA (International Swaps and Derivatives Association), are therefore, working towards introducing standard fallback

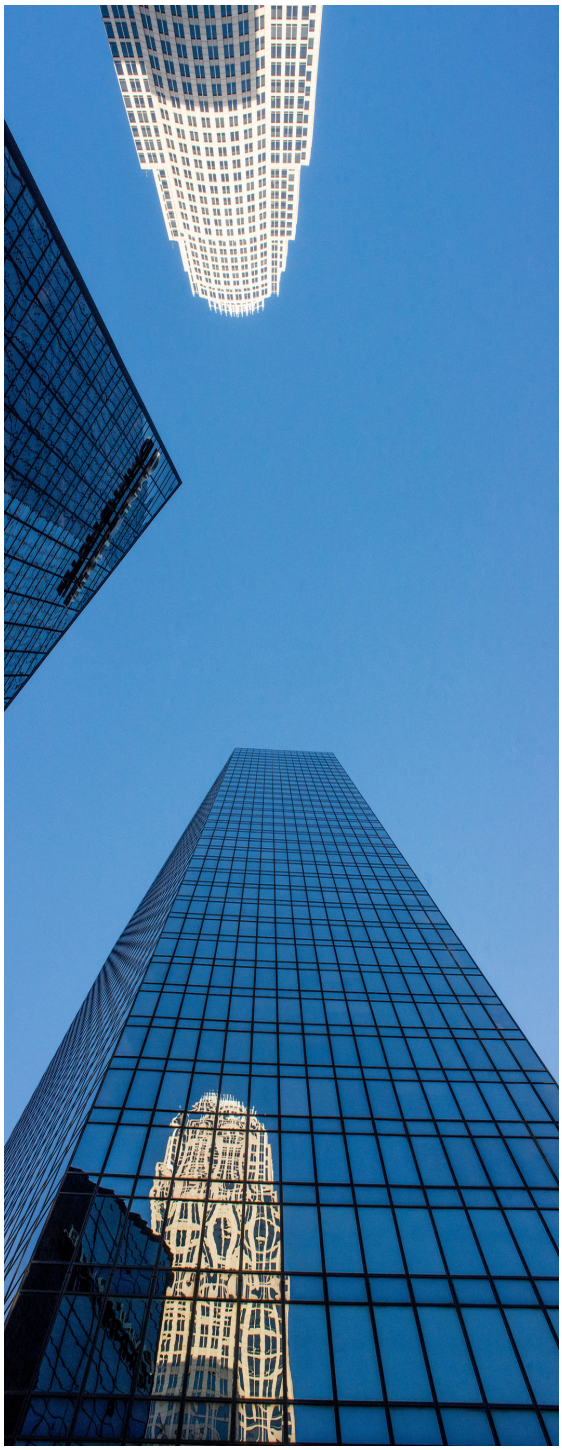
provisioning language that the market players can readily embed in the contracts scheduled to expire beyond 2021.

While, updating fallback clause seems to be a straight-forward solution yet its implementation can stretch well beyond the deadline of 2021 because of the sheer number of contracts (ranging in millions) requiring updates thus demanding banks to fight on multiple fronts including logistics, resources and infrastructure challenges . Especially the contracts between banks and millions of retail customers who will be looking for an opportunity to strike a better deal with the lenders and in the process may eventually put the banks at disadvantageous levels.

Consider the case of mortgages in the US where the maturity of contracts anchoring LIBOR lie as far as 30 years ahead in future and most of the consumers of such contracts are individuals who would be looking to renegotiate their contracts with the lenders and in the process, would expect better rates than ongoing LIBOR (because SOFR has traditionally been lower than LIBOR) thus, making lenders being the sole losers in the newly negotiated contract.

Such contract amendments may also attract peripheral issues involving tarnished image for the banks and even potential chances of litigation in the event of borrowers feeling wronged as a result of change in underlying benchmark.

Needless to say, time is of essence for the banks who have to amend huge volumes of contracts and therefore, must have a plan in place to finish up the job before LIBOR becomes history.



Challenges for Australian Players

While the Australian financial firms may not have challenges of sorts that includes amending retail contracts, the industry, nonetheless, is still heavily exposed to the LIBOR demise.

One of the major difficulties that the Australian financial industry could face is the issuance of funding instruments linked to the alternate risk-free reference rates and also hedging their positions with the help of derivatives underpinning the same reference rates.

The other major obstacle surrounds cross-currency interest rate swaps that have been the preferred hedging tool for Australian firms while usually embedding IBOR/BBSW as underlying references. Switching over to alternative rates/BBSW will certainly require multitude of hurdles to be overcome such as:

a. *estimating accurate & adequate hedging position,*
b. *re-negotiation of existing contracts,*
c. *incorporating changes in existing data models that take IBOR as input variable,*
d. *upgradation of data systems & underlying infrastructure and;*
e. *potential implications on accounting & taxation regime.*

Maneuvering the LIBOR Replacement Program

Like any regulatory driven initiatives, time is the key for successful implementation and LIBOR replacement is no different except for the fact that the process shall heavily rely upon handshakes with multiple external entities, depending upon the level of LIBOR exposure that a firm carries.

It is this atypical nature of the reform requiring interaction at all levels with the counterparts that makes the reform unique and challenging at the same time. Even the best of strategy may fail to deliver if the initiatives are not kicked off with ample time in hand to steer clear the impediments thrown in way of successful migration.

To track the progress of major banks and insurance firms on the transition, many regulators have sought for them to centralize the process by setting up steering committee that will be responsible for tracking and enabling the LIBOR replacement and be directly governed by the board of directors. As per UK Senior Managers and Certification Regime (SM&CR), FCA has asked for the larger banks and insurance firms to appoint senior manager bearing accountability for the successful transition before 2021.

In Australia, the Council of Financial Regulators (CFR), which includes the Reserve Bank of Australia (RBA), the Australian Securities and

Investments Commission (ASIC), the Australian Prudential Regulation Authority (APRA) have at multiple forums expressed their trust in the domestic rates benchmark system and also advised the regulated entities to start working towards smooth transition from LIBOR to Alternative risk-free rates.

ASIC in its letter to the industry dated 9th May 2019, did not explicitly ask for specialized onboarding for overseeing the process; however, if necessary, the benchmark regulator can formally enforce the transition process especially with the newly found enforcement powers it wields as a result of the introduction of BEAR (Banking Executive Accountability Regime). Nonetheless, ASIC has revealed that it is in direct touch with some of the majorly LIBOR exposed entities of Australia to oversee their progress of transition.

ASIC also made it clear that it expects the LIBOR exposed entities to have conducted their own risk assessment in terms of the potential impact that the replacement project can induce from all possible directions.

LIBOR Replacement – The Solution Pack for Australian Players

One of the advantages that Australian market enjoys is the timely removal of dependency on LIBOR from local market and in the process, building of robust infrastructure that continues to supply dependable reference rates to the industry. Yet, there is still room for substantial progress for certain financial majors before they confidently ease into the post LIBOR era after two years.

Here are some of the strategic steps that LIBOR exposed entities can take to ensure smooth transition with minimal hiccups:

Start at the top

LIBOR replacement analogous to any organization-wide change management initiative requires guidance and goal setting to be carried out right at the top. The Board of Directors therefore, must lead the change initiative from front by forming a steering committee that feeds back the updates on a regular basis and also remains responsible for timely overcoming of obstacles in the way. It is also advisable for the committee to be chaired by a board member such as CRO or CFO. The steering committee may further delegate its responsibilities to one or more core working groups depending upon the size and levels of exposure of the firm.

Know Your Exposure - KYE

LIBOR as a reference benchmark is deeply rooted in various kinds of credit as well as money market instruments including hedged positions; thus making it imperative for an organization to arrive at total LIBOR based notionals that it is exposed to and be able to segregate it further on the basis of instrument type, maturity, counterparty type and ideal alternative benchmark.

The exercise serves multifold benefits: it would not only help identify the sponsors within the firm who should be taking actions towards ensuring smooth transition but also go a long way in clearly defining & segregating responsibilities of impacted business all the way down to individual levels.

LIBOR Switch - Fixed or Floating

While most of the Australian entities may not be directly impacted with retail exposure towards LIBOR, yet, there can be instances where credit products requiring re-negotiation of reference rates leads to potential risk of losing customer who may not take the change so kindly.

Therefore, the lenders not only run the risk of reputational damage but also the potential decrease in business and/or profitability in the newly incorporated interest rate regime. The

management must therefore be able to provide multi-dimensional instructions to its workforce on whether they would offer alternative reference rates as fixed or floating. And in case of floating, what would be the offered markup?

For non-credit based products, the official rewording instructions of fallback provision would certainly help in standardizing the proceedings. It would also aid in reducing the element of negotiation to minimal levels in most of the contracts. However, credit products such as bonds and mortgages that are directly linked to LIBOR may see substantial back and forth before alternative risk-free references can be agreed upon therefore, allowing longer duration for the process will certainly help firms reach an agreement with lesser pressure to finalise the new rates in a rush.

Enabling Infrastructure

The impact of LIBOR replacement on both business as well as technology must be assessed in totality. The CTO must be on-board with steering committee to pledge IT support in enabling infrastructure to support timely transition.

The implications of LIBOR replacement are widespread and touch multiple areas such as data models, systems and related infrastructure. Many such areas would require close coordination among business, technology and operations to ensure success of the program.

Communication is the Key

It is the responsibility of steering committee to drive awareness program for both internal as well as external stakeholders.

Internally, the business facing workforce must be provided with adequate guidelines and knowledge to confidently steer the negotiation talks while making clear the boundaries of acceptable changes in the contract. Some counterparties may take this as an opportunity to negotiate other terms of contract at the same time and therefore, ringfencing the scope of conversations and amendments in contracts must be clearly set out without any scope of misinterpretation. It is also important that the legal as well as finance department is kept in the loop to avoid any potential judiciary or taxation pitfalls.

The awareness program must be extended beyond the walls of the firm and the regulated entities may consider holding roadshows in communicating the cause and effects of LIBOR replacement thus setting the right expectations in smooth transition.

Conclusion

1. With the year ending 2021, the LIBOR as interest benchmark will no longer be backed by the current regulator FCA.
2. Banks are still free to keep providing their panel rates however, the same will not be considered official and therefore, their acceptance by industry players is highly unlikely.
3. Regulators around the globe have started (working towards) introducing their alternative risk-free reference rates comprising both overnight as well as term rates.
4. Australia has since worked towards upgrading its infrastructure to promote BBSW as the benchmark term rate whereas Cash Rate as the overnight lending rate.
5. While BBSW enjoys ample liquidity for derivation, challenges lie ahead for industry players that are still heavily exposed to LIBOR due to their international operations.
6. ASIC has reached out to Australian regulated entities seeking update on their LIBOR replacement readiness plans and progress.
7. The financial watchdog is directly taking stock of the transition program of some of the impacted entities.
8. Replacing LIBOR consists of multiple challenges such as amending the legacy contracts lasting beyond 2021, agreeing upon alternative reference rates, successfully upgrading infrastructure to accommodate the massive changes, covering the change in accounting, taxation & legalities involved and lastly, effective usage of Alternative Rate/BBSW swap contracts for interest rate hedging pby the Australian entities.
9. Firms running substantial exposure to LIBOR would require a full blown transition program to meet the deadline of 2021.
10. It is imperative that the transition be initiated and looked after by top management by assigning the implementation responsibilities to the dedicated steering committee and/or working groups.
11. Technology and business must work together to manage expectation of both internal as well as external stakeholders.

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