IBOR Transformation update

Member Updates

AFMA’s IBOR Transformation Work Group meets regularly and is engaging with the authorities on key strategic issues affecting the Australian market. The following reports give a sense of the sweep of issues that are being considered and pursued with the official sector.

Official Messages to the Market

Recently, the Reserve Bank of Australia has made statements and held an international panel event to communicate the importance of the transition away from LIBOR and its effects on the market.

International perspectives

In mid-May the RBA held a high level international session about the end of LIBOR and the impact on Australian financial markets, with Andrew Bailey (CEO, UK Financial Conduct Authority (FCA)) and Christopher Giancarlo (Chairman, US Commodity Futures Trading Commission). This provided a first-hand opportunity to hear from Bailey, the man who started the ball rolling on LIBOR transition. After covering the well known reasons for the transition he provided an official view on the current situation. He said that there is substantial consensus that the largest part of the market currently relying on LIBOR – that is the bulk of interest rate derivatives – does not need term rates. This part of the market is focused on hedging the general level of interest rates rather than term bank credit risk. It is already able to operate from a risk management perspective with the overnight risk-free rates, compounded where appropriate.

Because term rates are not needed for the bulk of the derivatives market, and because the overnight, Risk Free Rates (RFRs) are likely to be the most robust interest rate benchmarks available – since they are firmly grounded in transactions – he expects that liquidity in interest rate derivative markets will in future be OIS-based, i.e. directly linked to the overnight RFRs.

Bailey thought it is probable that with future liquidity in swaps and futures centred on these overnight RFRs, so that spreads are tightest and hedges cheapest in these RFR-based derivatives, there will be powerful incentives for other instruments, including bonds and securitisations, also to reference the overnight RFRs. On the other hand, he is also aware of the demand in cash markets for forward-looking term rates, perhaps especially in respect of smaller and medium-sized issuers, and in syndicated loan markets, where parties may decide that knowing coupon or interest payments in advance is more important to them than a few basis points in spread. So he also voiced support for the development of forward-looking term rates derived from the RFRs.

He thinks that it is quite feasible that we will in future see two centres of gravity in interest rate reference rates – the largest one, used in the bulk of interest rate derivatives, will likely be around overnight RFRs. But a segment of cash markets, and perhaps a small part of the derivatives market which directly hedges cash market instruments, may prefer term rates. Where the term rate also has the overnight RFR as its core, this will facilitate hedging with minimal basis risk.
Bailey cautioned that those for whom forward-looking term rates are not necessary or desirable, should not wait for their arrival. But the work to develop new forward-looking RFR-derived term rates could be a useful facilitator of transition in cash markets.

From the US perspective, Chairman Giancarlo pointed out that the authorities have been warning market participants of the high likelihood that LIBOR will no longer be available after 2021 for use as a reference benchmark for the global markets. He noted the growing evidence of a shift in sentiment among market participants from “why are we moving away from LIBOR” to “how do we adopt SOFR”. He believes that in the US they are making good progress as well as in other currency jurisdictions like Sterling and Swiss Franc, where the transition is well under way.

There is broad consensus that development of SOFR swaps markets will follow SOFR futures. His expectation is that in the next 12 months, both these markets – SOFR futures and swaps, as well as related debt markets – will hit critical levels where liquidity begets liquidity. Also due to the work of the ARRC, major legal and operational steps necessary for the switch from LIBOR to SOFR-based rates have been identified that are critical for the switch from LIBOR to SOFR-based rates for derivatives, loan products, mortgages, retail loans and others.

**Multiple Rate Approach in Australia**

RBA Deputy Governor, Guy Debelle said that in Australia, we have a ‘multiple rate approach’. The credit-based benchmark BBSW has been strengthened and coexists alongside the cash rate, which is the RFR for the Australian dollar. This has been possible since both BBSW and the cash rate are supported by underlying markets with enough transactions to calculate robust benchmarks.

He said BBSW can continue to exist even after LIBOR ends. For many financial products, it will still make sense to reference a credit-based benchmark. But as markets transition from referencing LIBOR to RFRs, there may be some corresponding migration away from BBSW towards the cash rate. This will depend on how international markets for products such as cross-currency basis swaps end up transitioning away from LIBOR. Debelle said good progress is being made on developing new market conventions for trading cross-currency basis swaps, referencing RFRs or combinations of RFRs and IBORs, to give market participants the choice.

Debelle gave three clear messages to the Australian market.

1. The end of LIBOR is approaching. Market participants should continue preparing for this by transitioning to alternative risk-free rates.

2. It is prudent for users of all benchmarks to have robust fall-back provisions in their contracts, not just those referencing LIBOR. ISDA’s work on fall-backs is progressing well, and we encourage all users of interest-rate benchmarks to adopt ISDA’s fall-backs once they are finalised.

3. Most jurisdictions in the Asia-Pacific region have chosen to strengthen their credit-based benchmarks. This includes Australia, where BBSW remains robust. Credit-based benchmarks can coexist alongside risk-free rates when they are supported by liquid underlying markets. Users can then choose the benchmark that is most appropriate for their circumstances.

**RBA comments concerning 1-month BBSW**

Member attention is drawn to the comments of RBA Assistant Governor (Financial Markets), Christopher Kent in March 2019. He said that users of 1-month BBSW should be considering...
alternative benchmarks given the illiquidity in the underlying market. He suggested that participants consider using other robust benchmarks that are already available rather than waiting for the development of a term risk-free rate. He cited as reasons that users of BBSW should be aware that the market underpinning the 1-month tenor is not as liquid as for the 3-month and 6-month tenors. Unlike for these longer tenors, banks have no incentive to issue 1-month bills. This is because under the liquidity standards, they would be required to hold an equivalent amount of high-quality liquid assets. The few transactions that do occur are mainly ones where investors are selling their bills back to the banks.

In subsequent discussion with RBA officials it has been made clear that the RBA is not suggesting 1-month BBSW will end, that they think it should end, or that the authorities here would take action to bring it to an end. This is in sharp contra-distinction to the UK FCA’s position with regard to LIBOR. What the authorities want to emphasise to the Australian market is that market participants should continue preparing for a move to alternative risk-free rates and adopting more robust fall-back provisions in their contracts. While BBSW remains robust, it would be prudent for all users to also adopt more robust fall-back provisions for BBSW in their contracts.

**Fallback provisions to be required**

It is highlighted to members that Kent said that once ISDA has finalised its wording for fallback provisions, the RBA expects all users of BBSW to adopt them where possible. For new securities referencing BBSW, the RBA will make it a requirement that these fall-back provisions be adopted before the securities can be eligible in the RBA’s market operations. Currently, this would affect FRNs issued by banks, securitisation trusts and the state governments.

**ASIC Inquiry Letter**

ASIC has written to the CEOs of major Australian financial institutions regarding their preparations for the end of LIBOR. This letter was prepared in consultation with other member of the Council of Financial Regulators. APRA has also recently written to prudentially regulated entities about their risk assessment work and preparation in relation LIBOR’s demise.

The purpose of the letters is to better understand how major Australian financial institutions are preparing to transition away from LIBOR to alternative benchmarks. ASIC, APRA and RBA are seeking assurance that the senior management in these institutions fully appreciates the impact and risks and is taking appropriate action ahead of the end of 2021.

The financial regulators made clear their expectation that all institutions currently relying on LIBOR need to consider the impact of LIBOR transition on their business. In particular, users of LIBOR should:

- be aware of the size and nature of their exposures to LIBOR;
- put in place robust fall-back provisions in contracts referencing LIBOR; and
- be taking action to transition to alternative rates.

This letter was strongly endorsed by the IBOR Transformation WG as it assists communication with financial institutions that have not been engaged to date with the consequences of the transition away from LIBOR and accommodating robust fallback arrangements.
**Accounting Issues Consultation**

Accounting issues have been identified by the IBOR Transformation WG as a matter of priority importance for attention where benchmark changes are concerned. The International Accounting Standards Board (IASB) in recent months has been looking at these issues and has released an exposure draft for proposed amendments to IFRS 9 and IAS 39. For effect in Australia, the IFRS changes would have to be adopted into AASB 9 and AASB 39 and they have circulated a corresponding exposure draft with the support of the IFRS consultation. This consultation ends on 31 May.

The IASB has identified two groups of issues that could have financial reporting implications for changes in benchmarks. These are:

a) issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark with an alternative interest rate (pre-replacement issues); and

b) issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative interest rate (replacement issues).

The proposals set out in the Exposure Draft address only the pre-replacement issues with regard to the implications for specific hedge accounting requirements in IFRS 9 Financial Instruments and IAS 39 Financial Instruments: Recognition and Measurement, which require forward-looking analysis. As a result of the reform, contractual cash flows of hedged items and hedging instruments that are based on an existing interest rate benchmark will likely change when the existing interest rate benchmark is replaced with an alternative interest rate. Until decisions are made with respect to what the alternative interest rate is and when that replacement will occur, uncertainties will exist regarding the timing and the amount of future cash flows of the hedged items and the hedging instruments.

The IASB notes that the hedge accounting requirements in IFRS 9 and IAS 39 provide a clear basis to account for such uncertainties. These uncertainties about the timing and the amount of future cash flows could affect an entity’s ability to meet specific forward-looking hedge accounting requirements in the periods before replacement. In some cases, solely due to such uncertainties, entities could be required to discontinue hedge accounting for hedging relationships that would otherwise qualify for hedge accounting. Also, IFRS Standards may prevent entities from designating new hedging relationships that would otherwise qualify for hedge accounting. Discontinuation of hedge accounting would require an entity to recognise gains or losses in profit or loss. In the IASB’s view, discontinuation of hedge accounting solely due to such uncertainties before the reform’s economic effects are known would not provide useful information to users of financial statements. Therefore, the IASB decided to propose exceptions to specific hedge accounting requirements in IFRS 9 and IAS 39 to provide relief during this period of uncertainty.

It is important to be aware that the IASB has not yet considered whether and, if so, how to address any issues that might affect financial reporting when an existing interest rate benchmark is replaced with an alternative interest rate, i.e. replacement issues. As more information becomes available, the IASB will assess the potential financial reporting implications of the replacement and determine whether it should take any action and, if so, what. Members need to diligently assess what these “replacement issue” financial implications may be.
ISDA Consultations

In mid-May, ISDA published two new consultations on benchmark fallbacks – one covering adjustments that would apply to fallback rates in the event certain interbank offered rates (IBORs) are permanently discontinued, and another relating to pre-cessation issues for LIBOR and certain other IBORs.

The first consultation sets out options for adjustments that will apply to the relevant risk-free rates (RFRs) if fallbacks are triggered for derivatives referencing US dollar LIBOR, Hong Kong’s HIBOR and Canada’s CDOR.

ISDA previously published a consultation in July 2018 seeking input on the approach for addressing certain technical issues associated with adjustments that will apply to the RFRs if the fallbacks are triggered. This consultation covered GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW and requested preliminary feedback in respect of USD LIBOR amongst other IBORs. The compounded setting in arrears rate approach and the historical mean/median approach were identified as the preferred approaches for addressing certain technical issues associated with fallbacks for GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW based on responses to the July 2018 Consultation.

Pre-cessation consultation

From an Australian perspective the second consultation relating to pre-cessation issues is of importance. ISDA is seeking comment on how derivatives contracts should address a regulatory announcement that LIBOR or certain other IBORs categorized as critical benchmarks under the EU Benchmarks Regulation are no longer representative of an underlying market. The pre-cessation language will have general application in ISDA Master Agreements and situations which might give rise to pre-cessation triggers have been discussed at some length by the IBOR Transformation WG. While there are theoretical scenarios which can be envisaged giving rise to a pre-cessation trigger, in practice for Australia we could only foresee event driven triggers, such as announcements by the benchmark administrators that they are ceasing publication of a benchmark and no successor will continue its publication.

AFMA intends to make comment on this second ISDA consultation.