Stand out for the right reasons
Financial Services Risk and Regulation

Regulators crack whip on LIBOR transition

AT A GLANCE

January 2020

What's new?

- The PRA and FCA published a [Dear SMF letter] and [joint statement] on 16 January 2020, encouraging market makers to switch from LIBOR to SONIA by 2 March 2020 for interest rate swaps.
- At the same time, the BoE, FCA and the Sterling Risk-Free Reference Rates Working Group (RFRWG) published materials outlining upcoming priorities and milestones on LIBOR transition, as well as guidance to market participants.
- This includes an updated [roadmap], a [paper] setting out case studies on the use of overnight SONIA relative to alternatives including forward-looking term SONIA rates, a set of [lessons] learned from recent conversions of legacy LIBOR contracts, and a [factsheet] on LIBOR transition and the need to act now.

What does this mean?

- In their strongly-worded Dear SMF letter, signed by various Executive Directors, the regulators reiterated an earlier call for firms to reduce holdings of legacy LIBOR contracts to a minimum by the end of 2021. They also highlighted that while progress has been made, greater momentum was needed and that 2020 will be a key year for markets to transition.
- A new target of 2 March 2020 has been set for changing the market convention in interest rate swaps. Firms have until September 2020 to cease issuing cash products linked to sterling LIBOR.
- The PRA and FCA have also indicated that they will step up monitoring efforts, including greater engagement with firms, collecting further data, and reviewing MI to assess progress.
- The regulators also set out their view that the market for SONIA derivatives is well-established, and highlight their concern about the risk of new LIBOR transactions. In particular, they note that clients should be appropriately informed of the risks where LIBOR is still used.
- The RFRWG's updated roadmap sets out their views on appropriate use of SONIA and guidance for use of appropriate alternative approaches. It also notes that the development of term rates has been pushed back, with provisional rates now set to be published in Q3 2020.
- Plus, the RFRWG sets out use cases where Term SONIA Reference Rates (TSRR) would be beneficial and where overnight SONIA compounding in arrears is likely appropriate. Based on a market survey, it found that alternative rates may only be required for around 10% of new loan deals and primarily relate to small SMEs, working capital and trade finance, and Islamic Finance.
- In its note on the progress of the use of consent solicitation for transitioning legacy bonds to SONIA, the RFRWG sets out further points to consider in such cases, including the suitability of consent solicitation for a particular legacy bond, whether to pre-announce via Regulatory News Service announcements, whether other appropriate amendments can be made to the conditions of bonds, and broader timing aspects to consider.

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What do firms need to do?

- The Dear SMF letter and related documents represent a clear message from the regulators that firms must respond to, or risk supervisory action.
- In line with the explicit direction from the regulators, firms should make sure they are actively engaged with the wider transition efforts in the market - both those of the authorities and the industry. Clear evidence of this activity is expected from the beginning of Q1 2020.
- Firms should make clear that they are working towards the targets published by the RFRWG. This means making sure that the LIBOR transition plan explicitly includes the targets in project milestones.
- If they are not doing so already, firms should pay particular and immediate attention to the four areas in which the regulators deem progress being critical to successful delivery: product development; reviewing infrastructure, including updating loan system capabilities; client communication and awareness; and updating documentation.
- Firms should also be prepared to evidence the progress they have made against the June 2019 Dear CEO letter feedback statement.
- Finally, dual-regulated firms were required to provide management information and data to the regulators by 31 December 2019. If they have not yet provided this information then this should be a priority.

Next steps

The FCA and PRA say they will now step up engagement with firms on LIBOR transition through their regular supervisory relationships, reviewing management information and collecting data to assess progress. This engagement will inform the FPC's consideration in mid-2020 of whether sufficient progress is being made to avoid the use of supervisory tools.

The RFRWG's targets for 2020, which have been endorsed by the FCA and the BoE, are:

- **2 March 2020:** Target for switching the convention from LIBOR to SONIA for sterling interest rate swaps.
- **End-Q3 2020:** Target for cessation of issuance of cash products linked to sterling LIBOR.
- **Q1 2021:** Target date for significantly reducing the stock of LIBOR referencing contracts.

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