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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

# Global Risk Watch Newsletter

## China: inclined toward putting off hard structural policies?, etc.

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### 2. Overview of Development in Financial Regulations (Trends & Topics)

#### **# Financial benchmark reform: a grand implementation plan required (Shiro Katsufuji, Director, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)**

The market is increasingly keen on preparation for benchmark rate reform. Since a possibility is emerging that LIBOR (London Interbank Offered Rate) be discontinued at the end of 2021, it is imperative that regulators, central banks, and market participants develop and implement an action plan for transitioning to an alternative reference rate.

The LIBOR manipulation scandal exposed around 2012 was a catalyst for enhanced international regulation and supervision of financial benchmarks. The IOSCO (International Organization of Securities Commissions) published “Principles for Financial Benchmarks” in 2013, and the FSB (Financial Stability Board) released “Reforming Major Interest Rate Benchmarks” in 2014. The IOSCO paper presents multiple principles such as addressing conflicts of interest and the arbitrariness in the quotation of benchmark rates, which may be amplified by the use of “Expert Judgement”. The FSB advocates for a “multiple-rate approach.” The approach requires the establishment of two types of benchmark rates; (1) “IBOR+” (interbank rates like LIBOR reflecting transaction data to the greatest extent possible), and (2) risk free rates (reference rates used in derivatives and other markets that are close to risk-free).

With these developments in global-level supervision, benchmark reform is picking up speed in many countries and currencies. In Japan, the study group on risk free rates (organized by the Bank of Japan) selected in 2016 an uncollateralized overnight call rate as a risk free rate for the Japanese yen. In the following year, the Japanese Bankers Association completed the TIBOR reform. In April 2018, the New York Fed began publishing SOFR for

US dollar while the Bank of England introduced SONIA for the pound sterling. The European Union embarked on unique benchmark regulation in January 2018, with a transition period lasting up until 2020.

In July 2017, Andrew Bailey, the Chief Executive of the FCA (Financial Conduct Authority) in the UK, declared that the FCA will no longer “persuade or compel banks to submit to LIBOR” and will not “sustain the benchmark through our influence or legal powers” after 2021. Consequently, risk free rates became a likely alternative to LIBOR for currencies that do not have any other interbank rates, such as the US dollar and the pound sterling. This also means that the transition from LIBOR to a risk free rate has to be completed by the end of 2021. It will be a grand project to revise a large number of financial contracts and their reference away from LIBOR to a risk free rate within the next three years. This transition should expect to face the following challenges.

First, a “fallback clause” is an important matter. A fallback clause is a segment in a financial contract that mandates alternative measures in case the specified reference rate becomes unavailable. During the transition period as well as the time after the LIBOR discontinuation, another reliable fallback rate is necessary for all contracts referencing LIBOR. Next, there is an issue arising from the different nature of IBOR and risk free rates, such as credit spreads and term structure. While LIBOR includes credit spreads and represents term loans of one month, three months, etc., a risk free rate does not contain credit spreads and is based solely on an overnight rate. In order to ensure the same level of economic results from financial contracts referencing LIBOR, it is necessary to create a new rate with credit spreads and term structure based on risk free rates. Furthermore, for risk management and financial accounting purposes, if both LIBOR and a risk free rate are employed and referenced for different elements (e.g. foreign exchange swap by currency, hedging trade and underlying assets), it would affect valuation and hedge accounting. It would also require tremendous labor to revise terms and conditions for loans and interest rates for bonds, and reach agreement with debtors and creditors.

The International Swaps and Derivatives Association (ISDA) is considering a standardized fallback clause for transactions based on the ISDA master agreement. ISDA is also exploring a method to calculate and determine a rate with credit spreads and term structure based on an overnight risk free rate. However, replacing benchmark rates requires establishing a practice with a wider range of stakeholders targeting a wider range of financial contracts, including those not based on the ISDA master agreement. It is ideal to create a cross-industry working group to address the benchmark transition. The tasks should include revision of corporate loan contracts, prompting awareness of non-financial sectors of the benchmark rate transition, to achieve a smooth transition across the market. Financial institutions will have to engage not only a department responsible for market transactions, but also finance, risk management, compliance, and client relations. It is a priority for financial institutions to recognize at the management level the significance and impact of the benchmark reform, and prepare the internal roadmap and implementation plan for the transition period in the coming three years.

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