ICAEW KNOW-HOW
FINANCIAL SERVICES FACULTY

10 QUESTIONS NEDs SHOULD BE ASKING ABOUT LIBOR TRANSITION

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Libor (the London Inter-Bank Offered Rate) is one of the most important numbers in financial markets and is used in many financial arrangements including loans and derivatives. Therefore, the imminent change to Libor and its replacement with overnight rates will be far-reaching. It will be more than a 'find and replace' task because the new replacement rates are very different in their construction to Libor. ICAEW's Financial Services Faculty highlight 10 questions non-executive directors can ask to build a robust conversation around how their business is responding to the change.

1. Do you know how are you identifying where your firm has exposure to LIBOR?

Libor is intended to reflect the borrowing cost for an international bank at different terms and in five major currencies. However, as a benchmark interest rate its use has expanded, even to some unexpected areas. Libor may also be used in legal contracts, computer code for pricing, valuations, accounting, in models as a discount rate, third party contracts and risk IT systems.

- ❑ All firms should do an inventory and quantification exercise to understand their exposures. Re-coding and repapering will follow this.
- ❑ Firms should be capturing the movement in both their Libor and RFR exposures, as well as the linkages of these exposures to contractual language.

2. What are the key challenges for your firm as a result of the transition?

While regulators are keen for markets to take up the new risk-free rates as Libor replacements, the markets may take a different view. For example, where there is more transaction volume use of Libor could continue for some currencies. Some firms have delayed transition project work because some rates may continue. However, the board is responsible for driving awareness and commitment from senior management and staff.

- ❑ Is there a Libor transition project plan? What is the RAG status of the different elements of your transition exercise?
- ❑ What isn't getting done now as planned, as a result of C19?

3. What are your governance and reporting mechanisms?

There should be a clear link to Senior Management Responsibilities in your transition plans. NEDs should be comfortable with how this is structured and make sure that governance and committee arrangements are appropriate.

- ❑ Is there a centralised global steering committee and specific director responsible for Libor transition?

4. Has you firm looked at conduct risk?

In some cases, contracts will be repapered to reflect the new replacement rates (e.g. SONIA). However, the new rates are economically different to the old Libor rates. They do not have a term structure, or a bank credit spread included in the rate. Libor does have these as it is an interbank rate. Therefore, customers will need to be treated fairly during and after the transition.

- ❑ Has your firm identified the key conduct risks and mitigating actions?
- ❑ What are your firm's plans re customer communication, potential value transfer and staff training?

5. How are you dealing with Libor exposures in different currencies?

Libor is heavily used because it covers five major currencies at seven different maturity terms, but all under one convention. However, the approaches taken internationally are not consistent with the configuration or timing of replacement rates. This could present issues for products like multi-currency loans.

- ❑ How is your firm approaching the heterogeneity across relevant international jurisdictions?

6. How is your firm approaching the accounting impacts of Libor transition?

Hedge accounting for example, allows a more forgiving accounting treatment where firms use an interest rate derivative to offset interest rate changes, if certain tests are met. The uncertainty around the future of Libor places these key tests under enormous pressure. Financial standard setters have granted relief for firms to continue to use the hedge accounting rules in these circumstances, despite the uncertainty and performance of the usual tests. They are also granting relief for other aspects of accounting e.g. modifications to financial instruments (IFRS 9).

- ❑ What is your firm's approach to hedge accounting and Libor transition?
- ❑ How are the other accounting implications of Libor transition being considered within your firm?

7. How aligned are the firm's plans relative to regulatory expectations?

In the UK, the PRA and FCA have written to the largest firms and set out their expectations in a 'Dear CEO' letter. A number of global regulatory bodies across the world have issued similar letters to banks and corporates.

- ❑ Do you understand what the regulators expect you to do in relevant jurisdictions?

8. What are your firm's plans to use the new RFR replacement rates for Libor?

Some firms are still using Libor in new loan and derivative products despite the December 2021 end-date. Has your firm made comprehensive changes to all new product pricing and to your operations where appropriate?

- ❑ Will you cease issuance of GBP LIBOR-based cash products maturing beyond 2021 by end Q4 2020, as per regulatory calls? This is important for lender firms or issuers of acsh products.

9. Are you keeping up to date and engaging in the relevant industry solutions?

As above, there are various aspects to Libor transition (governance, conduct, valuations, risk, operations, legal accounting, tax etc.) to consider. Strong firms are engaging with the industry consultations and feeding into developing solutions. You can keep track of these through your relevant industry body, working group web pages or by contacting us.

- ❑ How is your firm keeping up to date across the numerous aspects that relate to Libor transitions?

10. Tax

In some cases, Libor transition and the change to an alternative reference rate could be a taxable event. For example, gains or losses could be realised if a debt obligation is exchanged or significantly modified. Your firm should review contractual terms and discuss with professional advisors to understand potential tax implications.

- ❑ How are the tax implications of Libor transition being considered within your firm?

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