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December 2020

The End of LIBOR is Approaching: FINMA Published Transition Roadmap for Supervised Institutions

On 4 December 2020, FINMA published its Guidance 10/2020 in which it recommends supervised institutions such as banks, securities firms and insurance companies to take action and follow the transition roadmap outlined below in order to be fully prepared for the expected cessation of the publication of most of the widely-used LIBOR setting by end of 2021. In its latest guidance on the LIBOR transition, FINMA made it clear that it expects every market participant to use the remaining 12 months to get ready for the replacement of many LIBOR rates with alternative reference rates (ARR) such as the Swiss Average Rate Overnight (SARON) for Swiss Francs. FINMA will continue to closely monitor the developments in the market and will take institution-specific measures to limit the risks imposed by the LIBOR transition if measures taken by supervised institutions prove inadequate.

1. Introduction

Since the ICE Benchmark Administration (IBA) as the administrator of LIBOR started its consultation procedures in December 2020, market participants know of IBA's intention to cease the publication of GBP, EUR, CHF and JPY LIBOR settings (all tenors (overnight, 1 week 1, 2, 3, 6, and 12 months)) and 1-week (1W) and 2-month (2M) tenors for USD LIBOR after 31 December 2021. The cessation of the publication of the remaining USD LIBOR tenors will take effect, according to IBA, after the publication of LIBOR on Friday 20 June 2023.

For individual currency-tenor settings, a synthetic LIBOR for „tough legacy" contracts may become available for a short period after the end of 2021. It is unlikely, however, that the conditions required for the UK Financial Conduct Authority (FCA) for the use of its proposed powers under the UK Benchmark Regulation will be met for CHF and EUR LIBOR after the end of the relevant LIBOR panels. Consequently, market participants relying on CHF LIBOR must have completed the transition to alternative reference rates by 31 December 2021.

FINMA Guidance 10/2020 is the third guidance from FINMA in a series of recommendations for supervised institutions in connection with the LIBOR transition (FINMA Guidance 03/2018 „LIBOR: Risks of Potential Replacement" and FINMA Guidance 08/2020 „LIBOR Replacement for Derivatives"). The purpose of the latest guidance is to clarify FINMA's recommendations to ensure that financial institutions use the remaining time until the end of 2021 to prepare for the discontinuation of the affected LIBOR settings.

Although much progress has been made since 2017, when the plan to end the publication of the LIBOR was first announced, FINMA still considers the end of LIBOR to be one of the major operational risks that supervised institutions face in 2021.

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2. Transition Roadmap

FINMA's transition roadmap follows the Financial Stability Board's global roadmap published on 16 October 2020 setting out a timetable for actions to be taken in order to enable a smooth and timely transition. It contains five milestones until the end of 2021:

25 January 2021

By 25 January 2021, supervised institutions who have LIBOR-linked OTC derivatives outstanding, should have **signed the ISDA 2020 IBOR Fallbacks Protocol.** In this context, FINMA has pointed out in its Guidance 08/2020 that after this date, supervised institutions should only enter into LIBOR based derivatives contracts with robust fallback clauses.

31 January 2021

By 31 January 2021, **no new „tough legacy" contracts** should be concluded. Across all product types, it is recommended that no new transactions based on CHF or EUR LIBOR are entered into that mature January 2022 or later and do not contain robust fallback clauses. If possible, this rule is also to be applied to contracts based on GBP, JPY or USD LIBOR.

Moreover, by that date, lenders should be **ready to grant loans that are based on alternative reference rates** such as e.g. SARON instead of LIBOR.

31 March 2021

Financial institutions should have carried out a full assessment to evaluate existing CHF and EUR LIBOR contracts that mature after 2021 and do not contain robust fallback clauses. Based on this assessment, financial institutions should prepare a **detailed project plan** outlining the steps to be taken to **reduce the volume of such contracts to a minimum by the end of 2021.**

To achieve this goal, supervised institutions are advised to reach out to counterparties of potential „tough legacy" contracts by 31 March 2021 at the latest to start the process of renegotiating such contracts or inserting robust fallback language into them. This approach applies to all products including capital instruments, floating rate notes and securitization transactions and not just to loans and derivatives.

With respect to tenors of LIBOR in GBP, JPY and USD which may be continued in 2022, affected institutions should nevertheless consider addressing the issue with their counterparty by agreeing on a conversion of those contracts to ARR.

30 June 2021

It is recommended that supervised institutions implement **the necessary changes to their systems and processes by 30 June 2021** to enable a smooth transition to ARR and the application of fallback rates.

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Furthermore, by reducing contracts maturing after 2021, **risks** relating to „tough legacy" contracts in CHF and EUR LIBOR and the discontinued GBP and JPY LIBOR tenors, as well as the 1W and 2M tenors of USD LIBOR **can be mitigated.** For each contract for which no solution is in sight, a risk assessment should be carried out and specific measures taken to mitigate the risks identified. In particular, the likelihood of a legal dispute, possible outcomes in court and the consequences for the internal valuation of the contracts need analyzing.

As a general rule, supervised institutions should **only use ARR in new contracts** irrespective of whether they refer to CHF, EUR, GBP, JPY or USD.

31 December 2021

By 31 December 2021, financial institutions should have achieved **full operational readiness** and all relevant systems and processes should no longer rely on LIBOR.

No new contracts based on LIBOR should be entered into and all transaction with variable interest rates in all currencies should be based on ARR.

3. What to Expect from FINMA in 2021

In its Guidance 10/2020, FINMA reminds supervised institutions that the time to act is now. The roadmap clearly outlines FINMA's expectations with respect to the LIBOR transition. Since no significant reduction in contract volume linked to LIBOR occurred until mid-2020, FINMA will continue to closely monitor the developments. In particular, progress made to reduce risks in connection with the cessation of the LIBOR by the firms having the biggest exposure will be examined in detail. Where necessary, FINMA will take institution-specific measures to limit the risks of inadequate preparation for the replacement of LIBOR.

4. Outlook and Next Steps for Supervised Institutions

According to FINMA, important steps towards the replacement of LIBOR have been achieved in 2020. In addition to the industry-wide solution for most derivatives contracts with its fallback documents by the International Swaps and Derivatives Association (ISDA), the Swiss Bankers Association (SBA) has also published a corresponding amendment agreement for its Swiss Master Agreement for OTC Derivative Instruments. Moreover, several banks have successfully launched SARON mortgages and the National Working Group on Swiss Franc Reference Rates (NWG) has prepared and communicated guidance for replacing CHF LIBOR with SARON. However, additional work remains to be done. Supervised institutions not following FINMA's roadmap face having to answer questions from their supervisor on how they will deal with the risk.

If not already done so, banks, securities dealers and insurance companies should, as a first step, identify existing LIBOR-based contracts that mature after 2021 and define a clear, robust and realistic strategy for substantially reducing its LIBOR exposure. Such a strategy should also aim at avoiding damages due to reputational and legal risks relating to the transition. For this purpose, supervised institutions should consider issuing internal directives and instructions regarding appropriate behavior towards clients as well as conducting appropriate training for employees. Additionally, it is recommended to appoint a member of the executive board with accountability for the LIBOR transition.

Finally, FINMA expects banks and other financial institutions to take proactive actions towards issuing new products and entering contracts based on ARR.

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