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Dear Andrew and Sam,

The transition from LIBOR to SONIA is one of the most challenging regulatory reform initiatives faced by UK Finance members, and others, over the coming years. The transition forms part of a global effort to replace all IBORs with alternative risk-fee rates (RFRs) in accordance with IOSCO and FSB endorsed standards, and will impact a wide variety of financial products, services, and stakeholders including financial and non-financial firms, corporates, SMEs, retail clients and consumers.

UK Finance acknowledges the considerable efforts both the UK and global regulatory authorities have taken in spearheading the development and transition to RFRs from the IBORs, and the significant resources already committed by a number of other industry stakeholders. We also welcome the transition to SONIA as an opportunity for the industry to move towards rates that are based on transactional data, improving market stability and delivering greater transparency.

Following the 2018 “Dear CEO” letter from the PRA and FCA, UK Finance is writing to set out what we see as the key obstacles to achieving a smooth transition from LIBOR to SONIA. The most significant issues include the risks associated with the asymmetric approach to the development and implementation of RFRs, the transition of legacy products, and the need for Term SONIA Reference Rates (TSRRs).

We have recommended actions which we believe the UK regulatory authorities could take in order to mitigate these challenges, reduce the impact on consumers and businesses in the UK, and enable the industry to maximise the opportunities that SONIA can provide.

Asymmetric approach towards RFRs

(i) LIBOR based products, services and systems

UK regulated firms offer a wide range of products linked to LIBOR including (but not limited to) derivatives, bonds, loans, and mortgages. They also provide a number of services and use operational systems which rely on LIBOR-based calculations. The industry has begun to introduce initiatives to assist firms with the transition from LIBOR to alternative RFRs for the various areas of LIBOR impact, but there are still difficulties with providing a consistent and coordinated approach.

Firms are unlikely to find a "one-size-fits-all" solution for their LIBOR transitioning challenges. LIBOR is applied differently across products, services and operations; for example, a revision of the appropriate fallback rates and triggers for derivatives will most likely differ from those required for loans and cash products. Alternative RFRs will need to accommodate the appropriate risk profile for the product or service offered, and determine any secured or unsecured RFRs, transaction-based data variations, daily term rate assessments, or particular liquidity requirements which might affect such a profile.

The interconnectedness of these LIBOR impacts, combined with the potential adverse effects on global financial market infrastructures, means co-ordinated development and implementation across all relevant markets and impacted firms is critical in the transition to alternative RFRs. Failure to do so will lead to uncertainty in the markets, potentially impact adoption and liquidity, and affect industry participants' preparation for transition.

(ii) *Global approaches and adoption of RFRs*

Transition from LIBOR to SONIA must be considered alongside the transition of other global IBORs to RFRs, which will affect the vast majority of our members. For example, the industry is concerned about:

- uncertainty of a definitive "cessation" date. We acknowledge the January 2019 speech on "LIBOR transition and contractual fallbacks" from the FCA's Edwin Schooling Latter, which recognises that some legacy contracts may need the continuation of LIBOR post-2021 to avoid market disruption, and the FCA would announce when it believes LIBOR is no longer capable of being representative. However, at present there is an absence of regulatory guidance regarding a definitive cessation date from which firms should cease offering LIBOR-based products and services to clients, and what constitutes appropriate "transition conduct" for firms vis-à-vis consumers and the market.

- viability of the cessation of certain IBORs. For example, the uncertainty of the EU Benchmark Regulation implementation date of 1st January 2020. There is also concern that ESTER, the proposed replacement of EONIA, is not expected to commence publication until 1st October 2019, a timeframe providing market participants only three months for adoption, assuming the necessary market infrastructure regarding term rates and liquidity are in place.

- different timelines and approaches of the RFRs across UK, US, European, Swiss and Japanese RFR currencies.

- potential impact of Brexit, a possible consequence of which is that a UK administrator would be a third country administrator under the EU Benchmarks Regulation, and would need to re-apply to be added to the list of benchmarks for use of LIBOR in the EU through the third country regime. Such a procedure may not necessarily be an issue, but it does add to the uncertainty surrounding implementation.

A lack of co-ordination and uncertainty regarding the development and introduction of the alternative RFRs across jurisdictions could have a significant impact on the ability of the market to develop products and services based on these new rates, exacerbating the challenges in building liquidity and the roll-out of the new rates. There is also a considerable risk of regulatory arbitrage if each jurisdiction progresses at different speeds, and there is insufficient alignment in approaches and methodologies.

UK Finance recommendation

UK Finance fully acknowledges the diversity and complexity of the different products, markets, jurisdictions and stakeholders which need to transition to new rates. Nevertheless, there will need to be a considerable increase in the co-ordination across these different elements in order to achieve a smooth transition, and we urge the UK regulatory authorities to do everything they can to increase industry collaboration on a cross product, market, and jurisdictional basis in order to mitigate the unintended consequences highlighted above.

Legacy products – transition of contracts

A common issue across most legacy products is that the contracts are not drafted to mitigate the permanent discontinuation of LIBOR. For example, the standard fallback documentation in commercial loan contracts should LIBOR be unavailable is frequently “cost of funds”. However, this provision is typically for the scenario of LIBOR not being available on a temporary, rather than a permanent, basis. It will not be an option to simply replace LIBOR with SONIA as the latter is generally a lower rate to reflect it is an overnight rather than term rate, which will reduce the lender’s future margin and impact their financial planning.

For many contracts a standard approach will not be available, potentially resulting in each contract requiring individual renegotiation, an enormous exercise for firms. The practicalities of amending cash products based on LIBOR could be particularly challenging. Updating floating rate securities may require majority or unanimous noteholder consent, and will likely be onerous, expensive, time intensive, with no guarantee of success.

The result may well be value transfer, and there is a strong possibility that an unintended consequence could be to create “winners” and “losers”, which could affect the adoption and treatment of the new rates.

As highlighted above under the development of global RFRs, there is no formal end-date which prohibits firms offering LIBOR based products and services to clients. There is also a lack of definitive clarity as to whether LIBOR may be used for legacy contracts post 2021. While we understand that panel banks will not be compelled to submit to LIBOR post 2021, there is uncertainty as to whether submissions may nevertheless continue beyond this date, and in particular, whether LIBOR rates may still be provided for legacy contracts where solutions cannot be found.

UK Finance recommendation

UK Finance commends the UK regulatory authorities for the efforts they have undertaken (for example, through the Bank of England RFR WG and related sub-groups) to acknowledge these challenges, and help support the industry in finding solutions. We believe it is vital that the UK regulatory authorities are continually available to support the industry, not only through official sector WGs, but also by liaising with trade associations and similar organisations in order to facilitate the development of solutions for these considerable challenges.

We also recommend regulatory authorities increase official dialogue with the industry, and clarify both regulatory expectations and proposed time frames for the industry to put in place an effective transition (beyond that of firms not relying on LIBOR post 2021), as well as how the UK regulatory authorities will work with the industry to meet the challenges which firms face.

Legacy products – conduct, legal and modelling risk, tax and accounting implications

(i) Conduct risk

UK Finance is very concerned that the practical challenges of transitioning legacy products will give rise to significant consumer protection and/or conduct risk for firms in relation to their clients, for example, meeting both regulatory requirements and client expectations.

In cases where firms are able to identify a contractually acceptable replacement for LIBOR, lenders must still be mindful of applying “Treating Customers Fairly” conduct principles to how the contract variation is operated. Examples of how this may impact customers include the following:

- Varying contractual replacement provisions and interpretations may lead to customers who previously held similar LIBOR-linked contracts to be treated differently depending on what lender they have.

- Across products customers (especially retail) are still not fully aware of the impact of transitioning to a new RFR, and therefore may be faced with unexpected outcomes or treated unfairly.

- Consumers with LIBOR-linked contracts may find they are treated differently depending on whether they are customers of a closed-book or an active mortgage lender. In cases where a closed mortgage book is held by an unregulated firm, it is unclear whether the firm can be compelled to treat its customers equally to that of a regulated firm.

There will inevitably be different approaches across products, services, and firms themselves, which could result in an unlevel playing field, and increased likelihood of consumer detriment. There is also risk that creation of winners and losers could give rise to situations where it will be difficult to manage client outcomes across products and services.

(ii) Legal risk

Diligent (and extensive) consideration of potential consequences of transitioning legacy contracts and contractual terms will be required to identify and mitigate considerable legal risk, for example, in that of contract law and fiduciary obligations. A significant proportion of LIBOR-based contracts will be bespoke, and consequently the (to be agreed) standard fallback and trigger provisions may not be appropriate in all cases and will require renegotiation, resulting in significant repapering requirements. Renegotiating contracts could be particularly difficult when the alternative rate gives rise to a value that is not present value neutral, is relatively illiquid, or performs in a way inconsistent with the terms of the affected contract. The potential creation of “winners” and “losers” in itself gives rise to significant legal risk.

Where corporate trust agents and trustees are party to contracts, there are typically limited adequate fallback arrangements that at times impose difficult consent requirements and call upon the agent or trustee to inappropriately exercise its discretion to determine an alternative rate, giving rise to considerable legal risk. In most cases these agents and trustees will not be in a position to exercise that discretion.

A further risk is that whilst fallback language addresses legal risk and mitigates contract frustration, it does not address conduct risk detailed above, particularly on product mis-selling, and link to the new product approval and sales process i.e. how are firms managing the legal and conduct risk associated with the sales process to investors, SMEs, and retail customers.

(iii) *Modelling risk*

While LIBOR has sufficient historical data on which firms can base their models, the new rates will most likely have insufficient historical data to support financial and risk modelling. In practice, alternative data/proxies will most likely need to be used, but regulators will need to agree to this approach and provide guidance, and the lack of appropriate data may still lead to uncertainty and risk for firms.

The uncertainty around the details of the new rates, how they will be accepted by the market, and practical transition on a global scale, are all obstacles to firms' financial planning. For example, in terms of counterparty credit risk, LIBOR has a credit spread built into the rate to reflect the risk that the borrowing bank could default, however the new RFRs fail to incorporate this risk.

(iv) *Tax and accounting implications*

There is considerable uncertainty with regards to the approach to tax and accounting principles. For example, there is a strong risk that the present value of such legacy contracts will be adversely affected, but is unclear how fair-value will be affected until fallback methodologies are certain. Another issue which requires clarification is once the fallback has been triggered, whether non-fair-value instruments (i.e. cash products) are considered "modified" or "extinguished", with the latter having broader implications for triggering recognition of gains/losses

Hedge accounting could also be impacted, where potentially de-designating hedges could result in profit and loss volatility, and unintended consequences to tax structures resulting in tax events and accelerated tax payments. There will also need to be consistency in approaches from accounting standard setters, for example, on disclosure requirements.

The absence of a consistent approach to tax and accounting issues will result a fragmented approach to accounting principles, which will have a detrimental impact on firms, clients, and counterparties. There is also the risk of (unintended) arbitrage between firms when developing their methodologies.

<u>UK Finance recommendation</u>

UK Finance strongly recommends that the UK regulatory authorities provide clear guidance to all affected stakeholders on how to address these challenges in legacy transition in order to mitigate the related risks. Regulatory guidance would provide stakeholders with the assurance they need in order to transition to the new rates, and would also deliver the significant benefit of ensuring the industry adopts an aligned and consistent approach to transition.

Development of TSRRs

UK Finance supports the Bank of England's acknowledgement that TSRRs can play an important role in facilitating transition to SONIA, particularly in loan and debt capital markets, and its efforts to facilitate the development of such term rates. For example, term reference rates are typically key to mortgage contracts as they allow lenders to match funding in variable rate mortgages, securitisations, and provide borrowers with transparency and certainty.

UK Finance strongly believes that the transition from LIBOR to SONIA term reference rates must be seamless in order to avoid consumer detriment, given that a significant number of UK consumers hold products which are directly linked to LIBOR. For example, we estimate our members hold at least £30bn in mortgages where the contractual rate is linked to a LIBOR term reference rate, corresponding to approximately 200,000 customer contracts. It should be noted this is likely to be an under-estimate of the total given that unregulated closed book mortgage owners are not in our membership and therefore not included in this figure.

There are currently no SONIA term reference rates available which would facilitate a smooth transition for these contracts, as we highlighted in our response to the consultation on TSRRs from the Bank of England Working Group on Sterling Risk-Free Reference Rates. Once they are established, firms will need to then undergo a highly resource intensive effort to communicate and explain the changes to their clients and end customers.

<u>UK Finance recommendation</u>

UK Finance acknowledges the Bank of England's work to date in moving towards the development of TSRRs, and recognises the technical difficulty involved in such an undertaking. We encourage the Bank of England to continue its work on this issue, and ensure any final TSRRs are appropriate for all LIBOR-linked products.

IT & System Upgrades

LIBOR will be firmly embedded in the systems, process and risk infrastructures of firms, their clients, counterparties, and all other impacted stakeholders. It will take significant resources over an extensive period to adapt current systems and approaches to incorporate new rates and approaches. Systems will typically need to be able to capture and calculate the new rates, different currencies, times, and many other data inputs.

There are likely to be product specific systems that will require adaptation and testing. For example, with respect to mortgages, there are specific FCA Mortgage Conduct of Business requirements for customer documentation, such as annual statements and arrears letters. The processes around this activity will need to be tested to ensure any underlying calculations are correct.

Industry stakeholders will vary in the sophistication and resources available to them to update their systems, which could impact the implementation of the new RFRs and/or Term Reference Rates.

The challenge of updating IT infrastructure is further complicated by the interaction with the wider program of regulatory change. Given that the majority of regulatory requirements are interlinked, all of the IT updates that are needed to incorporate LIBOR transition will also need to be aligned with other reporting requirements, increasing the challenge considerably.

UK Finance recommendation

UK Finance acknowledges that to some extent this is a challenge for firms to overcome on an individual basis. However, in practice the requirements of the fallback rates will need to be aligned with what firms can realistically build into their reporting frameworks. We strongly recommend the industry is given a realistic timeframe (in line with typical system build times) to prepare their data capture and reporting systems in order to reduce the significant operational risk of going live with systems that are possibly inadequate due to a compressed lead time. It should also be noted the actions firms can take to start implementing the changes are limited until the industry has a final position on the approaches for implementing the alternative RFRs.

We also acknowledge the initial priority list identified by the Working Group on Risk-Free Reference Rates is the start of this process. We recommend this list is augmented with an estimated timeline for implementation for each of the items to give market participants an overview of the timeframe required for IT updates.

Conclusion

UK Finance would once again like to reiterate its acknowledgement of the UK regulatory authorities' efforts to date in supporting the transition from LIBOR to SONIA. The industry is working hard to develop solutions for the significant challenges that are inherent in the various products and services. The quantity of legacy contracts, and the complexity of the related challenges in transitioning them to new RFRs, cannot be overstated.

UK Finance has a wide range of members from some of the smallest to the largest institutions, covering wholesale, retail and commercial business lines. We are actively engaging across our membership on this critical issue, and are very well placed to support the authorities in this transition.

We are also working closely with our fellow trade associations and industry stakeholders to ensure we work collaboratively and co-ordinate efforts as we deal with the challenges across products, services and markets.

We trust our comments in this letter will support the UK regulatory authorities in their efforts to facilitate transition from LIBOR to SONIA, and would welcome the opportunity for early discussion and clarity on these issues to support the banking and finance industry's preparation for transition.

Please note this letter has been shared with Katharine Braddick at HM Treasury, and Sir Jon Cunliffe, Andrew Hauser, and Mark Yallop at the Bank of England.

Yours sincerely,

Stephen Jones
CEO
UK Finance