Transitioning Away from IBORs: The View from Asia

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Asian banks have a large and complex operational task ahead of them as they prepare for a post-LIBOR world after 2021, say KPMG's Marie Gervacio and Luke Gower.

Even as regulators and firms prepare to transition away from LIBOR (London Interbank Offered Rate), identifying and mitigating the more than USD 200 trillion of exposures has proven to be a daunting and complex task.

The transition from IBORs (interbank offered rates) to a new set of overnight risk free rates is a "paradigm shift" for markets, according to the BIS (Bank for International Settlements), and will bring about a massive transformation effort. The problem is particularly acute for banks in Asia, which are also having to contend with the reform of local benchmarks, a smaller talent pool and less clarity from the regulator.

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- Luke Gower
Associate Director
KPMG

KPMG was recognised as 'Consulting Firm of the Year' in the 2018 inaugural *Regulation Asia* awards for its outstanding contribution in helping firms navigate regulatory challenges across APAC markets, including in relation to the transition away from LIBOR. Given its deep understanding of the views of both the industry and its regulators, and of the evolving technology that can help to manage and automate transition processes, KPMG is uniquely positioned to gauge current industry preparedness for LIBOR's cessation.

Regulation Asia sat down with KPMG Partner Marie Gervacio and Associate Director Luke Gower to understand the transition landscape in Asia-Pacific, as well as specific challenges for firms in the region as they prepare to remove all LIBOR exposures and dependencies before 2021.

Regulation Asia: What has progress been like among institutions in Asia as they prepare to adopt alternative risk free rates and finalise contractual fall-backs to LIBOR?

Gower: Our analysis suggests that progress has been uneven. In the major financial centres – Sydney, Tokyo, Hong Kong and Singapore – banks are moving a little more quickly, because their regulators are pressuring them, and neighbouring US and EU banks are on the move. The pace also tends to be a little quicker in jurisdictions where the local benchmark rate is slated for replacement.

Emerging markets in the region are also making uneven progress, but in a different way. The Philippines has already been through a round of local benchmark reform, and Indonesia has been working hard to promote the new risk-free rate IndONIA as an alternative to JIBOR.

The BOT (Bank of Thailand) has also recently become more active in this space. In China, discussion of benchmark reform is currently dominated by the shift to the LPR (Loan Prime Rate) – a development that seems more aligned with cyclical monetary policy objectives than with the considerations motivating benchmark reform elsewhere.

All that aside, progress still seems slower in emerging markets than in leading jurisdictions. We recently surveyed 21 banks across the region, and only a handful had begun the process of quantifying their exposures or developing plans for the transition.

RA: What are the key challenges faced by Asian jurisdictions in transitioning to alternative benchmarks?

Gower: The key challenge for many banks in the region is a certain degree of isolation. In other parts of the world, LIBOR is an important conversation in financial circles, and banks have many different local reference points and sources of advice as they begin their transition.

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In the emerging markets of Asia, this is often not the case. Of particular significance is the fact that some central banks in the region have been quiet about the LIBOR transition. Banks accustomed to relying on local authorities for guidance are a little unsure of how they should respond to this partial policy vacuum. This uncertainty is particularly acute in jurisdictions where the future of local benchmarks has not yet been settled.

A little further down the track, the main challenge for Asian banks will be recruiting the right skills. The LIBOR transition is a simultaneous global process, and retaining the right people in areas like financial modelling and legal analysis will be difficult especially if there is a global resource squeeze in play. Once again, this squeeze is likely to be most acutely felt in the emerging markets of the region, where the resource base is smaller to begin with.

The other distinctive challenge for at least some countries in the region is the implied change to the monetary framework. Rate fixings in some countries take USD LIBOR as a direct input, and in these countries the cessation of LIBOR will have to be managed with particular care.

RA: Can you discuss the progress on the adoption of alternative rates to local IBORs, such as JPY LIBOR, TIBOR, HIBOR, SIBOR?

Gervacio: One of the most recent developments in the region has been the MAS (Monetary Authority of Singapore) announcement that they will move from the SOR (Swap Offer Rate) to the SORA (Singapore Overnight Average Rate) over the next two years, targeting the second half of 2020 for a SORA term structure.

In Japan, the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks recently completed a public consultation on the transition away from LIBOR, with a senior BOJ (Bank of Japan) official noting that financial institutions should begin using non-LIBOR interest rate benchmarks in new contracts as soon as possible, and that fallback language should be added to existing contracts where their maturities go beyond 2021.

The TIBOR (Tokyo Interbank Offered Rate) will remain in use, subject to improvements in its calculation basis. Meanwhile work is also underway to create a TONAR (Tokyo Overnight Average Rate) term structure based on futures or overnight index swap transactions.

Similarly, in Hong Kong, the HKMA (Hong Kong Monetary Authority) has indicated that HIBOR will remain in use, albeit with further reforms. The current industry consultation has been aimed at improving the calculation basis and robustness of the HONIA (Hong Kong Overnight Index Average).

RA: Do you foresee issues around adoption of different benchmarks across jurisdictions in different currencies – specifically around the fragmented and varied pace of adoption?

"Solving the LIBOR transition for Asia-Pacific is a moving target."

- Marie Gervacio
Partner
KPMG

Gervacio: Solving the LIBOR transition for Asia-Pacific is a moving target. While regulators in many jurisdictions do not currently intend to move away from their existing benchmarks, the calculation basis for some Asian benchmarks relies on LIBOR. Thailand's THBFIX and the Philippines' PHIREF are good examples.

For domestic financial institutions, it will mainly be a case of waiting for local regulators and industry bodies to support a move away from local IBORs. For financial institutions who operate across the region – and in particular – for global financial institutions, the adoption of different benchmarks will be especially challenging.

For these global players, challenges will include the same moving target issues, but on a location-by-location basis, further complicated by the complexity of their operations in multiple products across those jurisdictions – as well as the spectrum of systems and models that underpin those businesses.

RA: What is your view on the co-existence of secured and unsecured rates in specific jurisdictions, like in the case of Australia with an unsecured BBSW (Bank Bill Swap Rate) in use alongside the SOFR (Secured Overnight Financing Rate), which is secured?

Gower: In the case of Australia, the benchmark administrator (ASX Group) is comfortable with the existing local BBSW benchmark rate and it has the support of the central bank on this point. The role of BBSW seems safe for the time being. Some individual tenors are definitely showing strong signs of illiquidity, and participants have been strongly advised to check and remediate their fallback language.

Some of our Australian clients have indeed questioned whether it might be difficult to simultaneously maintain the unsecured BBSW rate alongside the secured SOFR rate over the longer term. While recognising that the differential credit risk profiles of the two reference rates do create some issues, we are reasonably confident that the market will be able to manage them.

There is also a very strong appetite for products referencing BBSW from the buy-side of the market.

RA: What feedback are you seeing from firms in APAC on the transition exercise as currently proposed?

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Associate Director
KPMG

Gower: Opinions on this vary quite widely. Some banks we have spoken to are openly sceptical about the timeframes for the exercise, and they point to the low levels of liquidity in the new products. While many of the markets are indeed not yet liquid, bankers have taken note of an upward trend in interest in the new products, and they appreciate the problems with the existing benchmarks.

Not surprisingly, the main concern that we have encountered in relation to robustness concerns the development of term rates.

RA: What has been the uptake of SOFR and SONIA (Sterling Overnight Interbank Average Rate) based derivatives among institutions in Asia?

Gervacio: Issuance of SOFR or SONIA based derivatives has been extremely limited across the region thus far, with the region closely watching the development of a term rate. Beyond derivatives, however, there has been a recent pioneering move by a subsidiary of one Chinese bank to issue a SOFR-linked trade finance loan, which has prompted some speculation that more institutions might do the same very soon.

RA: As firms look to develop an operating infrastructure for new benchmarks, how can they ensure they manage liquidity and other risks effectively?

Gervacio: It is important that firms approach their infrastructure requirements methodically. We recommend that banks plan this in detail at an early stage to avoid programme derailment later on. This means conducting a proper stock-take of the processes which are affected by LIBOR. We recommend that programmes begin with a properly scoped mobilisation phase. We also recommend that banks coordinate with their in-house IT teams and/or stay close to the vendors of their systems to ensure that they are keeping up with the ongoing changes.

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As to the specific matter of liquidity risks, the overall problem is mitigated in some ways by the strong relationship between the new reference rates and observable transactions in deep and liquid markets. This relationship tends to lessen the price volatility that might otherwise arise out of low liquidity. That being said, with an increase in the range of products referencing the new rates, it seems likely that basis risks will indeed become more prevalent. Banks in the region are likely to follow the lead set by banks in the US and Europe in response to these emerging risks.

The risks are likely to vary over the course of the transition. Later on in the process, we expect to see model risks becoming more threatening. Banks need to structure their transition and implementation plans around this shifting pattern of risks, and to be ready for them before they come online.

RA: What is your view on conduct risks? How will these risks be managed?

Gervacio: Conduct risk is already a live issue for those banks that are selling longer-dated LIBOR products. The challenge around quantifying and managing the impact to valuations will be closely linked with the risk of misconduct.

Financial institutions must ensure that they contemplate conduct risk throughout the entire LIBOR transition process and that their governance and controls are uplifted accordingly in order to identify and remediate these new risks. This has been a particular focus for the UK FCA (Financial Conduct Authority), and other regulators in the region will likewise be looking to understand how this has been addressed.

“Financial institutions should ensure that they have a complete model inventory and understand where and how LIBOR is built into model assumptions or algorithms.“

- Luke Gower Associate Director KPMG

RA: Are you seeing concerns from clients around potential value transfers or losses as a result of switching to overnight risk free rates?

Gower: The risk of value transfer and/or loss resulting from the move away from LIBOR weighs heavily on Asia-Pacific financial institutions. There are, of course, pricing and valuation issues that arise from the absence of a term rate structure, most notably where rates are calculated based on foreign exchange forward prices against the US dollar, but there will also be significant impact to valuation models and hedging structures.

Financial institutions should ensure that they have a complete model inventory and understand where and how LIBOR is built into model assumptions or algorithms, and whether there is upstream or downstream impact to any LIBOR-related data flow.

The challenge around quantifying and managing the impact to valuations will also be closely linked to the risk of misconduct.

RA: What impact, if any, will the EU Benchmarks Regulation have on the transition process in Asia-Pacific?

Gervacio: With respect to the EU Benchmarks Regulation, time is the enemy. As of August, equivalence decisions have been granted to only two jurisdictions in Asia: Singapore and Australia. Other third-country administrators in the region are looking to the extension to the end of 2021 to achieve equivalence.

RA: Lastly, are there any final thoughts you’d like to share for firms that are trying to prepare for the transition away from LIBOR?

Gower: There is certainly a lot that we don’t yet know about the transition end-game. But I would urge banks not to see this as a reason for deferring tasks that can be covered off now on a no-regrets basis.

Marie Gervacio is a partner with KPMG China based in Hong Kong, and Luke Gower is an Associate Director with KPMG Australia based in Sydney. Both have been working closely with consulting colleagues in other KPMG member firms around the region to help clients transition away from LIBOR and mitigate the risks the change presents.

KPMG at the Regulation Asia Awards 2018

KPMG won the award for Consulting Firm of the Year and was highly commended in Regulatory Change Management category in the inaugural Regulation Asia Awards for Excellence 2018. The award represented a recognition that KPMG has defined itself as a leading player when it comes to understanding the views of regulators as well as the entities they regulate, a position strengthened by a diverse team of consultants that includes compliance specialists, technology experts and former regulators.

In the submission process, KPMG was able to demonstrate its strengths across the region, including in Singapore, Hong Kong, Australia, Taiwan, as well as several emerging markets.

Get in touch

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