ICAEW KNOW-HOW
FINANCIAL SERVICES FACULTY

10 QUESTIONS INTERNAL AUDIT SHOULD BE ASKING ABOUT LIBOR TRANSITION

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26 August 2020

The London Inter-Bank Offered Rate (LIBOR) has been the most widely used interest rate benchmark in financial markets and the daily published rates are referenced in an estimated total of around US$400 trillion of financial contracts, including loans, mortgages, bonds, securitised products and derivatives. The transition from LIBOR to the alternative reference rates (RFRs) is essential to strengthen the global financial system and with the end-2021 LIBOR cessation date firmly held, significant effort is required to effect this change. ICAEW's Financial Services Faculty highlights 10 questions to inform the critical contribution Internal Audit can make in firm's challenging and far-reaching transition to alternative reference rates.

1. Has the firm established a LIBOR transition programme and suitable governance?

Many UK financial services firms were asked by UK regulators to appoint an accountable senior manager, in line with the Senior Manager & Certification Regime (SMCR). They must also report transition provisions and their LIBOR exposures periodically. Non-financial firms face similar risks from LIBOR transition, and therefore need plans, measures, and robust governance with senior executive oversight. Transition impacts, risks and dependencies need to be well understood, so that appropriate decisions can be made and a suitable transformation programme to complete transition to alternative rates can be put in place.

- ❑ Ensure senior executive oversight, suitable stakeholder engagement and expert resourcing.
- ❑ Assess governance structure and granularity of project plans, considering enterprise-wide impact areas, risks, dependencies, and timeline.

2. What is important for a successful LIBOR transition programme?

The global reform of LIBOR is complex, so transition programmes need to be wide ranging and flexible. The reforms may have been initiated by regulators, but they are market-led and reliant on industry collaboration. Firms will need agile programmes to respond to new policy and market initiatives. Furthermore, their scopes will require several dedicated work-streams and an integrated approach to ensure alignment across teams.

- ❑ Evaluate cross-functional, cross-divisional, global programme alignment, external and internal communication, and ensure effective collaboration across first, second and third lines.
- ❑ Assess flexibility of the delivery approach and adaptability to changing market conditions, regulatory provisions, evolving market standards as well as client needs and feedback.

3. What processes and controls are in place to identify LIBOR exposures?

Ideally, firms will develop comprehensive reporting to understand LIBOR-linked exposures by product, currency, tenor and maturities. High quality management information will help to identify the full impact, help to drive the strategy and support monitoring of progress.

- ❑ Evaluate the quantitative monitoring framework covering primary LIBOR exposures as well as secondary exposures, such as pension liabilities or commercial contracts
- ❑ Evaluate reliance across systems and processes within the operating model, particularly valuation, pricing, risk models and internal booking models, and data lineage
- ❑ client-level granularity supports meaningful client engagement.

4. Is the programme on the critical path to complete LIBOR transition?

Although the FCA has supervisory power over LIBOR submissions in all currencies there are now multiple authorities drive the reform across overseas jurisdictions. The reforms have also seen industry working groups, associations and international bodies have evolved to develop market practice, standards, and certain waivers to help. The transition roadmap is now a combination of regulatory milestones and market-driven best practice target dates.

- ❑ Evaluate new product development, legacy portfolio transition strategy, budget and delivery plans against the firm specific scope and applicable regulation, standards, guidance and target dates in each relevant currency jurisdiction
- ❑ Ensure that supervisory or legislative provisions are understood and traceable, and that your firm can meet critical regulatory milestones
- ❑ Refer to key dates in the ICAEW’s LIBOR Transition **Timeline**

5. How does the firm approach transition of legacy contracts?

Transition of legacy contracts is a significant undertaking. For derivatives, fallback standards will be set in a Supplement to ISDA 2006 Definitions, complemented by an optional protocol for legacy contracts. Guidance on fallbacks and spread adjustment for cash products is expected to align to this, but there is considerable customer outreach and repapering effort overall. Some tough legacy contracts may even require legislation. Transition of floating rate notes and bonds is further complicated by bondholder identification and a high rate of required bondholder consent.

- ❑ Evaluate transition strategy and decisions, especially around adoption of the ISDA protocol
- ❑ Consider that non-financial corporates may also have a responsibility to initiate investor outreach for transition of issued debt, seeking consent in a general meeting

Refer to our separate “10 Questions” with respect to “Corporates” for further information.

6. Does the firm’s approach appropriately consider and mitigate conduct risk?

Given the potential for misconduct when transitioning away from LIBOR, conduct risks need to be carefully assessed. Firms will need to think about information asymmetries, conflicts of interest, customer awareness and communication. They will also need to think about product suitability, the timing of contract repapering, spread adjustment and how to manage value transfer. UK and US regulators, such as the Consumer Financial Protection Bureau (CFPB), have emphasised conduct risk in LIBOR transition. There is also the risk of rates dislocation in stressed markets and continuing economic uncertainty giving rise to added to complexities of what “treating customers fairly” means. Dealing with non-performing loans referencing LIBOR will be particularly tricky.

- ❑ Ensure the firm's conduct framework is fit for purpose to be applied to the multi-facetted LIBOR transition related activities across front-, middle- and back-book.
- ❑ Ensure robust quantitative and qualitative KPIs have been defined for client outreach and contract transition.

Refer to our separate "10 Questions" with respect to "Conduct Risk" for further information.

7. Do the firm's solutions meet operational readiness criteria and target dates?

Successfully transacting a range of products referencing alternative rates in several currencies will need operational enablement to process the new RFRs. Additionally, continued demand for LIBOR products will also require fallback provisions. The transition of legacy portfolios will need comprehensive identification of relevant contracts and clauses to be amended. The Target Operating Model may require technology upgrades or specialised solutions, for which new third-party vendors may need to be procured.

- ❑ Assess documentation of booking models, developed or re-calibrated risk models, and suitability of end-to-end processes for alternative products referencing RFRs.
- ❑ Assess suitability and status of technology solutions, especially critical upgrades to vendor lending and treasury platforms, as well as solutions for back-book transition.

8. Have prudential risks, accounting and tax implications been sufficiently considered?

Interactions between benchmark reform and prudential frameworks, accounting and tax treatment have been identified at industry level and raised with national and international authorities and standard setters. Some have proposed measures to offer relief for certain impacts that arise as a result of LIBOR transition. It is important to contribute and track continuing developments and optimise the firm's transition strategy to mitigate such transition-related enterprise risks as well as considering customers who face these issues.

- ❑ Validate impacts of contract transition on market risk, especially basis risk, liquidity, capital, leverage ratios, balance sheet and stress testing, and consider regulatory relief provision
- ❑ Evaluate possible accounting impacts against IASB and FRC amendments and assess identified tax implications against HMRC rules

Refer to our separate "10 Questions" with respect to "Accounting and Disclosures" for further information.

9. Do transition plans consider alternative discontinuation and contingency scenarios?

The period of market volatility and rates dislocation during the pandemic has again highlighted LIBOR weaknesses. International authorities have therefore not only reaffirmed the LIBOR cessation target end date, but there have been some efforts to accelerate the transition.

- ❑ Challenge assumptions about the manner and timescale of LIBOR cessation and ensure suitability of the transition strategy to accommodate alternative scenarios.
- ❑ Assess transition risks, risk frameworks and mitigating actions, focussing on basis risk, financial, operational, legal and conduct risk under a range of market scenarios

10. How can Internal Audit create most value in LIBOR transition programmes?

LIBOR transition programmes are complex, multi-dimensional undertakings. Internal Audit and the audit committee fulfil a supporting role and key control function in identifying risks and ownership, challenging and providing quality assurance that the firm’s governance, risk management and control processes are designed suitably and tracking that they operate effectively through all transition stages.

- ❑ Validate plans and execution against legal and regulatory guidance, market standards and best practice, and track actions, risks, issues, dependencies, and decisions.
- ❑ Get involved in risk assessment from the outset and establish a repeatable process, to enable continuous improvement through design, delivery, and operational phases.

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