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Autorité fédérale de surveillance des marchés financiers FINMA
Autorità federale di vigilanza sui mercati finanziari FINMA
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LIBOR: risks of potential replacement

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1 What is it about?

The UK's Financial Conduct Authority (FCA), which is responsible for overseeing the LIBOR[1] benchmark interest rate, announced on 27 July 2017[2] that it no longer intends to compel the banks currently participating in setting the LIBOR to contribute rates from 2021 onwards. The FCA justifies its decision on the grounds that LIBOR is based on an insufficient number of actual underlying transactions and is therefore vulnerable to manipulation. One possible scenario is that there will no longer be any submissions available for LIBOR from 2021. As alternatives to LIBOR, reference interest rates are currently being discussed around the world at national level.

In Switzerland too, a substantial contract volume – mainly comprised of mortgages and derivative contracts – is tied to LIBOR. The National Working Group on Swiss Franc Reference Rates (NWG)[3] is the key forum for considering proposals to reform reference interest rates and replace LIBOR. The NWG has already established an important basis for replacing the Swiss franc LIBOR with the introduction of the Swiss Average Rate Overnight (SARON).

Nevertheless, there are still uncertainties and risks in Switzerland in connection with a potential replacement of LIBOR. The Swiss Financial Market Supervisory Authority FINMA therefore considers it important to make the supervised institutions aware of the challenges they face in this guidance. The timing of this guidance is intended to give the supervised institutions sufficient time to address the principal risks and make plans to adequately counter these risks.

2 What are the risks?

FINMA has identified three main risk areas, which NWG is also examining, in connection with the possible replacement of LIBOR. These are legal risks, valuation risks and risks in relation to operational readiness.

2.1 Dealing with legal risks

Numerous contracts for financial products that reference LIBOR have a final maturity date after 2021. Amending these contracts to include practicable fallback clauses could help minimise potential legal risks. How can the risk of possible legal disputes be limited? Active management of exposures in the

[1] London Interbank Offered Rate
[2] https://www.fca.org.uk/news/speeches/the-future-of-libor
[3] https://www.snb.ch/en/ifor/finmkt/fnmkt_benchm/id/finmkt_reformrates

context of LIBOR-based contracts and preparing for a transition to contracts based on alternative reference rates are important steps. A transition of this kind, however, requires that the alternative reference rates are based on a sufficient trading volume.

To ensure a seamless transition to equivalent products which are based on alternative reference rates, the supervised institutions should adopt a clear communication strategy towards their customers and counterparties. This will provide transparency and help reduce the likelihood of legal conflicts.

2.2 Dealing with valuation risks

The high amount of receivables and payables in the area of derivatives and lending contracts that reference LIBOR result in valuation and basis risks. The alternative reference rates proposed in the context of national efforts are based solely on overnight rates, for instance. However, the maturity structure still needs to be defined in some cases. Accordingly, it is not currently possible to reliably predict the impact of LIBOR replacement on the valuation of LIBOR-based contracts and on corresponding hedge transactions. However, a quantitative analysis will reduce this uncertainty.

2.3 Ensuring operational readiness

Another key factor in a possible replacement of LIBOR is ensuring from an operational point of view that products that are based on new reference rates can be used in practice. A timely assessment of operational readiness will help achieve a smoother transition to alternative reference rates. In this context, proper valuation, pricing and adequate risk management with regard to alternative reference rates are key. However, this means that both the technical infrastructure and also data management must be ready for a potential replacement.

3 What are the next steps?

FINMA recommends that the supervised institutions address the challenges of a potential replacement of LIBOR in good time. The above information about the primary risks inherent in replacing LIBOR is intended to aid the supervised institutions in focusing on the essential aspects.

FINMA will pursue its supervisory activities in two ways: firstly, it will discuss the issue of the risks posed by a potential replacement of LIBOR in general with the supervised institutions and continue to support the NWG in its work. Secondly, from January 2019 onwards, FINMA will also contact supervised institutions that are particularly affected individually and in a risk-oriented manner. In particular, it will review the adequacy with which risks associated with a possible replacement of LIBOR are identified, limited and monitored. In addition, FINMA will address the potential replacement of LIBOR within the Swiss Solvency Test (SST).