BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Tushar Morzaria
Chair
Working Group on Sterling Risk-Free Reference Rates

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Dear Tushar,

Thank you for your letter regarding regulatory capital impediments to InterBank Offered Rates (IBOR) transition. We consider that the need to transition is a critical one for all involved, and firms must take appropriate action now so that they have transitioned to alternative rates ahead of the end of 2021.

The letter raises a number of important legal and practical issues and I welcome the efforts and engagement of the Working Group on Sterling Risk-Free Reference Rates (Working Group). We are keen to engage closely with the Working Group to address any unintended barriers within our control to support a smooth and timely transition away from London InterBank Offered Rate (Libor) linked products and infrastructure.

Turning to the focus of your letter, we have been working on the potential interactions between the prudential framework and benchmark rate reform, both in the transition period and in steady state. As you recognise, a number of the issues raised in your letter need to be solved at the European or global level. We will welcome your continued engagement with relevant non-UK authorities over the coming months, and for our part, we have been actively pushing for resolution of these issues at the Basel Committee on Banking Supervision, and will continue to do so.[1]

To take the main themes highlighted in the body of your letter:

- *AT1 and Tier 2 Capital*; capital instruments that currently reference Libor will need to be amended. Some firms have informed us that such amendments to instruments might mean that the eligibility of the instrument as capital under the Capital Requirements Regulation would need to be reassessed as if it were a new instrument. This could mean, for example, that where the terms of a legacy instrument are amended for a new reference rate, the instrument may no longer count as a fully eligible instrument, if it is judged to fall short of the eligibility criteria. This could result in a sudden drop in a bank's capital position.

  In relation to AT1 and Tier 2 Capital, we do not believe it is desirable to reassess the eligibility of instruments where the amendments are solely to replace the benchmark reference rate. The PRA has made the point at the Basel Committee on Banking Supervision and is making progress towards achieving an internationally consistent response.

- *Bilateral margin requirements for non-cleared derivatives*; a similar issue to the one above has previously emerged in the context of the impact of benchmark reform on legacy non-cleared derivatives contracts. In this case, international regulators have already made clear that the new requirements are

[1] https://www.bis.org/bcbs/bcbs_work.htm#workprogramme and https://www.bis.org/press/p191031.htm.

not intended to apply to legacy contracts where they were amended solely to deal with interest rate benchmark reforms.[2] Within the European Union, the European Supervisory Authorities have recently confirmed their commitment to this approach,[3] and we are strongly supportive of these clarifications.

- *Rules related to Resolution;* in certain circumstances, our rules on Contractual Recognition of Bail-In and Stay in Resolution could be considered relevant where legacy contracts are judged to have been materially amended. We are also considering possible implications of benchmark rate reform for those rules, and plan to provide an update in spring 2020.

- *Counterparty Credit Risk, Market Risk, and Interest Rate Risk in the Banking Book (IRRBB);* your letter raises a number of modelling challenges that are relevant to counterparty credit risk, market risk and interest rate risk in the banking book. Some of these challenges include the following:
  - reduced liquidity of Libor contracts can have implications in a number of frameworks. In the counterparty credit risk framework, risks associated with illiquid contracts are reflected through increased margin periods of risks for affected netting sets. As outstanding Libor contracts fall to an irreducible minimum we expect liquidity to fall to levels where such provisions may become relevant, and firms will need to take this into account when planning their transition programme. Liquidity risks can also change capital requirements in the market risk framework;
  - how to address basis risks in both the market risk (including Risks Not In Value-at-Risk models) and IRRBB frameworks. These can arise in a variety of ways – for example, when hedging relationships become less effective as only particular contracts are transitioned over to reference an alternative reference rate, or where assets and liabilities in the banking book refer to different underlying rates; and
  - changes relating to new benchmark rates could require widespread model changes, putting pressures on firm and supervisory capacity.

  In response, in the immediate future:
  - we will meet again with major firms in Q1 2020. Supervisors will discuss with firms how they can take a consistent and appropriate approach to managing these risks through the transition period, and will expect appropriate analysis to feature in the upcoming Internal Capital Adequacy Assessment Process (ICAAP);
  - supervisors will write to firms with Internal Model Method (IMM) and Internal Model Approach (IMA) model approvals to ask them to identify the number and type of models that will need amending and to let supervisors know when they expect to submit model changes for pre-approval; and
  - based on responses and feedback we will look to communicate our plans for model review in Q2 2020. We will also consider communicating more formally our expectations on risk management or modelling aspects in due course, particularly if we see unacceptable practices emerging. While pre-approval of any material change is likely to be required, we plan to take a proportionate approach to ensure that pressures on firm and supervisory capacity do not cause an unnecessary barrier to a smooth transition.

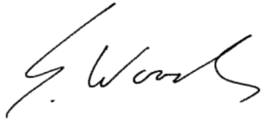
As we stressed in our June 2019 feedback on Firms' preparations for transition from London InterBank Offered Rate (LIBOR) to risk-free rates (RFRs) last year,[4] it will be important for banks' senior management to remain closely engaged with these risks (and others as they emerge) to ensure that they receive the attention needed. Supervisors will be engaging regularly with firms in the coming year. As set out in September 2018, the participation and commitment of market participants to develop new market structures,

[2] https://www.bis.org/press/p190305a.htm.
[3] https://eba.europa.eu/emir-rts-various-amendments-bilateral-margin-requirements-and-joint-statement-introduction-fall.
[4] https://www.bankofengland.co.uk/prudential-regulation/publication/2019/firms-preparations-for-transition-from-libor-to-risk-free-rates.

new technologies, and standards and solutions to address the various challenges during this transition has been, and will continue to be, an essential part of the success of this collective effort.

Relevant PRA teams are actively engaged bilaterally and through the Working Group to take forward the detailed issues included in the Annex to your letter and other issues as they emerge. I would like to suggest that we meet in spring 2020 to consider how work on the regulatory interactions of benchmark reform is progressing. In the meantime, please feel free to contact either myself, or Victoria Saporta, who heads up the Prudential Policy Directorate, as things progress.

Yours sincerely



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