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The International Swaps and Derivatives Association
New York

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Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA Definitions Consultation

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make observations on the consultation concerning Interbank Offered Rate (IBOR) Fallbacks for 2006 ISDA Definitions Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW (Consultation).

AFMA is a member-driven and policy-focused industry body that represents participants in Australia's financial markets and providers of wholesale banking services. AFMA's membership reflects the spectrum of industry participants including banks (both foreign and domestic), stockbrokers, dealers, market makers, market infrastructure providers and treasury corporations.

As an industry body we are not providing specific feedback on the Consultation's central question regarding the approach for addressing certain technical issues associated with adjustments that will apply to the RFRs if the fallbacks are triggered. Our purpose here is to inform ISDA on action being taken in Australia to prepare for the transition from IBOR benchmarks to alternative fallbacks.

1. Preparing Australia for the transition

In contrast to LIBOR which is facing an existential threat due to the impending withdrawal of support by the UK Financial Conduct Authority, the Australian benchmark (BBSW) has ongoing official sector support. As a result, BBSW continues to enjoy domestic industry support. It has the strength of being based on actual market transactions so does not face the fundamental criticism which has affected official confidence in LIBOR. Looked at from a domestic point of view for local transactions the market could continue on a business-as-usual course if it was isolated from global influences. However, as an open economy for which a large proportion of capital is raised offshore and swapped back into Australian dollars, international developments in major financial markets have a strong influence on

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local activity and practices. Accordingly, the impact of transition to risk free rates (RFRs) in the major global financial markets is a disruptive one for Australia which we must prepare for in a timely manner.

It is felt by Australian market participants that they could not continue to rely on a traditional interbank rate if the RFR methodologies adopted in other markets meant a divergence in the basis of credit and term risk elements of the rates and that Australia will have little choice but to adapt to these external developments. The Australian authorities have taken a watching brief on the transition away from LIBOR while supporting changes to the BBSW methodology to encourage its sustainability. As for how to deal with move away from IBORs for foreign currency transactions, the Australian markets will be largely influenced by the developments in offshore markets.

In general comments from AFMA members are consistent with observations by market participants in other jurisdictions. The transition from IBORs remains a matter of great uncertainty. The term structures of the new reference rates, or even if they will have term structures, remains unclear, as does the timing of the transition. This is predicted to bring considerable costs and risks for financial firms. Since the proposed alternative rates are calculated differently, payments under contracts referencing the new rates will differ from those referencing LIBOR. The transition will change firms' market risk profiles, requiring changes to risk models, valuation tools, product design and hedging strategies.

AFMA members indicate that there will need to be broad market adoption of the alternative RFRs and applied methodologies. Liquidity in the derivatives markets referencing the alternative RFRs will be the key factor in broad market adoption because over-the-counter and exchange traded derivatives account for over 80% of total notional outstanding volumes of IBOR linked contracts. It is too early to know how the replacement to IBORs will price and how quickly liquidity in the derivative markets will develop, and accordingly how quickly commercial risk will begin to price off new reference rates.

2. AFMA activity

AFMA has been seeking to promote industry dialogue and thinking about these broader implications. For Australia, AFMA supports the IOSCO January 2018 Statement on Matters to Consider in the Use of Financial Benchmarks that users need to have robust fallback provisions in relevant contracts and instruments that reference a benchmark.

Over the last year AFMA has been actively promoting Australian market awareness of the issues associated with IBORs transition. Our assessment is that, among the major financial institutions, there is at a minimum awareness of this as an important issue in Australia, and among an increasing number of larger sophisticated financial institutions planning and preparations have commenced. AFMA has now moved on from promoting awareness and acceptance of the importance of the issue to Australian market participants to creating a working group to facilitate information sharing and mechanisms for adaptation to alternative rates at a practical level.

The challenges facing members have been identified through AFMA market technical and governance committee meetings. The impression formed is that members have varying approaches to assessing the impact of broader IBOR reform on their operations. Given that the operational issues and risks go across a number of areas of responsibility it is important to identify how these issues are being organised and at a senior level in our members. The key operational and financial challenges that have so far been identified are:

Operational

- Determining IBOR exposures
- Renegotiation of contract terms
- Governance and controls
- Litigation and valuation disputes
- Technology and infrastructure
- Models and risk management

Financial

- Fair value adjustments
- Accounting and hedging
- Timing basis
- Term basis
- Regulatory costs
- Taxation consequences

To assist in assessing the readiness of members for the effects of IBOR disruption on the Australian market and better understanding our members' preparations we have prepared a survey which asks respondents about aspects of organisational readiness to deal with a range of operational and financial issues and risks. Survey feedback will be used to inform AFMA members on the current state of awareness and preparedness in the Australian market and local member sentiment on methodologies being favoured in responses to ISDA's consultation. This will inform the direction of future work that needs to be undertaken by AFMA from an industry wide perspective.

3. Australian fixed income market considerations

As highlighted in the consultation, the anticipated disruption caused by the transition is a considerable challenge for all IBOR users, including those in Australia. While much of the notional value of affected contracts sits in the derivatives markets, the cash markets in the form of loans and bonds underlying end user economic activity, constitutes a significant proportion of the overall total. In relation to the Australian fixed income market, term LIBOR is currently used as a reference in floating-rate notes, securitisations and also capital securities.

With regard to our central role in dealing with debt capital market issues in Australia, AFMA is focused on the fixed income market considerations associated with this issue. We see ISDA as taking the lead with regard to derivatives contracts thorough its current processes. There is need for coordination with other industry groups with regard to other market documentation such as loans, as noted below.

Australian issuers referencing BBSW in their floating rate notes because of their shorter dated tenors do not yet face the immediate problems of longer-dated bonds referencing LIBOR which mature in 2021 onwards, but it is recognised that it is far better to face the issue now and adopt more robust and flexible alternative reference rate mechanisms in bond issue documentation that is currently being created rather than wait and allow the issue to build until it becomes a major problem for the market. The key broader objective that ties in with ISDA's Consultation is to ensure bonds can be hedged effectively if the associated derivative is referenced to an RFR. If a permanent discontinuation of an IBOR or other benchmark occurs, the fallback provisions would need to be sufficiently robust to prevent potentially serious disruption to markets and market participants (including users and their clients), and to safeguard the continuity of contracts, as a result.

Conversion is likely to be more complex in the bond market than in the derivatives market. Unlike the derivatives market, which can look to an ISDA protocol to amend the master agreements governing the great bulk of derivatives contracts, the protocol mechanism is not available to the bond market. In addition, the terms and conditions of bonds are not entirely consistent across different issues. If LIBOR is discontinued and legacy contracts are not amended, many of the legacy bonds could revert to a fixed rate (being the last available floating rate) for the remaining term of the bonds. This is not an outcome that would be desirable from either the issuers or the bond holders' point of view. Amendments to bond terms and conditions are difficult, costly and time consuming for issuers and bond holders and with an uncertain outcome because amending the terms of bond issues requires very high thresholds of bondholder consent. This makes it impractical in terms of effort and cost to obtain bondholder consent to a new fallback provision. This is a difficult problem we are tackling.

4. Industry coordination

AFMA is of the view that international coordination is needed between the bond markets and the derivatives markets during the transition from the IBORs to RFRs, and particularly as new bond issues are frequently hedged in the derivatives market. It would be helpful if there is international coordination across products both in agreeing fallbacks on new contracts referencing RFRs, in case LIBOR ceases to be published, and in setting the triggers under which the fallbacks would be used. It is AFMA's intention to work to this end with our members and in collaboration with relevant industry associations such as ISDA and ICMA.

AFMA is also in dialogue with other local associations on issues, including the Australian Securitisation Forum, the Finance & Treasury Association and the Asia Pacific Loan Market Association. We have agreed to establish an industry group of the associations to coordinate work across the Australian market sectors and interact with the authorities. A key focus will be on coordinating industry documentation with close attention being paid to ISDA's work on a protocol and the 2016 ISDA definitions.

AFMA is committed to working with ISDA on the issues associated with IBORs transition and will maintain our close dialogue through its Asia-Pacific representatives.

Please contact David Love either on 02 9776 7995 or by email dlove@afma.com.au if further clarification or elaboration is desired.

Yours sincerely

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