Practical Applications Checklist for Adopting Alternative Reference Rates

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2 Introduction

In the context of the interest rate benchmark reform carried out by the FSB (Financial Stability Board), the British Financial Conduct Authority (FCA) had announced that it will not support LIBOR as of the end of 2021. Institutions that set the standards then started works to determine alternative reference rates. Alternative reference rates were determined as part of the transition works conducted by global authorities for some time. A similar process is continuing in our country where Borsa Istanbul has been publishing the Turkish Lira reference rate (TLREF) and the TLREF index as of 2019 to replace TRLIBOR. The IBOR transition National Working Committee (NWC) was established to both plan the transition from TRLIBOR to TLREF, ensure that the global IBOR transition processes are carried out smoothly and coordinate the transition to new alternative reference rates. The NWC includes CBRT, BRSA, CMB, TCMA, Borsa İstanbul A.Ş. and banks. In statements made by regulatory authorities, it was expressed that the publication of the current reference rate s would strictly be ceased and that market participants had to take the necessary measures for transition from the current reference rates to alternative reference rates. The issue of timing is of great importance for market participants considering that the current rates will be ceased as of the end of 2021.

Although the practical applications discussed in this document aim to accelerate the adoption of TLREF, they also aim to ensure a smooth transition of other IBOR-indexed products on bank balance sheets.

The working group is carrying out works to guide market participants about practical issues related to transition from the current reference rates to alternative reference rates. The “Practical Applications Checklist for Adopting Alternative Reference Rates” was taken into consideration under ten subheadings in detail to inform market participants.

3 Summary

The IBOR (Interbank Offered Rate) transition in an important fact that affects various financial products and financial markets. Planning, mobilizing and executing a comprehensive schedule is important considering that the current reference rates are deeply related to the financial ecosystem. The “Practical Applications Checklist for Adopting Alternative Reference Rates” document was prepared to address main topics that institutions that will be affected from the transition need to assess.

4 Practical Applications Checklist for Adopting Alternative Reference Rates – Summary

Establishing the Schedule Governance: A governance structure should be established that includes experienced and senior executives and tracks and supervises the preparation and coordination of the IBOR transition process schedule.

Developing the Transition Management Plan: A business plan should be developed that identifies and eliminates product and customer-specific risks caused by the transition.

Implementing the Communication Strategy: With the transition process, proactive communication should be established with stakeholders affected by the transition and a clear communication strategy should be created and implemented to increase the stakeholders' knowledge.

Risk Identification and Verification: The risks caused by the current reference interest rates should be determined and a flexible approach should be developed to track the situation. An infrastructure should be developed for adopting products related to alternative reference rates.

Developing a Product Strategy: New product strategies based on alternative reference rates should be developed to restructure product portfolios that are based on the current reference rates.

Risk Management: Financial and non-financial risks caused by the transition should be measured, tracked and controlled. Processes and routine supervision mechanisms should be established for the standard management of the risks.

Assessing the Effects and Design Plan of Contract Arrangements: Potential effects related to financial, customer-induced and legal issues, resulting from the application of fallback language during the IBOR transition should be understood. An implementation plan minimizing the risk posed by such effects should be assessed.

Developing an Operation and Technology Readiness Plan: An operation and technology plan should be developed that includes the operational model, data model and technology applications during the IBOR transition.

Accounting and Reporting: Issues such as the IBOR transition, fair value estimation, hedge accounting and fund transfer may create a complex structure. Accordingly, accounting issues and related reporting issues should be determined.

Taxing and Regulation: It may be necessary to review whether the changes resulting from the IBOR transition cause nonconformities related the tax legislation. In this context, stamp duty, transfer pricing and the taxation of the new products from the perspective of the investor should be taken into consideration.

5 Practical Applications Checklist for Adopting Alternative Reference Rates – Detailed

5.1 Establishing the Schedule Governance

A robust governance system should be realized where the IBOR transition schedule preparations across the institution and coordination will be supervised led by senior executives.

1. Sponsors and senior executives should be appointed, tasked with coordinating and supervising the IBOR transition schedule activities specific to the affected fields of business.
2. Sponsors, project/workflow leaders and a project management team should be determined to put the transition schedule activities into practice.
3. A schedule governance model approach should be adopted specific to the affected fields of business and corporate functions.
4. A "Steering Committee" chaired by sponsors suitable for the task of leadership should be established in all fields of business and corporate functions.
5. The frequency should be determined of the regular communications and reports to be applied for senior executives, the board of directors, senior management committees and suitable sub-committees.

5.2 Developing the Transition Management Plan

A plan should be developed specific to fields of business to identify and mitigate risks related to the transition. This plan should also include specific assessments for product and customer risks.

1. A comprehensive impact analysis should be conducted for financial products, contracts, business processes (with systems and models) and similar basic fields.
2. An implementation roadmap should be developed in consideration of priorities specific to the affected fields of business, products and corporate functions.
3. Resource and budget requirements should be determined to realize the implementation roadmap activities.
4. A project management systematic should be set up to track the current status of the activities in the implementation roadmap, observe the progress and timely identify the risks.
5. The activities in the implementation roadmap should be proactively tracked in accordance with changing sector dynamics and legislative developments.

5.3 Implementing the Communication Strategy

A strategy with clear objectives should be developed and implemented across the institution to establish proactive communication with the affected stakeholders including the senior management and the board of directors, ensure the continuity of communication and increase the level of training.

1. The main objectives and priorities of the external communication plan should be developed consistently with the internal communication works.
2. Internal and external stakeholders (customers, regulators, trade unions etc.) should be identified and duly prioritized and separated into segments. Maximum care should be taken to ensure that the rules of competition are not violated in the communication with external stakeholders.
3. The channels and media used in communication should be merged.
4. Suitable communication documents should be developed to inform internal and external stakeholders. (e.g., training documents and videos, new bulletins, customer statements).
5. Internal stakeholders (including the management) should be informed and trained on current developments in the sector and the objectives and effects of the IBOR transition.
6. Clear and consistent information should be provided to external stakeholders (customers and investors) about the effects of the transition.
7. External relations should be developed to proactively manage legal, management and reputation risks.

5.4 Identifying and Verifying the Risk

A flexible approach should be developed for the transition period to track the risk status caused by the current reference rates. Also, an infrastructure should be developed to be used in assessing products based on alternative reference rates.

1. Product risk analysis should be performed according to products and maturity dates, covering the credit limits and

similar off-balance sheet risks to determine the risks related to the current reference rates as specific to all fields of business.

2. The risk status should be measured of products based on the current reference rates with post-2021 year-end maturity dates.
3. If the current reference rates continue being used and published, a repeatable assessment and reporting process should be developed for risks that arise post-2021. The process should include trend analysis, work plans and management.
4. An alternative reference rate yield curve should be created to be used in discounting TRY derivatives and pricing products based on the alternative reference rates.
5. It should be known that historical data on the alternative reference rate to be used is needed for valuation, pricing system and model updates.

5.5 Developing Product Strategy

A strategy should be developed that involves the creation or use of new products based on alternative reference rates for the rearrangement of portfolios comprised of products based on the current reference rates.

1. A roadmap should be created that includes strategies and milestones for reducing the use of the current reference rates in new product developments.
2. Regarding offering new products based on alternative reference rates, a schedule should be prepared in consideration of the timing compliance of the product subject to hedge accounting.
3. Risks and new product approval requirements should be determined on issuing products based on alternative reference rates. In this context, focus should be put on the economies of the products.
4. The works disclosed to the public by other sector participants about products not based on the current reference rates should be assessed and the new product development process should be initiated subsequently.

5.6 Risk Management

Financial and non-financial risks related to the transition should be identified, measured, tracked and controlled. In this context, processes and surveillance routines should be established for ongoing risks.

1. The transition risks (including market, operation, financial and legal risks) caused by the cessation of the current reference rates should be identified and these risks should be assessed in the context of the risks already identified by the institution.
2. Processes should be created to track significant risks identified under the main and alternative transition scenarios (e.g., market adoption, product and currency liquidity; current and stressful market conditions). The effects on interest yield, finding, liquidity and capital should be assessed.
3. Mitigating actions should be determined that address specific transition risks specific to basis risks, product and operational risks and management risks.
4. Processes should be developed to update the risk management routines.
5. Regular reports should be submitted to the senior management after significant and critical risks are identified.
6. Their effect on risk models should be assessed and update processes should be developed as in the case of directives established for validation requirements.
7. The roles of Internal Audit and similar basic functions should be determined.

5.7 Assessing the Effects and Design Plan of Contract Arrangements

In consideration of the case where legacy signed contracts use contractual fallback language, the financial, customer-induced and legal effects to be caused by the transition from the current reference rates to alternative reference rates should be understood.

1. Contracts based on the current reference rates should be examined to understand the effects of fallback language on contracts. Determining the trigger events that activate fallback language, any changes in the conditions, the financial effects, the effects on the customer and legal interpretations should also be addressed in this context.
2. Any actions required to be taken as a consequence of examining the effects of fallback language on contracts should be assessed according to priorities. Such effects should be addressed in consideration of the financial, legal, customer and operational aspects.
3. Care should be taken to ensure that new contracts using the current reference rates have fallback language.
4. The approaches and priorities should be determined for contract renegotiation / adjustment for legacy contracts using the current reference rates. At this point, improvements should be made to simplify the IBOR transition, such

as making the fallback language more comprehensive. Works to be improved in advance should be determined and the realization of economies of scale should be addressed. As soon as possible;

a. Contracts should start to be amended to contain the developed fallback language; or
b. The issues should be clarified of whether contracts will be renegotiation or terminated before the end of 2021.

5. Assuming that it will not be possible to adjust a significant number of contracts, the schedule required to implement the fallback language in writing should be determined and planning should be initiated for implementation. Furthermore, it should be noted that such implementation should include customer notification processes.

5.8 Developing an Operation and Technology Readiness Plan

A plan addressing the large-scale operation model, data and technology applications should be developed for a successful transition.

1. Operational issued using and affected by the current reference rates should be identified. It should be noted that each business unit will have different risks and different priorities.
2. The places where the current reference rates are "particularly" used should be determined for all lines of business.
3. Process should be designed to incorporate new data sources and calculation methodologies into the bank systems. After new products based on alternative reference rates start being used on the markets, it will become possible to take into consideration the best practices in the sector.
4. Requirements should be determined and suitable infrastructures should be prepared to offer financial products based on alternative reference rates that will replace products based on the current reference rates.
5. The necessary technological infrastructure should be prepared for the activation of fallback language.
6. Test plans and model acceptance criteria should be developed for new products and the activation process of fallback language should be activated. In this context, it should be ensured that operational structure and technology providers are ready.
7. Planning should be started for internal tests, tests for third-party validation/preparation for the transition and sector-wide tests.

5.9 Accounting and Reporting

Issues such as the IBOR transition, fair value estimation, hedge accounting and fund transfer may create a complex structure. Accordingly, technical accounting issues and related reporting issues should be determined.

1. The effects on hedge accounting standards and processes should be determined (e.g., definition of hedging, effectiveness).
2. The effects of the IBOR transition on the accounting standards and processes of cash products should be determined and the publications of the International Accounting Standards Board (IASB) and the Public Oversight Authority (POA) should be closely monitored.
3. The fair value calculations and the fair value hierarchy should be reviewed.
4. The effects on existing finance systems, operations and reports should be determined and control systems should be developed specific to the affected processes.
5. The effect of a multi-rate system in interbank funding and derivative markets on transfer pricing should be determined.
6. Financial statements should be updated where necessary.

5.10 Tax and Legislation

Tax issues should be examined under two topics. The requirements of Tax Laws and points that companies should pay attention. While the Tax Administration needs to take action for the amendments in the law, the operations to be performed by Banks during the transition can be summarized as their tax teams taking into consideration how to tax;

1. Pricing changes in contracts with group companies with respect to transfer pricing,
2. All amended contracts with respect to stamp duty,
3. And financial products taking values from the new references with respect to investors.

6 Annexes

6.1 Abbreviations and Terminology

BRSA	Banking Regulation & Supervision Agency
FCA	Financial Conduct Authority
FSB	Financial Stability Board
CMB	Capital Market Board
NWC	National Working Committee
BAT	The Banks Association of Turkey
CBRT	The Central Bank of the Republic of Turkey
TCMA	Turkish Capital Market Association

IBOR	Interbank Offered Rate
LIBOR	London Interbank Offered Rate
USD	United States Dollar
TLREF	Turkish Lira Reference Rate

Basis risk	Increase or decrease of the difference between the spot price and forward price of an asset

6.2 References

ARRC - Practical Implementation Checklist for SOFR Adoption

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