

Developments of the Benchmark Rate Reform in Malaysia

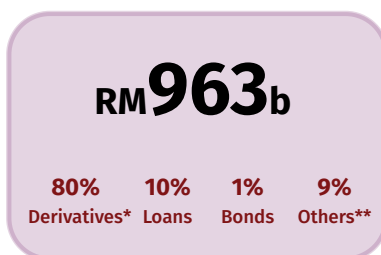
London Interbank Offered Rate (LIBOR) Transition: Recalibration of Malaysia's Transition Signposts

There has been considerable progress since the first publication of the Bank's LIBOR transition³ signposts in 2020.⁴ Banks in Malaysia have been proactively engaging borrowers to renegotiate benchmark replacements and to develop fallback provisions in existing LIBOR-based loan contracts in an effort to manage tough legacy⁵ contracts and reduce the consequential legal risk. Banks are also working through system enhancements needed to ensure their operational readiness to support products priced off alternative risk-free rates (RFR). These efforts were interrupted by COVID-19 in some banks, but are expected to pick up pace again in 2021. Malaysian banks with significant derivative exposures have also adhered to the International Swaps and Derivatives Association (ISDA) 2020 Interbank Offered Rate (IBOR) Fallbacks Protocol, which enables market participants to amend the terms of their derivative contracts. The Malaysian banking industry's LIBOR exposures⁶ stood at RM963 billion as of 31 December 2020 (Diagram 2.1).

Cash products present a different hurdle in transitioning to RFRs due to the lack of a forward-looking term structure. While borrowers prefer certainty in their future monthly cashflows, the actual rate under the compounded-in-arrears convention of term RFRs is known only at the end of the interest period. Hence, there is a mismatch between the demand and supply of RFR-referenced products without a forward-looking term structure. In order to address the lagging demand, the Alternative Reference Rate Committee (ARRC)⁷ in the United States of America (US) is working towards identifying a potential administrator to publish the forward-looking term Secured Overnight Financing Rate (SOFR) by the end of 2021. The success of this hinges upon liquidity conditions of the SOFR derivatives markets, from which the forward rate is derived.

Recently, the ICE Benchmark Administration (IBA), the global administrator of LIBOR, announced a delay to the cessation of the publication of USD LIBOR for the overnight, 1, 3, 6, and 12-month tenures by 18 months to 30 June 2023. The publication of all other USD LIBOR tenures and LIBOR currencies will, however, cease on 31 December 2021 as planned.

Diagram 2.1: Malaysian Banks' LIBOR Exposures as of 31 December 2020



* Refers to notional amount

** Mainly interbank lending/borrowing and customer deposits

Note: At consolidated banking group level

Source: Bank Negara Malaysia

³ As part of the global reform of benchmark interest rates, LIBOR will be discontinued and replaced with alternative risk-free rates (RFR).

⁴ Refer to the Information Box on 'Benchmark Rate Reform: LIBOR Transition' in the BNM Financial Stability Review for Second Half 2019 for further details.

⁵ Existing LIBOR referencing contracts that are unable to be converted into non-LIBOR rates or amended to include fallback provisions when LIBOR is discontinued.

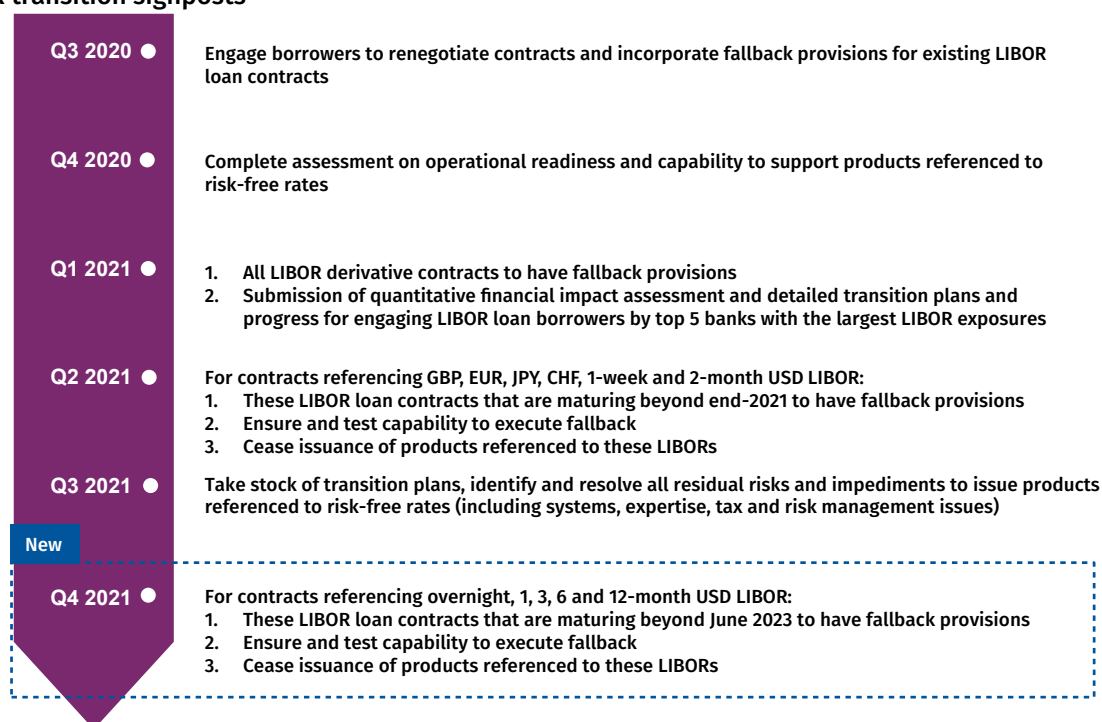
⁶ Refer to the outstanding amount of on-balance sheet exposures and notional amount of derivatives at the consolidated banking group level.

⁷ ARRC consists of a group of private-market participants, convened by the Federal Reserve Board and the New York Fed, to help ensure a successful transition from the USD LIBOR to the Secured Overnight Financing Rate.

In line with this development, the Bank is recalibrating key signposts to facilitate renegotiations and provide sufficient time for the demand of SOFR-based cash products to grow, as the forward-looking term SOFR is expected to be published before end-2021. Two signposts will be shifted from the original target of the second quarter of 2021 to the fourth quarter of 2021. First, the cessation of new products referencing the overnight, 1, 3, 6, and 12-month USD LIBOR, and second, the incorporation of fallback provisions in existing USD LIBOR-referenced contracts maturing beyond June 2023 (Diagram 2.2).

Diagram 2.2: Recalibrated Key Transition Signposts

LIBOR transition signposts



End of Dec 2021: GBP, EUR, JPY, CHF, 1-week and 2-month USD LIBOR cease to exist

End of Jun 2023: Overnight, 1, 3, 6 and 12-month USD LIBOR cease to exist

Note: Signposts may be reviewed if there is any change in the global transition timeline
Source: Bank Negara Malaysia

Development of an Alternative Reference Rate (ARR) and Refinements to the Kuala Lumpur Interbank Offered Rate (KLIBOR)

As for domestic benchmark rates, in line with global benchmark reform efforts recommended by the Financial Stability Board (FSB), the Financial Markets Committee (FMC) will oversee efforts in developing an ARR, which adheres to the Principles for Financial Benchmarks by the International Organization of Securities Commissions (IOSCO). The ARR will run parallel to the existing KLIBOR, providing sufficient time for market participants to prepare for its adoption.

In the first half of 2021, the FMC will conduct a public consultation to gather feedback on the proposed ARR and methodology. This is to ensure that the development of the ARR will take into account views from key stakeholders, including both the sell and buy side (e.g. banks and institutional clients), and will serve as an effective reference rate for all products including derivatives, loans and securities. Upon its finalisation, the Bank intends to commence publication of the ARR in the second half of 2021, which will allow market participants to start designing and pricing financial products based on the ARR.

Alongside this exercise, the Bank also intends to introduce additional refinements to the KLIBOR framework, including the incorporation of fallbacks, to further enhance its integrity and reliability as a financial benchmark.