

Benchmark Rate Reform: LIBOR Transition

London Interbank Offer Rate (LIBOR) has been a dominant reference rate used in financial transactions globally, with more than USD300 trillion in outstanding financial contracts that reference LIBOR. As part of the global reform of benchmark interest rates, LIBOR will be discontinued by end-2021³⁹ and replaced by alternative risk-free rates (RFRs).⁴⁰ As existing LIBOR panel banks will also gradually cease to support this benchmark rate, it is likely that LIBOR will no longer represent accurately and reliably the market or economic reality that the benchmark is intended to measure. The transition away from LIBOR could have significant legal, valuation, accounting, risk management, and system implications for banks globally. Therefore, there is a need for the financial industry to strategise and accelerate the preparation for the transition away from LIBOR.

The Malaysian banking industry's LIBOR exposures⁴¹ are considerable at RM857 billion as of 30 June 2019 (Diagram 1.5). Derivative contracts account for 79% of the LIBOR exposures but pose lower transition risk as these contracts are largely standardised with concerted global efforts⁴² to develop fallback provisions well in progress. Existing LIBOR loans maturing beyond 2021 pose greater concern, as these loans require banks and borrowers to renegotiate existing contracts individually and incorporate fallback provisions. The spread between the existing LIBOR and the RFR can result in potential gains to one party of the transaction and losses to the other. For example, if the RFR is lower than the existing LIBOR, the borrower may gain from the lower rate at the expense of the bank. Any potential transfer of value between parties of the transaction arising from the transition to the RFR could complicate contract modifications and pose legal, tax, reputational and economic risks to banking institutions.

Diagram 1.5: LIBOR Exposures as of 30 June 2019



*Mainly interbank lending/borrowing and customer deposits

Note: At consolidated banking group level

Source: Bank Negara Malaysia

The unavailability of a reliable term structure for RFRs presents a further challenge as under the new RFRs, the actual term rate will only be known at the end of the compounding period.⁴³ Given this constraint, borrowers are reluctant to adopt the new RFRs as they prefer more certainty in their expected monthly cash flows. In response, industry and regulatory efforts to offer new RFR term rates have recently intensified. The Federal Reserve Bank of New York, administrator of the US Dollar Secured Overnight Financing Rate (SOFR), for example, has begun to publish SOFR term rates⁴⁴ beginning 2 March 2020. This move will facilitate the renegotiation of LIBOR loan contracts.

For the Malaysian banking industry, the Bank has established key signposts to ensure that banks adequately prepare for and manage a smooth transition away from LIBOR (Diagram 1.6).

³⁹ Financial Conduct Authority (FCA) UK indicated that by end-2021, the FCA would no longer compel panel banks to submit quotes for LIBOR.

⁴⁰ Based on overnight trades in markets, whether unsecured or secured, where liquidity is deep enough to allow the rate to be strongly anchored in transactions, including in more adverse market conditions. The RFRs, by largely excluding bank credit risk, also closely track central bank policy rates, offering a more efficient and transparent way of measuring, managing, and hedging movements in those rates.

⁴¹ On balance sheet outstanding amount and derivatives notional amount at consolidated banking group level.

⁴² Developments in derivative contracts' fallback provisions are driven by International Swaps and Derivatives Association (ISDA).

⁴³ At present, only the overnight RFR is available. In the absence of published term rates for RFRs, the interest chargeable for RFR loans is calculated by compounding the overnight rate over the loan interest payment period (e.g. monthly). As a consequence, the actual rate of the loan will only be known at the end of the interest payment period.

⁴⁴ 30 days, 90 days and 180 days.

Diagram 1.6: LIBOR Transition Signposts



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

Source: Bank Negara Malaysia

All banks have since established dedicated transition teams to oversee the process but actual progress remains uneven across institutions. There is an urgent need for banks to ensure a robust process for identifying and evaluating the range of possible transition risks and accelerate efforts to prepare for the transition. Aside from the potential challenges in renegotiating existing contracts with borrowers, other risks should also be given due consideration. These include banks’ operational readiness and system capability to support products referenced to alternative RFRs, potential tax implications and the impact of changes to banks’ risk management models that rely on LIBOR-based parameters. Banks should also undertake adequate measures to mitigate consumer conduct risks arising from the issuance of new LIBOR-based financial contracts maturing beyond 2021. If not managed well, banks could face significant reputational risks arising from the failure to properly disclose and educate borrowers on the transition to an RFR.