General Guidelines

On

How to Cease Benchmark Interest Rates LIBOR and IBORs to Enhance Financial Stability

Arab Monetary Fund
September 2020

Introduction:

On July 9, 2020, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) submitted a report to the G20, regarding the risks associated with the transition away from the benchmark interest rate "LIBOR" (London Interbank Offer Rate). The report is developed within the framework of international financial institutions' efforts to strengthen global financial stability. According to the report, the reference interest rate "LIBOR", by which the pricing is determined in the London Stock Exchange, will cease after end-2021. Hence, banks and financial markets shall remove remaining dependencies on LIBOR with regard to LIBOR linked loans and financial transactions. The present report includes the results of a survey distributed to central banks around the world, as well as a similar questionnaire by the International Association of Insurance Supervisors distributed to insurance oversight agencies.

In this context, the report indicates that continued reliance of global financial markets on LIBOR poses clear risks to global financial stability. Transition away from LIBOR by end-2021 requires significant commitment and sustained effort from both financial and non-financial institutions (FIs and non-FIs) across many jurisdictions. The importance of transition stems from the fact that $400 trillion worth of global financial products are tied to LIBOR. It is widely used as a reference rate across nearly all asset classes, including: mortgage loans, credit cards and derivatives. Companies and banks use LIBOR to protect their financial positions from fluctuation in the market interest rates, as loans are linked to LIBOR as a reference rate for lending. There are also many international institutions, such as the World Bank, that grant their loans to countries by linking the interest rate to LIBOR (for a period of six months). The Bank for International Settlements (BIS) also estimates that $8 trillion US dollar-denominated cross-border loans linked to LIBOR have been granted outside the United States of America.

Accordingly, the FSB encourages jurisdictions to use overnight interest rates in their financial markets, or any alternative reference rate that enhances the ability of central banks like the US Federal Reserve, the Bank of England and the European Central Bank to shift interest rates in the market based on economic variables. Overnight interest rates depend on actual verifiable market transactions, unlike " LIBOR ", which is a reference rate set by commercial banks under the supervision of banking associations and unions (not subject to central bank supervision).

The FSB approach to the cessation of LIBOR serves as a notice to lenders to be prepared for further scrutiny of their activities to verify that variable interest rates have begun to be linked to an alternative reference to replace LIBOR. This is to bring about gradual transition before the end of 2021.

Mention may be made in this regard that the FSB had previously addressed letters to a number of global systematically important banks in Australia, Britain and Europe, calling for the adoption of alternative standards with less risks, instead of " LIBOR " to support financial reform efforts, and to avoid financial crises such as the global financial crisis of 2008. The FSB also indicated that after discussions with some UK commercial banks during June 2019, it became clear that "LIBOR" is deeply embedded in their asset and liability structures, and instruments used for assessment, pricing and risk management. The FSB also advised that continued linkage of interest rates to " LIBOR " rates in financial markets poses risks to global financial stability.

It is remarkable that the FSB's approach on the cessation of LIBOR rate is linked to the rigging scandal that hit the world in 2012. The scandal arose when several commercial banks were involved in setting the LIBOR rates. These banks made large profits in derivatives of securities rated based on a manipulated LIBOR rate. The scandal prompted the financial industry regulators to search for an alternative, after banks used "LIBOR" to secure loans and contracts worth hundreds of billions of dollars, which exposed loopholes in the benchmark standard.

Normally, interest rates raise when a high risk is prevalent and the liquidity available for interbank lending decreases. On the other hand, interest would fall when there is minor risks involved and availability of liquidity. Therefore, the levels of these instruments give an indication on the levels of supply and demand for funds available for loans and the levels of optimism and pessimism in global and local markets.

In this regard, the primary challenge is to gradually cease LIBOR rate, since it is still tied to more than 400 trillion dollars in financial contracts around the world. Therefore, finding an alternative to LIBOR would pose a challenge for commercial banks, companies and investors.

The report of the FSB and BCBS concludes that the cessation of " LIBOR " by global financial markets poses clear risks to global financial stability. Perhaps among the most prominent risks, according to the findings of the survey distributed to central banks, are the following:

A. Operational Risks: Systems and processes must be updated for all products currently referencing LIBOR so that they can instead rely on alternative reference rates, taking into account any banking systems that rely on third parties, as they need to be adequately prepared for the transition.

B. Legal Risks: If financial institutions do not adequately identify and address affected legacy contracts. The risks could be compounded by the volume and complexity of potential contract amendments and potential consent required for covenant modifications.

C. Prudential Risks: Financial Institutions may find difficulties in managing market risks and calculating embedded gains or losses for capital buffers requirements in case pricing and valuation inaccuracies arise.

D. Reputational Risks: Alternation of reference rate with variable interest applied may negatively affect fair treatment of clients and arise potential conflicts of interests.

Transition away from LIBOR by end–2021 requires significant commitment and sustained effort from both financial and non-financial institutions across many jurisdictions. On 1 July the FSB reiterated its view that financial and non-financial sector firms across all jurisdictions shall continue their efforts to make wider use of risk-free rates to reduce reliance on Interbank Offered Rates (IBORs) where appropriate and in particular to remove remaining dependencies on LIBOR by the end of 2021.

The report includes insights on remaining challenges to transition based on surveys undertaken by the FSB, the BCBS and the International Association of Insurance Supervisors (IAIS). It sets out recommendations for authorities to support financial institutions' and their clients' progress in transitioning away from "LIBOR" rate.

The report also shows that most FSB jurisdictions have a strategy in place to address LIBOR rate transition. However, several other jurisdictions lack a viable strategy or plan to address such transition.

In light of the expected cessation of LIBOR after end-2021, authorities shall strengthen their efforts in facilitating financial and non-financial institutions to transition away from LIBOR rate.

The report includes three sets of recommendations to support LIBOR rate transition:

1. Identification of transition risks and challenges – authorities and standard-setting bodies to issue public statements to promote awareness, and authorities to undertake regular surveys of LIBOR exposure.

2. Facilitation of LIBOR transition – authorities to establish a formal transition strategy supported by adequate resources and industry dialogue. Supervisory authorities shall consider increasing the intensity of supervisory actions when the preparatory work of individual banks is unsatisfactory.

3. Coordination – authorities to promote industry-wide coordination, maintain dialogue on the adoption of fall-back language, consider identifying legislative solutions, where necessary, and exchange information on best practices and challenges.

LIBOR transition is a G20 priority and the report responds to the G20 members request to identify remaining challenges to benchmark transition and to explore ways to address them

Based on the foregoing, and given the importance of the topic in reducing risks that may negatively affect financial stability, the Arab Monetary Fund has developed general guidelines on the transition from LIBOR and IBORs to enhance financial stability. The Guidelines provided for in this document are within the framework of the fund's keenness to provide advice to its member states in the field of developing the financial sector.

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LIBOR and IBORs to Enhance Financial Stability

Principle (1)

Forming an interim provisional committee within the Central Bank to draw up a transition plan from LIBOR (London Inter-Bank Offered Rate), and IBORs (Interbank Offered Rates) benchmark reference rates, if applicable. The committee shall submit periodic reports to the Central Bank management or the Financial Stability Committee or both, until the expiry of its mandate.

Principle (2)

In principle (1), it is preferable that members from departments concerned with financial stability, banking supervision, foreign investments, open market operations, risk management, financial consumer protection, information technology, finance and legal are included in the committee's membership.

Principle (3)

It is appropriate for the aforementioned committee to study the following aspects within its principal mandate:

- **The extent of exposure of the Central Bank and the financial sector to the benchmark reference rate LIBOR and IBORs.**
- **Developing a plan for a gradual cessation of LIBOR and IBORs.**
- **Issuing guidance to the financial sector on the cessation of LIBOR and IBORS.**
- **The potential transitional risks that may arise from the cessation of LIBOR and IBORs.**

Principle (4)

Promoting consultation and dialogue with commercial banks associations, in order to find a suitable alternative to benchmark reference rates (IBORs), including how to set up the commercial bank's systems to implement the transition from IBORs. Sufficient resources shall be allocated to support the transition efforts.

Principle (5)

In the event that the variable interest rates for banking products are tied to IBORs (Under the instructions of the Central Bank), it is proper to amend these relevant instructions to adjust the interest rates to be tied to one of the monetary policy instruments or to an interbank lending interest rate.

Principle (6)

In the event that principle (5) is inapplicable, the methodologies for calculating the IBORs may be amended to be calculated and audited by the Central Bank, in order to enhance the Central Bank's ability to direct interest rates in the market according to economic variables.

Principle (7)

The importance of continued development of the operational framework for the central bank's monetary policy to enhance the central bank's ability to influence lending interest rates among banks by using the Corridor System.

Principle (8)

Instructions for financial consumer protection shall be reviewed, and to identify the appropriate legal solutions for bank clients having existing credit contracts tied to benchmark interest rates linked to LIBOR or IBORs. Negotiation between banks and clients shall be encouraged to reach a mutually satisfactory legal solutions to contract amendments.

Principle (9)

Having regard of principle (5), Commercial banks shall develop a strategy or plan approved by the bank's board of directors to the cessation of LIBOR and IBORs, provided that periodic reports are submitted to the board of directors by the bank's executive management on the plan's progress.

Principle (10)

Promote awareness of banks on the amendment of information technology systems related to variable interest rates to be aligned with any new instructions or guidelines issued by the Central Bank in this regard.

Principle (11)

Urge commercial banks to study the extent of exposure to LIBOR and IBORs, assess the magnitude of risks involved in the cessation of these rates, and the impact of that transition on their business models.

Principle (12)

Commercial banks shall be encouraged to form an interim committee mandated with the development of the plan referred to in principle (9). Directors of risk management, treasury, compliance, finance, information technology, internal audit, banking operations, financial consumer protection, and legal departments shall be included in the committee's membership. The committee shall submit monthly reports to the bank's board of directors on the progress achieved.

Principle (13)

Commercial banks shall submit periodic reports on their transition plans from LIBOR and IBORS to the Central Bank in accordance with the bank's directives.

Principle (14)

The Central Bank, within the framework of field inspections on commercial banks, shall determine the readiness of commercial banks to the cessation of LIBOR and IBORs.

Principle (15)

Off-and On-Site Supervision of Domestic Systematically Important Banks (D-SIBs) shall be stepped up, as well as follow up on their transition plans to the cessation of LIBOR and IBORS.

Principle (16)

Expertise, experiences and information shall be exchanged between central banks, regional and international financial institutions on the cessation plans of LIBOR and IBORs. conferences, workshops and training programs shall be held in this regard.

Principle (17)

In the event of exposure of a non-banking financial sector to LIBOR or IBORs, it is advisable for the Central Bank to collaborate with supervisory authorities of these sectors. This is in order to assess the magnitude of that exposure, develop adequate plans and guidelines to the cessation of LIBOR and IBORs, and supervise the implementation of these plans by the non-banking financial sectors, both off-and on-Site.

Principle (18)

A suitable mechanism shall be set to obtain accurate data on financial sector exposure to LIBOR and IBORS (including contracts extending beyond 2021). Coordination with other local and foreign regulatory authorities shall also be enhanced.

Principle (19)

Coordination and cooperation between the Central Bank, the Ministry of Finance, the Ministry of Economy and Planning, along with other relevant authorities is significant to determine the magnitude of the government's exposure to LIBOR (such as: international institutions loans, bond issues in local and foreign currency, Sukuk, investments, financial derivatives … etc.). Adequate plans to prudently discontinue benchmark rates shall be also put in place, provided that coordination is made with the relevant regional and international financial institutions.

Principle (20)

Financial, legal, operational, accounting and reputation risks that may arise during the transition period from LIBOR and IBORs to a new benchmark rate shall be continuously assessed.

Principle (21)

Follow-up on the publications of regional and international financial agencies and institutions concerned with setting financial, banking and supervisory standards on any developments regarding cessation of LIBOR and IBORs benchmarks.