Benchmark rate reforms

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Topics:

The Basel Committee on Banking Supervision[i] fully supports the global efforts to strengthen the robustness and reliability of existing inter-bank offered rates (IBORs) and promote the development of alternative reference rates. It is critically important that banks consider the effects of benchmark rate reform on their businesses and make the necessary preparations for the transition to the alternative rates. In doing so, they should maintain a close dialogue with their supervisory authorities regarding their plans and transition progress, including impediments that may be identified. In this regard, as the London inter-bank offered rate (LIBOR) is not expected to exist past year-end 2021[ii], market participants should consider carefully the economic, legal and reputational risks associated with continuing to write new contracts based on LIBOR. Public authorities may also wish to consider the actions they can take to help ensure a smooth transition.

In cases where banks continue to use IBORs, the Basel Committee encourages them to include in their contracts robust fallback language that determines how the replacement of a discontinued reference rate would be handled. Banks should also plan carefully to ensure that internally developed and vendor-provided systems and services that they use are prepared fully to accommodate the alternative reference rates.

Updating existing contracts to include fallback language, or directly adjusting contracts to reference a new benchmark rate, may trigger a reassessment of the instrument under prevailing accounting standards. Any revaluation or reclassification of assets or liabilities that result from such a reassessment of contracts could have various impacts on the financial statements of banks. As such, the Committee welcomes the work of accounting standard setters to develop guidance that will address the accounting effects on financial reporting from the transition to the alternative reference rates and looks forward to a timely finalisation of these efforts.[iii]

Regarding capital instruments, an amendment to their contractual terms could potentially trigger a reassessment of their eligibility as regulatory capital in some jurisdictions. A reassessment could result in an existing capital instrument being treated as a new instrument. This in turn could result in it breaching the minimum maturity and call date requirements that apply to capital instruments within the Basel Framework.[iv] Existing capital instruments issued under Basel II that are being phased out could also fail to meet eligibility requirements if they are treated as new instruments.[v] The Committee is clarifying through this newsletter that, under the Basel Framework, amendments to capital instruments pursued solely for the purpose of implementing benchmark rate reforms will not result in them being treated as new instruments for the purpose of assessing the minimum maturity and call date requirements or affect their eligibility for transitional arrangements of Basel III.[vi]

Aside from contract changes, banks should consider what adjustments to their risk management frameworks will be necessary to take account of the transition to the alternative reference rates. Banks that use internal models for regulatory capital purposes should consider how they will adapts their models. This is especially important when the alternative reference rates do not have a history that is long enough to cover a stressed period for risk management purposes or sufficient price observations to meet model eligibility requirements. In this regard, the Committee notes that various parts of the Basel Framework permit the use of proxies in internal models. Banks should hold early engagements with their supervisory authorities on how they plan to adapt their models to account for the transition to the alternative reference rates, including what proxies they plan to use. Banks that are required to submit model changes for approval should discuss their submission plans with their supervisory authorities, which will help to avoid bottlenecks.

The Committee is continuing to monitor and assess issues related to benchmark reforms, and during the course of this year banks should expect greater supervisory scrutiny of their preparations and contingency planning. Based on its analysis, the Committee will consider what additional steps may be necessary to ensure a smooth and timely transition to the alternative reference rates, including issuing any further clarifications that may be necessary.

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[i] The Basel Committee on Banking Supervision (BCBS) is the primary global standard setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability. The Committee reports to the Group of Central Bank Governors and Heads of Supervision and seeks its endorsement for major decisions. The Committee does not possess any formal supranational authority and its decisions do not have legal force. Rather, the BCBS relies on its members' commitments to achieve its mandate. More information about the Basel Committee is available here.

[ii] In July 2019 UK Financial Conduct Authority and the US Federal Reserve reiterated that termination of LIBOR publication after the end of 2021 should be the base case assumption, and urged market participants to

engage immediately with the transition given its complexity and the tight timeframe.

iii See the Committee's response to the IASB Exposure Draft: *Interest Rate Benchmark Reform*. More information on the progress of the work of the accounting standard setters on benchmark rate reform is available on the IASB's phase 1 and phase 2 project website pages and the FASB's project update page.

iv Specifically, the definition of capital standard within chapter CAP10 of the consolidated Basel Framework requires that *at issuance*: (i) Tier 2 instruments must have a maturity of at least five years; and (ii) Additional Tier 1 and Tier 2 instruments may be callable at the initiative of the issuer only after five years. Thus, instruments with less than five years remaining until maturity or a call would breach these criteria if they were treated as entirely new instruments. By contrast, the Financial Stability Board's term sheet that sets out the criteria for debt instruments to be recognised as total loss absorbing capacity (TLAC) instruments requires a minimum *remaining* contractual maturity of at least one year. The inclusion of fallback language in TLAC contracts should have no effect on their remaining maturity even if they are reassessed and treated as a newly issued instruments.

v The transitional arrangements for legacy regulatory capital instruments are set out in chapter CAP90 of the consolidated Basel Framework,

vi In a similar vein, the Committee and the International Organization of Securities Commissions clarified last year that amendments to legacy derivative contracts pursued solely for the purpose of addressing benchmark rate reforms do not require the application of margin requirements for the purposes of the BCBS/IOSCO framework

Related information

- Press release: 27 February 2020