Interbank Offered Rate Reforms

Background

According to the announcement made by the Financial Conduct Authority ("FCA") on 5 March 2021, the FCA confirmed that all London Interbank Offered Rate ("LIBOR") settings will either cease to be provided by any administrator or no longer be representative after the following dates:

- Immediately after 31 December 2021, in the case of all Sterling, Euro, Swiss Franc and Japanese Yen LIBOR settings in all tenors, and US Dollar LIBOR 1-week and 2-month settings; and
- Immediately after 30 June 2023, in the case of US Dollar Overnight, 1-month, 3-month, 6-month and 12-month settings.

In view of this, the FCA and other regulators have encouraged market participants to stop using LIBOR.

Why is this relevant to you?

To facilitate the LIBOR transition, market participants should use Alternative reference rates ("ARRs") such as alternative "risk-free" rates ("RFRs") instead of LIBOR if LIBOR is permanently discontinued. The alternative benchmark rates to replace IBORs have been discussed by the global regulatory authorities as well as the public and private sector working groups, including the International Swaps and Derivatives Association (ISDA), the Sterling Risk-Free Rates Working Group, the Working Group on Euro Risk-Free Rates, and the Alternative Reference Rates Committee (ARRC). These working groups are still considering on how to support a transition to alternative rates and the development of new product referencing them. For IBORs such as EURIBOR, HIBOR and TIBOR, China CITIC Bank International Limited (the "Bank" or "CNCBI") does not anticipate any changes as there are currently no plans to discontinue and so expected to continue alongside the respective ARRs.

The reforms are expected to lead certain interest rate benchmarks to either perform differently to the way that they do currently or to disappear. This will have an impact on the CNCBI products and services customers own now and those the Bank may provide in the future.

What are Alternative reference rates ("ARRs")?

ARRs are overnight interest rate benchmarks that are recognised by the FCA and other regulators as more reliable and representative as a measure of "risk-free" rates comparing to IBOR. The calculation methodology of ARRs is different from that of IBORs, hence when an ARR is applied in place of an IBOR (either because it is specified in the contractual terms of the product as the replacement interest rate to use in certain scenarios such as the IBOR ceasing to be published (a "fallback" provision[2]) or because the contractual terms of the product are specifically amended to replace references to an IBOR with references to an ARR), interest payments under the product and/or the value of the product will be affected. Hedging arrangements, for example, that are associated with IBOR referencing liabilities/assets, may also be impacted.

What is "Fallback" provision?

A "fallback" provision specifies that, upon the occurrence of LIBOR replacement trigger event, LIBOR will automatically be replaced with ARR determined in accordance with terms of loan agreement using an agreed "waterfall" methodology

[2] A "fallback" provision is a provision in a contract which sets out the consequences of an event such as the discontinuation of LIBOR. For example, a "fallback" may provide for the use of an alternative rate, such as a rate based on a RFR.

plus a fixed spread adjustment which is a global industry standard. If fallback languages are included in LIBOR-referencing contracts, the contracts will continue even after the discontinuation of LIBOR occurs.

What will be the ARRs replacing IBORs?

LIBOR covers financial products denominated in five currencies: United States Dollar ("USD"), Euro ("EUR"), British Pound ("GBP"), Japanese Yen ("JPY"), and Swiss Franc ("CHF"). Transition away from LIBOR requires its replacement by new ARRs for each relevant currency.

For certain other IBORs, in response to regulators' expectation, near RFRs are also being developed in the relevant markets for use as ARRs in relation to those IBORs.

A key objective of the transition is the creation of an interest rate market based on actual transactions leading to a more transparent, reliable and representative interest rate market. Market consensus is that RFRs (which are principally overnight interest rates based on actual transactions) would be used as ARRs for IBORs.

Various working industry groups comprising public and private sector representatives across jurisdictions were established in order to identify appropriate RFRs as ARRs for different markets. These working groups have now identified the ARRs.

A summary of certain major ARRs identified by these working groups is set out in the table below.

IBOR		Discontinuation		ARR	Working Group
		Date	Announced by		
US	USD LIBOR	1-week, 2-month: 31 Dec 2021 Other: 30 Jun 2023	Financial Conduct Authority ("FCA")	Secured Overnight Financing Rate (SOFR)	Alternative Reference Rates Committee ("ARRC")
UK	GBP LIBOR	31 Dec 2021	Financial Conduct Authority ("FCA")	Sterling Overnight Index (SONIA)	Working Group on Sterling Risk-Free Reference Rates ("RFRWG")
EU	EUR LIBOR	31 Dec 2021	Financial Conduct Authority ("FCA")	Euro Short Term Rate (€STR)	Working Group on Euro Risk-Free Rates
	EURIBOR	-	-		
Japan	JPY LIBOR	31 Dec 2021	Financial Conduct Authority ("FCA")	Tokyo Overnight Average Rate (TONA)	Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks
Switzerland	CHF LIBOR	31 Dec 2021	Financial Conduct Authority ("FCA")	Swiss Average Rate Overnight (SARON)	National Working Group on Swiss Franc Reference Rates
Singapore	SOR	30 Jun 2023	Association of Banks in Singapore ("ABS")	Singapore Overnight Rate Average (SORA)	Steering Committee for SOR & SIBOR Transition to SORA ("SC-STS")
	SIBOR	6-month: 31 Mar 2022 1-month, 3-month: 31 Dec 2024			
Hong Kong	HIBOR	-	-	Hong Kong Dollar Overnight Index Average (HONIA)	Treasury Markets Association ("TMA")

IBORs and ARRs: What are the differences?

There are a number of fundamental differences between IBORs and ARRs. It is important to consider these differences carefully in order to understand the implications brought about by the transition to ARRs. Some of the key differences are highlighted in the below table.

	IBOR	**ARR**
Characteristics	• Designed to reflect the price of interbank funding markets • Based on submissions by a panel of banks • Includes a component of bank credit risk	• Largely risk-free rates • Secured by collateral; does not include a credit risk premium associated with interbank lending
Maturity	• IBOR is published for <u>multiple currencies</u> and <u>tenors</u> (overnight, 1 month, 3 month, 6 month)	• ARR is published as an <u>overnight rate</u> only *(Term Rate to be developed)* • <u>Daily compounding</u> of ARR is expected to calculate interest of desired maturities
Interest period calculation	• IBOR is <u>fixed at the beginning of the interest period</u>	• Loans, derivatives and securities are expected to utilize an ARR average over the interest period to calculate interest payments. <u>In arrears feature</u> is commonly seen in ARR products

Market update

Subjected to the FCA announcement on 5 March 2021, Internal Swaps and Derivatives Association ("ISDA") and Alternative Reference Rates Committee ("ARRC") made the following announcement.

Internal Swaps and Derivatives Association ("ISDA")

Spread Adjustment is fixed

ISDA has stated that the announcements constitute an "Index Cessation Event" under the IBOR Fallbacks Supplement (Supplement Number 70 to the 2006 ISDA Definitions) and the ISDA 2020 IBOR Fallbacks Protocol for all 35 LIBOR settings. The ISDA fallback spread adjustments published by Bloomberg is fixed as of the date of the announcement for all USD, GBP, EUR, CHR and JPY settings.

The fallback rates will apply to outstanding derivatives contracts for derivatives that incorporate the IBOR Fallbacks Supplement or are subject to adherence of the ISDA IBOR Fallback Protocol and for cash products (other than consumer products) that adopt the ARRC-proposed fallback language, including floating rate notes, securitizations, syndicated loans, and bilateral business loans, will apply the same spread adjustment to the recommended fallback rates.

Linear interpolation for 1-week and 2-month USD LIBOR settings for outstanding derivatives

All US dollar LIBOR settings will continue to be published until the end of 2021. After that point, one-week and two-month US dollar LIBOR will cease, but the new fallbacks will not immediately take effect. Instead, the rate for the one-week and two-month US dollar LIBOR settings will be computed by each calculation agent using linear interpolation between end-2021 and 30 June 2023. The fallbacks for all USD LIBOR settings will then apply after the end of June 2023, when the remaining USD LIBOR tenors cease or become non-representative.

Alternative Reference Rates Committee ("ARRC")

ARRC indicated that the announcement constitutes a trigger event ("Benchmark Transition Event") for all LIBOR settings and published ARRC FAQs Regarding the Occurrence of a Benchmark Transition Event. It serves to fix the spread adjustment in the IBOR Protocol offered by the ISDA and in conjunction with previous US supervisory guidance on stop issuing USD LIBOR transaction after this year to accelerate market participants to move away from USD LIBOR. The ARRC also stated that its recommended spread adjustment for fallback language in non-consumer cash products will be the same as the spread adjustments applying to ISDA for USD LIBOR.

For more information

If you would like more general information on interest rate reform and IBOR transition, please refer to the published information from regulators, working groups and other industry bodies, including:

- U.S. Alternative Reference Rates Committee (ARRC)
  https://www.newyorkfed.org/arrc
- European Central Bank (ECB)
  https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html
- Bank of England (BOE)
  https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor
- Financial Conduct Authority (FCA)
  https://www.fca.org.uk/markets/benchmarks
- Bank of Japan (BOJ)
  https://www.boj.or.jp/en/paym/market/sg/index.htm/
- Swiss National Bank (SNB)
  https://www.snb.ch/en/ifor/finmkt/fnmkt_benchm/id/finmkt_reformrates
- Association of Banks in Singapore (ABS)
  https://abs.org.sg/benchmark-rates/sor-sibor-to-sora
- Monetary Authority of Singapore (MAS)
  https://www.mas.gov.sg/monetary-policy/sora
- Treasury Markets Association (TMA)
  https://www.tma.org.hk/en_market_LIBOR.aspx
- Financial Stability Board (FSB)
  https://www.fsb.org/work-of-the-fsb/policy-development/additional-policy-areas/financial-benchmarks
- International Swaps and Derivatives Association (ISDA) https://www.isda.org/category/legal/benchmarks