Interest Rate Benchmarks Reform

Updated in July 2021

Background

Interbank Offered Rates (IBORs), including the London Interbank Offered Rate (LIBOR), the Euro Interbank Offered Rate (EURIBOR) and the Hong Kong Interbank Offered Rate (HIBOR), are widely accepted interest rate benchmarks. IBORs have been commonly adopted in financial markets to calculate interest rates or other payments in a broad range of financial products, such as loans, bonds and derivatives, and are frequently used as the basis for valuations by market participants.

The G20 instructed the Financial Stability Board (FSB) in 2013 to undertake a review of the major interest rate benchmarks and plans for reform in order to ensure that the interest rate benchmarks are robust and used appropriately. In 2014, the FSB published a report recommending:

- strengthening IBORs, where possible; and
- identifying alternative near-risk-free rates (RFRs) for use as alternative reference rates, and where suitable, to encourage market participants to transition to new, appropriate RFR contracts.

Why are IBORs being reformed?

IBORs are generally calculated from the estimates submitted by a selection of banks in relevant financial markets, and are meant to reflect the price of interbank funding markets. In some financial markets, banks no longer fund themselves in the interbank market to the same extent as they used to. This has led to declining transaction volume in the markets that underpin certain IBORs, creating growing concern about them no longer being representative.

Amongst all current IBORs, LIBOR has been the most widely used interest rate benchmark in financial products for decades. In 2017, the Financial Conduct Authority (FCA), the UK authority that regulates LIBOR, stated that after 31st December 2021, it will no longer compel banks to continue making LIBOR submissions. Consequently, the number of LIBOR submissions by banks could fall significantly, reducing the representativeness of LIBOR.

Global authorities consider that it is necessary to transition away from LIBOR and certain other IBORs are also undergoing reforms. This is commonly known as IBOR transition. Market participants are expected to implement a comprehensive process in managing the transition, as not doing so could result in significant market disruption.

Official announcement on the cessation of LIBOR

On 5 March 2021, following the announcement by the ICE Benchmark Administration (IBA), the administrator of LIBOR, the FCA announced that all 35 LIBOR settings of US Dollar (USD), Japanese Yen (JPY), Sterling Pound (GBP), Euro (EUR) and Swiss Franc (CHF) 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 LIBOR settings of JPY, GBP, EUR and CHF, and the 1-week and 2-month LIBOR settings of USD; and

- Immediately after 30 June 2023, in the case of the remaining US Dollar settings, i.e. Overnight, 1-month, 3-month, 6-month and 12-month settings.

What are the regulatory requirements in Hong Kong?

Transition milestones

In July 2020, the Hong Kong Monetary Authority (HKMA) and the Treasury Markets Association (TMA) jointly developed three transition milestones which Authorized Institutions (“AIs”), including our bank, should endeavour to achieve in view of the interest rate benchmarks reform[1]:

From 1 January 2021

- All AIs should be in a position to offer products referencing the Alternative Reference Rates (“ARRs”) to LIBOR.
- Adequate fallback provisions should be included in all newly issued LIBOR-linked contracts that will mature after 2021.

By 31 December 2021

- All AIs should cease to issue new LIBOR-linked contracts

Moreover, on 8 July 2021, the HKMA issued a circular to all AIs asking them to distribute a leaflet jointly developed by the HKMA and TMA to all corporate customers with whom AIs have outstanding LIBOR-linked contracts. This leaflet is meant to enhance the corporate sector’s awareness of the IBOR transition and its implications, and should be distributed by 31 July 2021. Sumitomo Mitsui Banking Corporation Hong Kong Branch (SMBC HK) will distribute the leaflet to all relevant customers accordingly.

What will be the Alternative Reference Rates (ARRs) replacing IBORs?

LIBOR covers financial products denominated in five currencies: USD, EUR, GBP, JPY and CHF. The cessation of LIBOR involves a transition of each LIBOR to a new ARR 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.

The cessation of LIBOR will impact our business relationships with customers in transactions referencing different benchmark interest rates. A summary of these benchmark rates and the respective ARRs identified by working groups in the industry is set out in the table below.

[1] HKMA transition milestones: https://www.hkma.gov.hk/eng/key-functions/banking/banking-regulatory-and-supervisory-regime/reform-of-interest-rate-benchmarks/

	US	UK	Japan	Hong Kong
Benchmark Interest Rate	USD LIBOR	GBP LIBOR	JPY LIBOR	HIBOR
Administrator	Intercontinental Exchange (ICE)	Intercontinental Exchange (ICE)	Intercontinental Exchange (ICE)	Treasury Markets Association (TMA)
Alternative Reference Rate (ARR)	Secured Overnight Financing Rate (**SOFR**)	Reformed Sterling Overnight Index Average (**SONIA**)	Tokyo Over-Night Average Rate (**TONA**)	Hong Kong Dollar Overnight Index Average (**HONIA**)
Expected to continue	✗	✗	✗	✓
Cessation timeline	Year-end 2021: 1-week and 2-month USD LIBOR settings June 2023: other USD LIBOR settings	End of 2021 for all settings	End of 2021 for all settings	-
Working Group	Alternative Reference Rates Committee (ARRC)	Working Group on Sterling Risk-Free Reference Rates	Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks	Treasury Markets Association

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 table below.

IBORs	ARRs
Based largely upon expert judgement by banks making relevant IBOR submissions	Based mainly upon transaction data in active markets
Forward-looking rates	Backward-looking rates calculated using historic transaction data
Available in multiple settings	Currently overnight rate only, but term rates for some ARRs are in development
Incorporate a bank credit risk premium	Do not incorporate a bank credit risk premium
A liquidity premium is applied to longer term rates	No liquidity premium is applied

ARRs are overnight interest rates based on a backward-looking calculation methodology, with reference to actual transactions. They have little or no credit risk and are without liquidity premium due to their overnight nature.

On the other hand, IBORs are forward-looking term interest rates for unsecured interbank loans with a number of different settings (which, for instance, could be up to 12 months in the case of LIBOR), with an embedded credit spread. Longer term IBORs may incorporate higher liquidity premium.

The overnight rates (ARRs) mentioned are risk-free whereas the corresponding IBORs incorporate bank credit risk premiums and several other factors including liquidity and fluctuations in supply and demand. A spread adjustment should be applied to the relevant fallback rates in order for such rates to be comparable to IBORs.

The fallback rate is the interest rate to be referenced instead of IBOR at the time when a fallback occurs.

Since there are differences in LIBOR and fallback rate levels, there are possibilities of "value transfer" at the time of fallback where one party wins and the other party loses. A spread adjustment is required to minimize the "value transfer".

Spread Adjustment Methodologies would need to meet 3 criteria:

- Minimizing value transfer at the time of fallback
- Minimizing any potential for manipulation
- Mitigating impact of market disruption at the time of fallback

Following the FCA announcement on 5 March 2021, the International Swaps and Derivatives Association (ISDA) stated that the FCA announcement constitutes 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[2] are fixed as of the date of the FCA announcement for all USD, GBP, EUR, CHF and JPY settings.

The fallback spread adjustments published by Bloomberg are applicable to outstanding derivative contracts that incorporate the IBOR Fallbacks Supplement or that are subject to adherence to the ISDA IBOR Fallback Protocol. Moreover, as announced by ARRC, the fallback spread adjustments published by Bloomberg are applicable to cash products as well.

How do the benchmark rate differences impact customers?

Forward looking vs backward looking:

- As an IBOR has forward-looking term structure, in a usual loan contract referencing an IBOR with interest payable in arrears, each interest payment amount can be fixed and known at the beginning of the corresponding interest calculation period. Borrowers may find it useful for cash-flow forecasting.
- However, for a typical loan referencing an ARR with interest payable in arrears, as the ARR is backward–Looking and based on actual transaction data, the interest rate for the corresponding interest period would be based on the compounded ARR accruing in arrears during the interest period. In such case, the interest rate and interest amount to be paid may only be known near the end of the interest period.

Transition from existing rate (IBOR) to a new rate (ARRs):

- In economic terms, IBORs (which incorporate credit risk premiums) are usually higher than corresponding ARRs, which are near RFRs.
- Using ARRs (which are overnight rates) for interest calculation for a term (say, 3 months) requires an appropriate rate conversion methodology to achieve proper calculation for the term interest period. The methodology is still being developed and for some products (e.g. trade finance), the market consensus on the methodology may not be fully developed by the time the relevant IBORs must be replaced.
- When parties replace a reference to an IBOR with the relevant ARR in an existing contract, the bank credit risk premium element of the rate is removed. In order to preserve the economic equivalence for new contracts, the spread adjustment published by Bloomberg, or an alternative spread adjustment agreed upon by both parties, is added to the respective ARR.
- Conversion of an overnight rate to be applied to a term interest period may also require changing to the existing contract term.

What potential risks should customers be aware of?

Some interest rate benchmarks are being reformed or will be discontinued. In particular, LIBOR, the most commonly used IBOR in financial markets, will be discontinued after 2021 for most currencies (1-week and 2-month USD settings only and all settings of JPY, GBP, CHF, and EUR) and after June 2023 for the remaining USD settings, i.e. overnight, 1-, 3-, 6-, and 12-month settings. Some IBORs other than LIBOR are also undergoing reforms due to applicable regulatory requirements and industry practice. It is not yet certain how and to what extent their reformed calculation methodology would differ from their existing forms.

[2] IBOR-Fallbacks-LIBOR-Cessation_Announcement_20210305.pdf (bbhub.io)

If customers have any existing contracts referencing IBORs or enter into any new contracts referencing IBORs, they should be aware of the following:

- LIBOR will cease to exist and there is a need to determine or agree to an ARR (and ARRs identified by the relevant industry bodies behave differently from LIBOR in many respects);
- Some IBORs subject to reform may result in different calculation methodology and may perform differently than in the past;
- The conversion from IBORs to ARRs for term financings is dependent upon the development of futures trading and other methods that are still being developed and might not be fully developed when the conversion needs to occur;
- Financial contracts referencing IBORs (in particular those linked to LIBOR) require adjustment to incorporate necessary fallback provisions (i.e. contractual provisions for alternative reference rates as replacement rates for IBORs), to substitute the alternative reference rates for the IBORs and to include any other appropriate amendments such as addition of applicable spread adjustment;
- The occurrence of any of the above may: (1) materially impact the economic value of the relevant financial transactions, and (2) result in a mismatch between the rate referenced in the relevant financial instrument and the customers' other financial instruments, including potentially those that are intended as hedges, and may have other unforeseen or adverse consequences.

The above list only highlights some of the matters pertaining to the IBOR transition and should not be treated as an exhaustive list of all the relevant risks.

The IBOR transition will impact certain SMBC products and services that SMBC customers now hold or use and those that may be provided in the future. The extent of the impact will depend on a range of factors, which include the particular IBOR adopted in the products or services, evolving market and industry developments, changes to valuations, legal documentation and the terms and conditions of the products or services. We are closely monitoring the developments. We may provide more information on the changes when there is greater certainty on the agreed new benchmarks, their methodology and the transition process.

It is advisable for customers to conduct their own independent assessment and analysis of the potential consequences of any relevant risks, including the potential market, financial, legal, accounting, tax and regulatory impact on their financial contracts and transactions.

What is SMBC's approach to IBOR transition?

SMBC HK has established an IBOR transition project team and is preparing for the cessation of LIBOR. We are taking steps to identify and act in areas such as client communication, product strategy, contract modification and the considerations of counter measures. The SMBC HK IBOR transition project team has also been working closely with the Head Office.

To align its approach with industry practice and the regulatory expectation, SMBC closely monitors the developments of the interest rate benchmarks reform both in Hong Kong and internationally, and has updated and implemented its transition programme and action plans as appropriate.

What are SMBC's next steps for contract negotiations?

As we approach the permanent cessation of LIBOR following the FCA announcement, there is a need to amend certain LIBOR-linked contracts by the end of 2021 to ensure a smooth transition to ARRs.

In the case of loan agreements, we are complying with the regulatory requirements (HKMA transition milestones) and are currently in the process of reviewing the contractual provisions (or fallback provisions) and pricing methodologies for all the existing LIBOR-linked contracts maturing after the respective LIBOR cessation date specified by FCA. We will contact you for negotiations with a view to agreeing the use of a replacement benchmark for these contracts in accordance with the respective cessation timelines.

In the case of derivative agreements, contracts signed before 25 January 2021 maturing after the respective LIBOR cessation date specified by FCA will have two ways to be amended, either by adherence to the ISDA 2020 IBOR Fallbacks Protocol, or through bilateral negotiations. If you have not adhered to this ISDA protocol and do not intend to do so, or you have hedged loans with us, we will review the relevant transactions and reach out to you for the necessary arrangements to negotiate the contract terms with you on a bilateral basis.

What can customers do to prepare for the IBOR transition?

Customers are encouraged to stay up-to-update on the latest developments of the transition. It is important that you are aware of what the changes from IBORs to ARRs means to you, including any financial, accounting, legal and taxation impact. The initial steps that customers may wish to take to prepare for the transition include:

- Understanding your exposures to IBORs by review of your existing documentation;
- For LIBOR-referenced contracts in particular, assessing how existing transactions may behave upon the cessation of LIBOR.
- Evaluating the impacts on you due to the differences between current IBOR references and the potential ARRs which may be incorporated in contractual documentation in the future;
- Considering what other impacts the IBOR transition may have on you or your business;
- Engaging professional advisors (financial, accounting, tax, legal or other) as you consider appropriate to help you on the assessment of the impact due to the transition.

The above is not an exhaustive list and is only intended to outline some of the steps you may consider.

More information

SMBC may periodically update this page as appropriate to reflect market developments. For further information on specific SMBC products and services you currently have or would like to enquire about, please get in touch with your usual SMBC representative.

For general information on IBOR-related market developments, a non-exhaustive list of websites of external industry bodies and organisations is included below:

Intercontinental Exchange (ICE) Benchmark Administrator (IBA)
https://www.theice.com/iba

Financial Stability Board (FSB)
https://www.fsb.org/

International Swaps and Derivatives Association (ISDA)
https://www.isda.org/category/legal/benchmarks/

Financial Conduct Authority (FCA)
https://www.fca.org.uk/markets/libor

Hong Kong Monetary Authority (HKMA)
Hong Kong Monetary Authority - Reform of Interest Rate Benchmarks (hkma.gov.hk)

USD LIBOR – The Alternative Reference Rates Committee (ARRC)
https://www.newyorkfed.org/arrc

GBP LIBOR – Working Group on Sterling Risk-Free Reference Rates
https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor

EURIBOR - Working group on euro risk-free rates
https://www.ecb.europa.eu/paym/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html

HKD HIBOR – Treasury Markets Association
https://www.tma.org.hk

JPY LIBOR - Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks
https://www.boj.or.jp/en/paym/market/jpy_cmte/index.htm/

CHF LIBOR - National Working Group on Swiss Franc Reference Rates
https://www.snb.ch/en/ifor/finmkt/fnmkt_benchm/id/finmkt_reformrates

Frequently Asked Questions (FAQ)

Q1: What is LIBOR? Will LIBOR cease to be available at some point in the future?

London Interbank Offered Rate (LIBOR) is the benchmark interest rate calculated based on the submissions by a panel of banks in London for five currencies (GBP, USD, EUR, CHF, and JPY), intended to represent an estimate of how much it would cost a bank to borrow money from other banks in the London interbank market.

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- Immediately after 31 December 2021, in the case of all LIBOR settings of JPY, GBP, EUR and CHF, and the 1-week and 2-month LIBOR settings of USD; and
- Immediately after 30 June 2023, in the case of the remaining US Dollar settings, i.e. Overnight, 1-month, 3-month, 6-month and 12-month settings.

In response to this, various working industry groups comprising public and private sector representatives across jurisdictions have been established in order to identify appropriate alternative reference rates for different markets.

Q2: I have a USD term loan with maturity date beyond June 2023 using LIBOR as the interest rate benchmark. Will the term loan be impacted by IBOR transition?

Upon cessation, USD LIBOR will be replaced by its expected alternative reference rate, namely the Secured Overnight Financing Rate (SOFR), which will be used for loans maturing beyond the respective LIBOR cessation date. For any relevant LIBOR-linked loan contracts requiring amendments, we will reach out to you for the necessary arrangements to negotiate the contract terms.

Q3: What is SOFR? Where can I get data on this benchmark?

The Secured Overnight Financing Rate (SOFR) is a secured treasury repo rate. The Alternative Reference Rates Committee (ARRC), which is the US working group leading the transition away from LIBOR, has selected SOFR as the recommended alternative reference rate for the US. SOFR is calculated based on actual repo transaction data. SOFR was first published in April 2018 and is published each business day on the New York Fed's website.

Q4: What is HIBOR? Is HIBOR expected to continue in the near future?

Hong Kong Interbank Offered Rate (HIBOR) is an interest rate benchmark for Hong Kong Dollars (HKD) and Chinese Renminbi in Hong Kong (CNH), calculated based on submissions by a panel of banks in Hong Kong, intended to represent an estimate of how much it would cost a bank to borrow money from other banks in the Hong Kong interbank market. There is currently no plan to discontinue HIBOR according to the Treasury Markets Association. HIBOR has been in place for decades and is still well

recognised by market participants as a representative and robust interest rate benchmark. Whilst Hong Kong Dollar Overnight Index Average (HONIA) has been identified as the alternative reference rate to HKD HIBOR, it is expected that HKD HIBOR and HONIA will co-exist in the market. Market participants may continue to use HKD HIBOR as an interest rate benchmark for their Hong Kong Dollar financial products.
For financial contracts referencing CNH HIBOR, as HIBOR is expected to continue in the foreseeable future, we do not anticipate that the current IBOR transition would result in the change in the interest benchmark rates in those financial contracts.

Q5: What are the methodologies for developing term rates based on the recommended ARRs?

Since ARRs are overnight rates, in order to be used as an alternative rate of LIBOR, it is necessary to develop a term rate based on the recommended overnight ARRs. These are the key options being considered:

• **Forward-looking** term rate is to be fixed at the outset of a given period, which captures the expected rates over the period. This could be derived from a combination of ARR futures and overnight index swap transactions.
• **Compound setting in arrears** term rate would compound daily values of the overnight rate throughout the interest period. Interest rate would be set few days prior to the actual payment.
• **Compound setting in advance** term rate compounds the overnight rate of the previous interest period. The interest rate due is known at the beginning of the payment period.

Development of term rates for these ARRs is still underway. For now, the "backward-looking" method by compounding the overnight ARR in arrears are being considered. Development of a forward-looking rate is contingent on there being sufficient liquidity for the respective ARRs especially for SOFR.

Q6: What are the necessary procedures to perform contract modifications for derivatives contracts?

In October 2020, ISDA published a supplement amending the 2006 ISDA Definitions to incorporate the new fallbacks. These changes will automatically apply to cleared and non-cleared derivatives referencing the 2006 ISDA Definitions that are executed on or after the date on which the supplement came into effect, i.e. 25 January 2021.

ISDA also published a fallback protocol which enables market participants adhering to the protocol to amend their non-cleared legacy derivatives contracts with fallbacks provisions. Adherence to ISDA fallback protocol means that if the counterparty also adheres to the protocol, the legacy derivative contracts with other adherents include the amended floating rate option for the relevant IBOR and therefore include the fallback. The fallbacks included in legacy derivative contracts by adherence to the protocol are exactly the same as the fallbacks included in new transactions that incorporate the 2006 ISDA Definitions. Adherence to the protocol is voluntary and the protocol amends contracts only between two adhering parties, that is, it does not amend contracts between an adhering party and a non-adhering party or between two non-adhering parties. SMBC adhered to the ISDA protocol.

For those counterparties who choose not to adhere to the ISDA protocol, parties could also agree to incorporate the new fallback by bilaterally amending their legacy non-cleared contracts using the bilateral negotiation forms published by ISDA. In this case, please discuss with your relevant contact parties for the detailed arrangements.

Q7: I have a Hong Kong Dollar facility with SMBC using HIBOR as an interest rate benchmark. Would IBOR transition materially affect the contractual terms of such HKD facility contract?

Currently, as HIBOR is expected to continue, we do not anticipate that the IBOR transition will result in the replacement of HIBOR by an alternative reference rate in existing Hong Kong Dollar facility contracts with us in the near future. As the IBOR transition is still ongoing, if there are any new developments in the IBOR transition which would result in any change to your HKD facility contract with us, we will let you know.

Q8: Where can I find more information on the IBOR transition?

If you wish to discuss the IBOR transition's impact on the products you currently have with SMBC, please get in touch with your usual SMBC representative. For general market information on IBOR transition, you may refer to the information available from external industry bodies or organisations listed in the "More Information" section.