BE ON THE MARK – APAC CENTRAL BANKS RELEASE STUDY OF BENCHMARK REFORM IMPLICATIONS

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Legal Briefings – By **William Hallatt, Hannah Cassidy, Natalie Curtis, Gareth Thomas, Dominic Geiser, Emily Rumble and Sophie Lundsberg**

On 24 September 2019, the Executives' Meeting of East Asia-Pacific Central Banks (**EMEAP**) published its study on the implications of benchmark reform across the East Asia and Pacific region (**Study**), including the effects of LIBOR discontinuation, the *EU Benchmarks Regulation* (**BMR**) and the ongoing reform of local benchmarks.

The Study provides important insight into market participants' varying levels of awareness of and preparedness for benchmark reform, as well as valuable guidance as to future regulatory developments we are likely to see from regulators keen to ensure regional markets are well equipped to handle these reforms. The Study also refers extensively to Herbert Smith Freehills' market-leading work on the BMR with ASIFMA.

BACKGROUND

The EMEAP consists of executives from eleven central banks and monetary authorities from across the East Asia and Pacific region, including the Hong Kong Monetary Authority (**HKMA**), Reserve Bank of Australia, Monetary Authority of Singapore (**MAS**) and the People's Bank of China.

However, as the Study is based in large part on a survey undertaken by EMEAP of both its member institutions as well as other local regulatory institutions, financial institutions, institutional investors, corporates and retail investors, the Study provides not only valuable insight into central banks' thinking on these issues but also on the market's awareness and preparedness for these reforms.

The Study considers the issues and challenges associated with each of the three following key areas of benchmark reform affecting the East Asia and Pacific region, and sets out recommendations as to actions which could be taken by EMEAP members in respect of these issues.

LIBOR DISCONTINUATION

The Study sets out in detail the LIBOR discontinuation challenges reported by survey participants as affecting regional markets, including:

- Low levels of awareness of the potential discontinuation of LIBOR and acceptance of alternative risk free reference rates (**ARRs**), particularly given a tendency by market participants to take a "wait and see" approach to this issue because of a perception that this issue will be dealt with at a head office level;
- Significant legal risk as a result of the need to renegotiate and amend legacy contracts; and
- The "chicken and egg" liquidity problem being experienced by market participants, as the liquidity of ARRs affects the price discovery and efficiency of interest rate risk of market participants. As a result, sufficient liquidity in ARRs is necessary before participants will view the ARRs as an appropriate replacement for LIBOR – but such liquidity requires a critical mass of participants.

The Study also noted that awareness and readiness levels vary significantly, with central banks and financial institutions being “moderately aware” but institutional investors and corporates only “slightly aware” of this issue. Given this, it is unsurprising that one of the Study’s key recommendations to EMEAP members is to continue to focus on raising awareness in the market of the importance of preparing for LIBOR discontinuation and taking steps to transition accordingly.

However, importantly, the Study notes that while the region is heavily exposed to LIBOR through OTC derivatives, the work undertaken to date by ISDA and IOSCO has played an important role in mitigating the risks associated with LIBOR discontinuation in relation to these derivatives. This means that LIBOR discontinuation may in fact be more problematic for participants whose exposure to LIBOR is through corporate bonds, syndicated loans and other cash products. Accordingly, the Study specifically recommends that EMEAP members increase awareness of LIBOR discontinuation amongst these participants.

The Study also encourages central banks to:

- require banks to undertake a risk assessment and impact analysis of their LIBOR exposures, ensure senior management oversight of LIBOR transition issues, and prepare transition plans. These recommendations are consistent with measures already implemented by the HKMA;
- collect more detailed information regarding exposure of their corporate bond and syndicated loan markets to LIBOR; and
- encourage the launch and trading of new ARR-based products (as also previously encouraged by the HKMA and the MAS).

EU BENCHMARKS REGULATION

The BMR will, from 1 January 2022, prevent EU supervised entities from using an unregulated third country (ie non-European) benchmark in the EU.

As noted in our December 2017 report with ASIFMA, and as quoted by EMEAP in their Study, the BMR exposes the APAC region to significant issues and challenges, including market fragmentation and decreased liquidity. The Study notes in particular that EMEAP members are concerned that the failure of non-EU benchmark administrators to seek registration under the BMR could potentially force EU supervised entities to exit certain markets due to the unavailability of funding and hedging instruments in EMEAP markets.

However, despite this, the Study notes that its members consider the impact on their jurisdictions to be moderate, rather than severe, but that the scope of the Study's survey of members in relation to the BMR was limited to interest rate benchmarks only on the basis that such rates are generally most relevant to central banks. However, the Study also notes that a large number of interest rate benchmarks across the East Asia and Pacific region are administered by central banks, and as such are exempt from the scope of the BMR.

While these exemptions are likely to have reduced EMEAP members' concerns in relation to the BMR, and may well be a primary driver of this "moderate impact" conclusion, we recommend against complacency. As noted in our previous reports with ASIFMA on this subject, (see our December 2017, February 2018, May 2018, and October 2018 reports), non-EU benchmark administrators, including of rates other than interest rate benchmarks (such as commodity and FX rates) face significant difficulties in seeking registration under the BMR.

Indeed, despite the Study's "moderate impact" conclusion, the Study highlights that market participants raised some of these challenges with EMEAP, including administrators' difficulties in identifying a Member State of Reference in the EU, and the limited data many administrators possess about the use of their rates in the EU. These challenges may well explain why the Study urges those central banks whose local interest rate benchmarks will not benefit from the central bank exemption (such as Hong Kong, whose HIBOR rate is administered by the Treasury Markets Association, and Singapore's SIBOR and SOR rates (among others) which are administered by ABS Benchmarks Administration Co Pte Ltd) to consider seeking equivalence through introduction of domestic legislation, which would allow local administrators to avoid the need to seek registration of their rates.

LOCAL BENCHMARK REFORM

Finally, the Study also discusses the work undertaken by EMEAP members to reform local benchmarks following IOSCO's 2013 release of its *Principles for Financial Benchmarks*, including through identification of ARRs and adoption of a multiple rate approach where strengthened local benchmarks are expected to co-exist with ARRs.

Importantly, the Study notes that there are significant challenges in relation to the development of liquidity for ARRs at a regional level and, as a result, at the point at which there is a significant shift towards ARRs at a global level, there may be substantial regional risks as a result of low market awareness and acceptance of these rates. In particular, the Study observes that benchmark reforms in relation to major currencies could affect regional markets through the use of cross-currency or foreign exchange swap related products.

As a result, the Study urges central banks to focus on the following while also working on IBOR reforms and fallback arrangements:

encouraging market participants to be prepared to transition to alternative benchmarks, including by regularly reviewing their exposure to particular rates, putting in place robust contractual fallbacks to accommodate the potential cessation of a rate, and ensuring that they have action plans to deal with any transition. Notably, this is similar to the requirement under the BMR that EU supervised entities must maintain robust written plans setting out the actions they would take in the event that a benchmark ceases to be provided, including nominating rates which could be referenced as an alternative;

encouraging launch and trading of new ARR-based products such as bond issues, futures and swaps where appropriate; and

engaging with industry and market participants to determine the calculation methodologies of ARRs, including by considering the potential economic transfer involved in the calculation methodologies of alternative ARRs as well as their correlation against existing benchmarks, as this may assist in encouraging the adoption of ARRs.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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