## Box 3
## LIBOR cessation: Impacts on Taiwanese banking industry and reponse measures

The London Interbank Offered Rate (LIBOR) is the main reference rate for pricing various financial instruments in global financial markets. After the 2008 financial crisis, there were multiple scandals related to LIBOR manipulation around the world. Moreover, the rapid shrinking of the interbank call loan market has affected the willingness of banks to submit LIBOR settings. To avoid undue market disruption caused by an unexpected cessation of LIBOR, the UK Financial Conduct Authority (FCA) stated that panel bank submissions for all LIBOR settings will no longer be required from January 2022 onwards. As a result, the approaching cessation of publication of the LIBOR settings and the transition of interest rate benchmarks posed challenges for financial markets. Against this backdrop, the way that the Taiwanese banking industry addresses the risks of LIBOR cessation warrants attention.

### *1. Background and developments of LIBOR cessation*

#### 1.1 Background of LIBOR cessation

LIBOR, calculated from estimates of unsecured interbank call loan rates submitted by a panel of banks, is widely used in the pricing and evaluation of various financial products. After the 2008 financial crisis, it was discovered that several banks had reported false interest rates to manipulate LIBOR to their own advantage. The scandal prompted a wave of financial benchmark rate reforms around the world. Although the LIBOR management mechanism was improved after the reforms, the interbank call loan markets in major economies continued to shrink over the same period. It not only affected the willingness of panel banks to submit LIBOR settings, but also led most LIBOR submissions to be reliant on assumptions or expert judgments. As a result, LIBOR submissions remained vulnerable to manipulation. Meanwhile, given shrinking interbank call loan markets, the scale of which fall disproportionately far below the amount of LIBOR-linked financial products globally, doubts about the representativeness of LIBOR in financial markets have been raised.

In order to avoid undue market disruption caused by an unexpected cessation of LIBOR and to promote the reform of alternative reference rates (ARRs), the UK FCA announced in July 2017 that it would no longer require banks to submit settings of LIBOR after the end of 2021 and jurisdictions are encouraged to establish robust ARRs to replace LIBOR. Then, with a view to reducing the burden of contract conversion on financial institutions, in March 2021, the FCA announced that it had decided to extend the cessation date of some

USD LIBOR settings to the end of June 2023. However, regulatory authorities such as the US Fed still encouraged financial institutions to cease entering into new contracts that use USD LIBOR as a reference rate for various tenors of financial instruments by the end of 2021.

### 1.2 Alternative reference rates for LIBOR

LIBOR is currently calculated for five currencies (USD, GBP, EUR, CHF, and JPY) and seven tenors (ranging from overnight to 12 months) with respect to each currency, resulting in the publication of 35 individual rates.[1] For those five currencies, ARRs were identified and recommended in respective jurisdictions. Unlike LIBOR, which represents an unsecured interest rate with a complete forward-looking term structure, ARRs are backward-looking overnight interest rates, relying entirely on transaction data. Among them, the Secured Overnight Financing Rate (SOFR) and the Swiss Average Rate Overnight (SARON) are secured rates calculated on the basis of repo transaction data, whereas the other three ARRs are unsecured rates.

## *2. Impacts of LIBOR cessation on Taiwanese banking industry*

### 2.1 LIBOR exposure of Taiwanese banking industry

LIBOR has been a long-established benchmark interest rate with the most influence on the world. Being a participant in the global financial market, the Taiwanese banking industry has widely used LIBOR in their daily business. Considering that LIBOR and ARRs are essentially different, it is necessary for the banking industry to align relevant systems and operating procedures with the characteristics of ARRs. However, this may impact product design and trading system in the front office, asset and liability valuation, capital allocation, and risk analysis models in the middle office, and collateral management, settlement, and hedge accounting in the back office. According to a survey conducted by the Bankers Association of the Republic of China (BAROC), in terms of the LIBOR exposures of the Taiwanese banking industry, the notional position of financial derivatives accounted for the largest share of approximately 60% of the total at the end of June 2020, while the rest mostly went to cash products in assets. Compared with Japan and Hong Kong, the Taiwanese banks' overall exposures to LIBOR-linked products and contracts were limited. However, an estimated more than 60% of current LIBOR exposures will successively mature after January 1, 2022. It is higher than the levels of major economies, ranging from 40% to 50%.[2] Considering that more than 90% of such exposures lack appropriate fallback language in contracts, banks may find it difficult to apply fallback mechanisms or adopt ARRs after LIBOR cessation.

### 2.2 Major LIBOR cessation risks to the banking industry

LIBOR cessation risks are widely present in various bank operations. In general, there are six key risks faced by the banking industry, including profit and capital risk, market risk, liquidity risk, operational risk, legal risk, and reputational risk. According to a Sionic research,[3] financial derivatives trades posed lower LIBOR cessation risks as most market participants adhere to the International Swaps and Derivatives Association protocol, whereas cash products, such as loans and bonds, may have higher legal and operational risks owing to the lack of standardized contracts that incorporate fallback language.

## *3. LIBOR cessation response measures in Taiwan*

### 3.1 Measures taken by the Bank and the FSC

In order to ensure that all banks are fully prepared for LIBOR cessation, in February 2020, the Bank and the FSC urged domestic financial institutions to carefully assess the risks of LIBOR discontinuation and address them appropriately. They are advised to: (1) make transition plans so as to shift to ARRs; (2) review legacy contracts referencing LIBOR, and actively communicate with affected customers and counterparties to negotiate relevant contract modifications; and (3) identify risks posed by LIBOR cessation and transition. In March 2020, the Bank, together with the FSC, urged the BAROC to establish a task force on LIBOR transition, which aims to investigate the impacts on and preparations by the Taiwanese banking industry and to recommend response measures for banks to make LIBOR transition plans. Currently, this task force is right on schedule in carrying out a series of working projects.

### 3.2 Current efforts of banks and recommendations

According to the information submitted by banks on October 30, 2020, most Taiwanese banks have set up dedicated committees or task forces for benchmark interest rate transition. They not only monitor the affected exposures regularly, but also assess potential impacts and carry out response strategies continually. In light of the wide-ranging impacts of LIBOR cessation, Taiwanese banks should conduct comprehensive impact assessments and develop complete LIBOR cessation and transition plans. In particular, they are advised to review the completeness of their own preparations and actively carry out LIBOR transition processes based on the recommendations of the aforementioned task force on eight major work items, namely governance structure and transition plans, impact assessments, new benchmark interest rate markets and product transition, contract renegotiation, customer communication, system and process adjustments, risk and revaluation models, and financial reporting and taxation.

***4. Conclusion***

The Taiwanese banking industry uses LIBOR widely in their front, middle, and back office operations. Therefore, LIBOR cessation will have significant impacts on their financial product contracts, customer retention, business processes and information systems, risk management models, accounting, and taxation. Currently, some banks with LIBOR-linked financial product contracts which lack appropriate fallback language would need to actively strengthen their preparations for LIBOR cessation. With the LIBOR cessation date getting closer, banks should have adequate manpower and resources in place to formulate and execute LIBOR transition plans prudently. They are encouraged to carry out LIBOR transition processes as soon as possible so as to reduce potential risks arising from LIBOR cessation.

Notes: 1. The ARRs for USD, EUR, GBP, CHF, and JPY LIBOR are the Secured Overnight Financing Rate (SOFR), the Euro Short-Term Rate (€STR), the Sterling Overnight Index Average (SONIA), the Swiss Average Rate Overnight (SARON), and the Tokyo Overnight Average Rate (TONA), respectively.

2. Financial Stability Board (2020), "Supervisory Issues Associated with Benchmark Transition," July.

3. Sionic (2019), "Benchmark Reform – Taipei Workshop," October.