BY EMAIL

24 September 2020

To the Senior Executive Officers of DFSA Authorised Firms

RE: Transition from Inter Bank Offered Rates to Alternative Reference Rates

Dear SEO,

This letter concerns the transition away from the Inter Bank Offered Rates (IBOR) benchmarks, including the London Interbank Offered Rate (LIBOR), to other alternative solutions, also known as Alternative Reference Rates (ARR).

International context

Historically, IBORs, and in particular LIBOR, have served as widely accepted benchmark interest rates for several currencies and maturities. They have been used by a wide range of financial market participants including financial institutions, corporations, governments and retail market participants for a variety of financial products, including loans, bonds and derivatives. IBORs have been used not only as benchmarks in financial contracts, but also often as the basis for valuations.

In 2013, the Financial Stability Board (FSB), under the auspices of the G20, undertook a fundamental review of major IBORs. This led to the publication of the Principles for Financial Benchmarks by the International Organization of Securities Commissions, which include 19 specific standards across governance, quality, methodology and accountability.

Despite the reforms that strengthened the underlying processes, certain risks relating to robustness and reliability of IBORs could not be fully addressed. In addition, the post-financial crisis environment has been marked by a decreasing importance of inter-bank unsecured markets, on which IBORs were built.

As a result, a number of G20 jurisdictions, in particular the central banks in the UK, USA, Japan, Switzerland and the EU, have been working jointly with the financial industry to overhaul some of the existing IBORs and replace them with more appropriate and representative ARRs. This has coincided with the changing structure of the inter-bank market where secured lending has largely replaced the unsecured transactions.

In addition, the UK's Financial Conduct Authority (FCA), which regulates LIBOR, declared in 2017 that after 31 December 2021 it will no longer compel banks to continue making LIBOR submissions. As a result, the number of submissions has fallen significantly, thus reducing the representativeness of LIBOR, which might ultimately lead to LIBOR publication ceasing entirely. The FCA's statement has triggered what is now known as the LIBOR transition, requiring LIBOR users to prepare to move to other ARRs before the end of 2021.

Impact on DFSA authorised firms

As a major structural change in global financial markets is now under way, and in advance of the end of 2021 deadline, regulators and industry groups have been strongly advocating - and working together - to prepare a gradual and controlled transition away from certain IBORs in order to avoid a "cliff-edge" event.

Given the historical scope and breadth of the IBORs across nearly all markets and products, the DFSA urges DFSA authorised firms, which are likely to be affected by the transition, for example in relation to USD LIBOR, to undertake pre-emptive work to prepare for this event in advance of the deadline. The DFSA also cautions against issuing any new LIBOR-related financial products or securities, which would run beyond the end of 2021 deadline or any IBOR-related products where the continuation of the benchmark is not certain.

Authorised firms should consider to what extent the upcoming transition will affect their business and prepare to replace the outgoing IBORs with suitable available ARRs, while bearing in mind the complexities related to replacement stemming from the market liquidity in new ARR-based products and the different nature of these rates relating to, for example, unsecured vs. secured, backward vs. forward looking and term rates vs. overnight only aspects.

The DFSA recognises that the transition process raises a range of important microprudential concerns, including in terms of prudential, hedging and accounting risks, operational risks including litigation and legal risks, as well as various conduct and market risks. From an operational perspective, the adoption of ARRs entails important adjustments to risk management processes and systems and any delay could have significant implications for a firm’s ability to transition smoothly.

As the anticipated transition may affect DFSA authorised firms in various ways, depending on their actual reliance or use of the IBORs and the agreed replacement ARRs, firms are likely to face various challenges, such as those set out below. The DFSA urges firms to consider how these challenges affect their DIFC operations by identifying and deciding, if necessary, subject to measurable timelines and targets, how they plan to:

a) deal with existing IBOR-referencing securities or products with maturities or rolling over arrangements beyond the end of 2021 LIBOR phase-out deadline;

b) negotiate with counterparties and include conversion clauses in legacy contracts referencing IBORs;

c) measure own exposures, and adapt to new valuation methods;

d) adapt internal and third-party managed systems, processes and documentation to factor in the transition; and

e) conduct appropriate awareness and outreach with the firm's clients on the impact of the transition.

In the coming months the DFSA is planning to engage with authorised firms, on an individual basis and in the context of our usual supervisory activities, on the progress of their transition arrangements.

The DFSA is also planning to follow up shortly with a questionnaire to authorised firms, to allow us to elicit areas of potential concern and highlight key areas where there is a need for more transition preparation and, where necessary, DFSA support and guidance.

Please note that a corresponding Markets Brief is being issued in parallel to this letter and is addressed to issuers of DIFC-listed debentures.

Yours faithfully,

Managing Director

Copy to: All Compliance Officers