Central Bank *of* Kenya

Guidance on LIBOR Transition

December 2021

1. Preliminary

1.1 Title

Guidance on LIBOR transition

1.2 Authorization

This Guidance on LIBOR transition is issued under section 33(4) of the Banking Act, which empowers the Central Bank of Kenya (CBK) to guide institutions in order to maintain a stable and efficient banking and financial system.

1.3 Application

This Guidance applies to commercial banks, microfinance banks and mortgage finance companies.

2. Statement of Policy

2.1 Background

The Financial Conduct Authority (FCA), which regulates the London Interbank Offered Rate (LIBOR), announced in 2017 that it would no longer compel panel banks to continue submitting quotes for LIBOR after December 2021 following attempts to manipulate key global benchmark rates and to declining liquidity in underlying markets.

On 5 March 2021, the FCA clarified and confirmed that all LIBOR settings would either cease to be provided by any administrator or no longer be representative as follows:

- immediately after 31st December 2021, in the case of all sterling, euro, Swiss franc and Japanese yen settings, and the 1-week and 2-month US dollar settings; and
- immediately after 30th June 2023, in the case of the remaining US dollar settings.

Representative LIBOR rates will thus not be available beyond the dates set out above, and publication of LIBOR settings will cease immediately after these dates. It is thus essential for market participants to take the requisite steps to be ready for the cessation of LIBOR publication by December 31, 2021.

2.2 Financial Stability Risks arising from LIBOR Transition

Because LIBOR is used in such a large volume and broad range of financial products and contracts, its vulnerabilities pose a potential threat to individual financial institutions and to financial stability. Without advanced preparation, a sudden cessation of such a heavily used reference rate would cause considerable disruptions to, and uncertainties around the large gross flows of LIBOR–related payments and receipts between many firms. It would also impair the normal functioning of a variety of markets, including markets for business and consumer lending. The current outstanding contracts referencing LIBOR, including loans, deposits, off-balance sheet commitments, tier II capital instruments and exposures to other banks total approximately Ksh. 695.3billion as at September 30, 2021. The proportion of loans priced on LIBOR stood at 450.6 billion, which is 14.2 percent of total banking sector loans and 52.2 per cent of foreign currency denominated loans as at the said date.

2.3 Purpose

The purpose of this guidance is to assist financial institutions in the transition process by setting out expectations regarding governance structure, risk identification approaches and other actions in relation to the LIBOR transition. CBK is aware of the potential financial, legal and reputational risks associated with inadequate preparation on financial institutions and the industry. Therefore, the onus of a timely and orderly transition remains purely on financial institutions to manage through well-designed transition programmes with appropriate levels of governance and oversight.

2.4 Responsibility

The board of directors and senior management of an institution should formulate strategies to manage the transition from LIBOR to alternative reference rates.

2.5 Progress made in LIBOR transition in Kenya

The CBK has remained at the forefront of the LIBOR discussion and continues to engage financial institutions (banks, microfinance companies and mortgage finance companies), including a meeting in which the CBK hosted all chief executives of these institutions on September 14, 2021. Following this meeting, CBK has conducted a preliminary survey to assess the exposures linked to the LIBOR and the steps taken to prepare for transition to alternative reference rates. From the survey, out of 39 operating commercial banks in Kenya, 27 banks were offering various products priced on LIBOR across loans, deposits, off-balance sheet commitments and Tier II capital instruments over various tenors, with exposure standing at approximately Ksh. 695.3billion as at September 30, 2021. CBK further noted that the banks' responses indicate that they are aware of the expected changes regarding LIBOR and have put in place plans to facilitate smooth transition to alternative reference rates.

3. Guidance on Transition

Governance

a) Financial Institutions should setup appropriate project management framework to manage the LIBOR transition with adequate resources and budget. The LIBOR transition should also form key part of the Asset-Liability Committee (ALCO) discussions.

b) The Board of Directors and senior management should exercise adequate oversight on the transition process. The Board and senior management should ensure that the transition plan adequately addresses the risks identified.

Monitoring, Communications and Training

In keeping with the Principles of the Banking Sector Charter (BSC) which were issued by the CBK in February 2019 and which are pursuant to Section 33(4) of the Banking Act and Section 48(2A) of the Microfinance Act, the CBK requires:

c) Financial Institutions to provide tailored communication to clients on bilateral contractual transitions, their implications and outcomes to ensure enhanced transparency and information disclosure.

d) Financial Institutions to closely monitor the development of and challenges with alternative reference rates and associated liquidity across term structures

e) Financial Institutions to develop a robust monitoring program to remain current with all jurisdictional and international developments affecting the LIBOR reform.

f) Financial Institutions should train staff on the benchmark rate reforms and associated risks for each business lines, and how communicate benchmark-related issues to clients.

Risks and Mitigations

g) Financial Institutions should have a comprehensive contract inventory, and carry out an exposure analysis in respect of LIBOR-linked products.

h) Financial Institutions should develop and implement fallback provisions for all contracts that reference LIBOR extending beyond 31 December 2021 and 30 June 2023 for US LIBOR contracts, taking note of best industry practices where available for each product type.

i) Financial Institutions should protect relevant outstanding LIBOR contracts from uncertainty by amending them to account for LIBOR's end through the adoption of the ISDA IBOR Fallbacks Protocol, wherever possible.

j) Financial Institutions should ensure that the pricing of instruments adhere to international best practices, and are adjusted in such a way so as to reduce or eliminate, to the extent reasonably practicable, any transfer of economic value from one party to another as a result of the application of the replacement RFRs.

k) Financial Institutions should consider the implications of the transition on fair value accounting, regulatory reporting and taxation. External auditors should be engaged in the process.

Systems Changes, Testing and Preparedness

l) Financial Institutions should assess the IT support and infrastructure required in order to amend existing contracts, and enable the issuing of new contracts

m) Financial Institutions should initiate changes to be made to current systems, operations and control environment to implement the transition to RFRs.

n) Incorporation of new market data sources/calculation methodologies into systems should be duly documented.

o) Financial Institutions should test their systems in a timely manner to ensure readiness for the transition and perform any required model validations.

4. Timelines

In order to be prepared for the LIBOR transition, CBK recommends the following milestones:

31 December 2021

a) Financial institutions should stop offering new LIBOR-linked products in all LIBOR settings; all new business should be conducted using alternative RFRs

b) For any legacy contracts for which it has not been possible to make amendments, Financial Institutions should have considered and discussed between the parties the implications of cessation or lack of representativeness of LIBOR settings ending at the end of 2021.

c) Financial institutions ensure that all critical processes and systems can be operated without reliance on LIBOR settings ending at the end of 2021 and use the alternative RFRs

30 June 2023

a) For any remaining USD LIBOR legacy contracts for which it has not been possible to make amendments, Financial Institutions should have considered and discussed between the parties the implications of cessation or lack of representativeness, and taken steps to prepare for this outcome as needed

b) Ensure that all critical processes and systems can be operated without reliance on USD LIBOR settings ending at the end of June 2023.

5. Reporting

5.1 Reports to Management

Based on the financial institution's internal strategy for LIBOR transition, reporting structures should be developed for internal reporting by banks to the Board and Senior Management on a periodic basis to provide status of transition activities.

5.2 Reports to CBK

As guided via the circular issued on September 16, 2021, Banks should submit to CBK the following information every month:

a) Total value and number of financial products priced on LIBOR (classified as one-month, three-month and over three-month tenors)

b) Status towards transitioning to alternative reference rates

c) Measures put in place to mitigate risks associated with transitioning to alternative reference rates.

Appendix – Definitions / Acronyms

1. LIBOR

London Interbank Offered Rate (LIBOR) is the most widely used interest rate benchmark in the world. LIBOR is calculated and published daily at around 11:45 (London time) by IBA based on submissions by panel banks for five currencies: Sterling, U.S. Dollars, Euros, Swiss Francs and Japanese Yen and in seven different tenors: overnight/spot next; 1 week; 1 month; 2 months; 3 months, 6 months; and 12 months.

2. Fallback language / triggers

Fallback language sets out the alternative rates (usually in the form of a waterfall of priority) which may become the benchmark rate where the originally referenced benchmark rate is no longer to be used. Fallback language in documentation is contingent on a trigger (i.e. an event that initiates that switch from one interest rate to another).

3. IOSCO

The International Organization of Securities Commissions is the international body that brings together the world's securities regulators and is recognised as the global standard setter for the securities sector. IOSCO develops, implements and promotes adherence to internationally recognized standards for securities regulation. It works intensively with the G20 and the FSB on the global regulatory reform agenda.

4. IOSCO Principles

International Organization of Securities Commission Principles for Financial Benchmarks.

5. OIS

Overnight Indexed Swap, refers to an interest rate swap involving the overnight rate being exchanged for a fixed interest rate. An overnight index swap uses an overnight rate index such as LIBOR or RFRs as the underlying rate for the floating leg, while the fixed leg would be set at a pre-agreed rate.

6. RFRs

Risk-Free Rates have been identified by the national working groups as alternatives to IBORs. RFRs have, for example, been identified for all the LIBOR currencies and the euro. The RFRs chosen are overnight risk-free (or near risk-free) rates measured from transactions in interbank unsecured lending markets or Repo markets

7. ISDA

International Swaps and Derivatives Association

8. SOFR

The Secured Overnight Financing Rate has been named by the ARRC as its recommended RFR alternative to LIBOR for US dollar denominated sums. SOFR is produced by the New York Fed and is a secured risk-free rate.

9. SONIA

The Sterling Overnight Index Average has been named by the Sterling RFR Working Group as its preferred RFR for sterling markets.

10. TONA

The Tokyo Overnight Average Rate has been named by the Japanese Yen RFR Working Group as the RFR replacement benchmark for JPY LIBOR.