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Benchmark reform: transition from IBORs to risk-free rates in the Euro area

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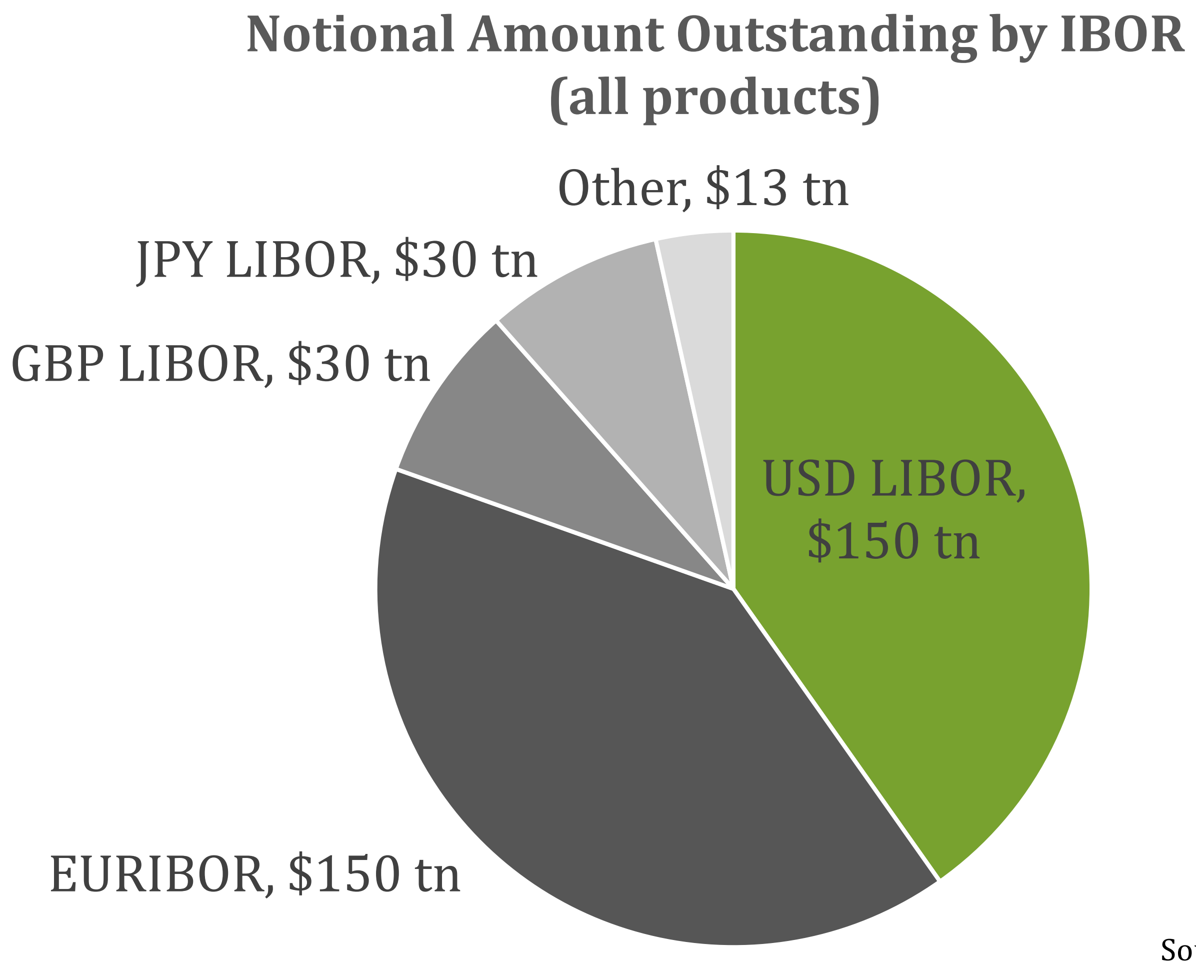
Outline

- Scope and effect of change: which products are affected, and how?
- What are the challenges in transition?
- Case studies
- What possible outcomes might there be?
- Topics for discussion

Total IBOR market exposure = > $370 trillion



Source: Market Participants Group on Reforming Interest Rate Benchmarks – Final Report (July 2014)

Typical users of IBOR rates

<u>Sell Side undertakes</u>

- Interbank borrowing and lending
- FRN issuance
- Securitisation
- Derivatives trading, hedging and market making
- Intermediary roles including in clearing
- Deposits, credit cards and loans

<u>Buy Side</u>

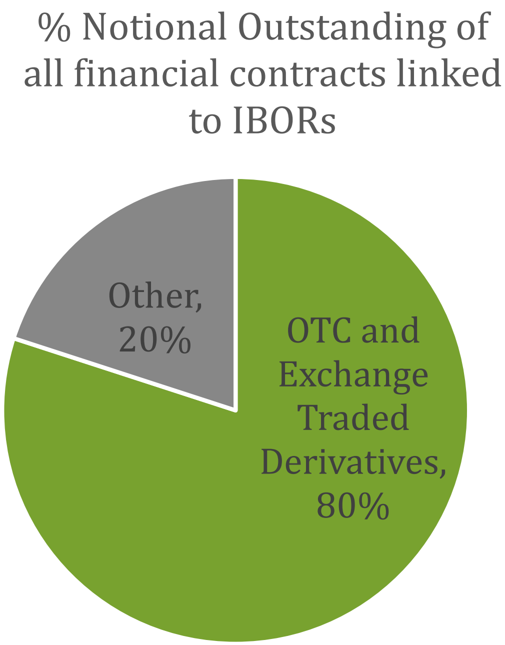
- Invests in securitised products and FRNs
- Enters into OTC and ETD with banks for hedging purposes
- Takes positions on derivatives and cash products

<u>Corporates and others</u>

- Issue FRNs and callable debt
- Trade OTC and ETDs with banks for hedging purposes
- Obtain loans

Source: IBOR Global Benchmark Survey – 2018 Transition Roadmap

Typical contracts based on IBORs



Source: Market Participants Group on Reforming Interest Rate Benchmarks – Final Report (July 2014)

- OTC derivatives: interest rate swaps, FRAs, cross-currency swaps.
- Exchange-traded derivatives: interest rate options, interest rate futures.
- Loans: syndicated loans, business loans, mortgages, credit cards, auto loans, consumer loans, student loans.
- Bonds and FRNs: corporate and non-US government bonds, agency notes, leases, trade finance, FRNs, covered bonds, capital securities, perpetuals.
- Short-term instruments: repos, reverse repos, time deposits, CDS, commercial paper.
- Securitisations: MBS, ABS, CMBS, CLOs and CMOs.
- Other: late payments, discount rates, overdrafts.

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Successful market adoption of alternative RFRs requires input from many different disciplines

Transition Challenges

Governance and controls
Institutions must have robust governance and controls to manage transitioning of contracts to alternative RFRs.

Accounting
The transition may result in complications related to fair value designation, hedge accounting and inter-affiliate accounting structures.

Tax
The transition may result in changes in the amount of taxes due or acceleration of payments on financial contracts or tax structures.

Regulatory
Requirements under existing regulatory regimes may make the transition to alternative RFRs more difficult (if not modified).

Liquidity
Liquidity in the derivatives market referencing the alternative RFRs is crucial. Such liquidity will also be necessary for development of term structures based on the alternative RFRs.

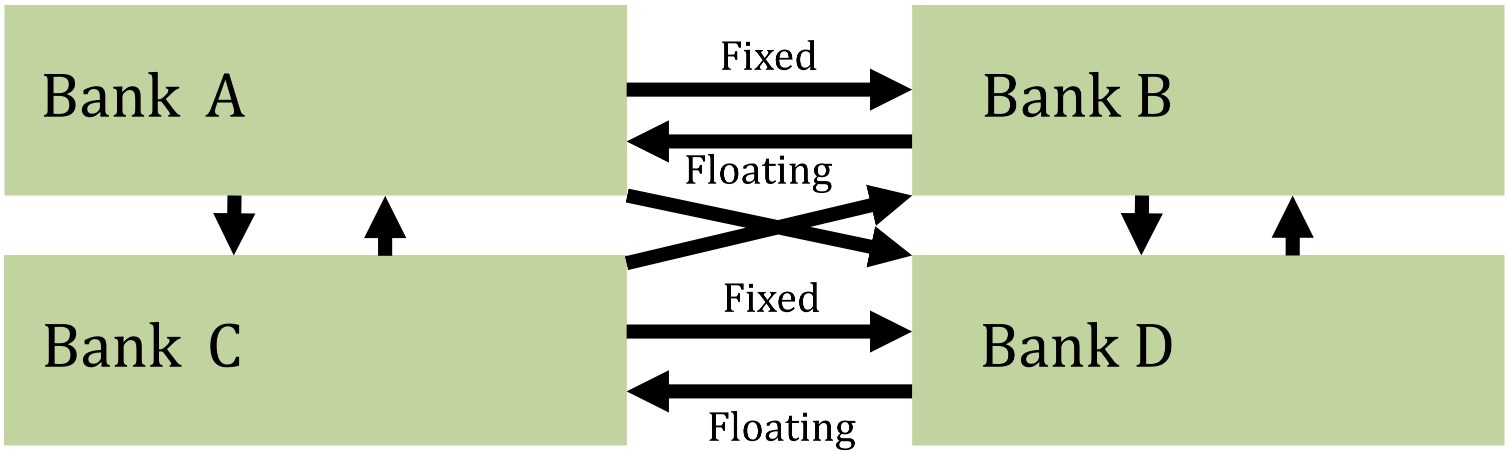
Valuation and risk management
Transition of legacy contracts could potentially result in less effective hedges and/or market valuation issues; may require adjustments to address differences.

Infrastructure
Significant challenges may arise when the required institutional infrastructures (data, systems and operational procedures) are established to support the transition to the alternative RFRs.

Legal
Contract amendments may lead to increased transition costs and operational risk. A significant administrative effort associated with transitioning contracts to the alternative RFRs may be required.

Source: IBOR Global Benchmark Survey – 2018 Transition Roadmap

Case Study 1: swap documentation has a mechanism for amendments



- ISDA protocol is a multilateral contractual amendment mechanism which has been used to address changes to ISDA standard contracts since 1998.
- First used in context of EMU.
- For the adhering party, adherence to a protocol eliminates the necessity for costly and time-consuming bilateral negotiations and reduces the number of agreements required.
- BUT the protocol mechanism still requires *consent* – all relevant parties must agree to the change.

Contingencies for FRNs if IBOR is not available

- Screen Rate

- Contingency 1: if Screen Rate not available, Calculation Agent requests quote from (say) four major banks in Financial Centre A and uses average

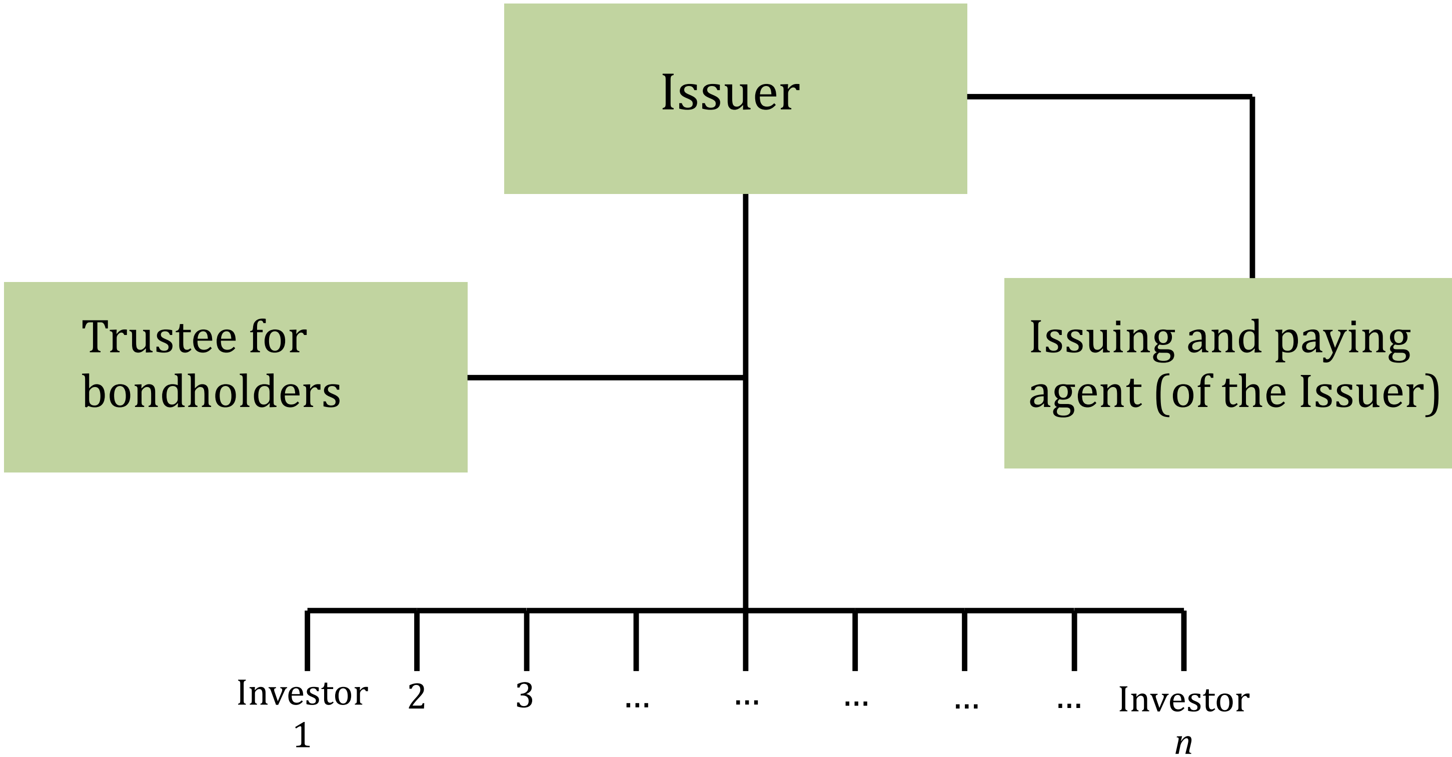
- Contingency 2: if Contingency 1 fails, Calculation Agent takes average of rates quoted from major banks in Financial Centre B

- If both contingencies fail, then typically either:
  - Use IBOR from immediately preceding interest payment date (commonest)
  - Calculation Agent determines IBOR in its own discretion (minority approach)

- In most FRNs, there is no flexibility to use an alternative benchmark and investors will be left with a fixed rate exposure if IBOR ceases to exist and banks decline to quote

Source: Barclays US Credit Research 16th August 2017

Case Study 2: it is very difficult to amend FRNs



- Eurobonds are bearer instruments: investor identities are not known.
- A bondholders' meeting would be required.
- Attendance is voluntary, a quorum required and a super-majority must vote to change the interest basis.
- There will likely be diverging incentives over value at risk.
- Asset valuations or liabilities for securitisation and covered bonds could change.

Case Study 3: overnight RFRs are not term rates

Current procedure for 3-month Ibor fixing

3 month IBOR fixing

Start of interest period

End of interest period

-2 business days

March 1st 2018

June 1st 2018

Coupon determined in CCY

Coupon paid in CCY

Potential future procedure

Coupon not known

Coupon determined only with hindsight. And paid when?

March 1st 2018

June 1st 2018

Daily overnight rate determined after the fact?

Possible outcomes

- Exchange IBOR-linked securities
- Leave IBOR-linked securities outstanding
- Keep IBOR but change its methodology to base it off RFRs
- A legislative solution

Source: Barclays US Credit Research 16th August 2017

Topics for discussion

- How do we raise awareness of the issues?
- How should we identify, convene and deploy the required expertise to find solutions?
- What priorities should we set?
- What role should regulators and policymakers play?