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

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• 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

Notional Amount Outstanding by IBOR (all products)

- USD LIBOR, $150 tn
- EURIBOR, $150 tn
- JPY LIBOR, $30 tn
- GBP LIBOR, $30 tn
- Other, $13 tn

Source: Market Participants Group on Reforming Interest Rate Benchmarks – Final Report (July 2014)
## Typical users of IBOR rates

<table>
<thead>
<tr>
<th>Sell Side undertakes</th>
<th>Buy Side</th>
<th>Corporates and others</th>
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</thead>
<tbody>
<tr>
<td>Interbank borrowing and lending</td>
<td>Invests in securitised products and FRNs</td>
<td>Issue FRNs and callable debt</td>
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<tr>
<td>FRN issuance</td>
<td>Enters into OTC and ETD with banks for hedging purposes</td>
<td>Trade OTC and ETDs with banks for hedging purposes</td>
</tr>
<tr>
<td>Securitisation</td>
<td>Takes positions on derivatives and cash products</td>
<td>Obtain loans</td>
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<tr>
<td>Derivatives trading, hedging and market making</td>
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<tr>
<td>Intermediary roles including in clearing</td>
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<tr>
<td>Deposits, credit cards and loans</td>
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Typical contracts based on IBORs

- 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.

Source: Market Participants Group on Reforming Interest Rate Benchmarks – Final Report (July 2014)
Successful market adoption of alternative RFRs requires input from many different disciplines

**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: March 1st, 2018
- End of interest period: June 1st, 2018
- Coupon determined in CCY
- Coupon paid in CCY
- Coupon not known

Potential future procedure

- 3 month IBOR fixing
- Start of interest period: March 1st, 2018
- End of interest period: June 1st, 2018
- Coupon determined only with hindsight. And paid when?
- 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?