 

Key publications on the global transition to risk-free rates

By Charlotte Bellamy and Katie Kelly

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As the end of 2021[1] draws closer, developments in the transition to risk-free rates from LIBOR are picking up speed and authorities and other bodies involved in the transition are frequently publishing relevant materials. This article seeks to draw together and summarise the most important recent publications for the bond market. It follows a similar article in the Third Quarter 2019 edition of this Quarterly Report, which summarised key publications from the first half of 2019.

The key publications are organised by theme as follows: (i) adoption of risk-free rates in the international bond market; (ii) fallbacks; (iii) regulatory, tax and other matters; (iv) the development of term risk-free rates; and (v) developments in relation to the EU Benchmarks Regulation (EU BMR), including a summary of ICMA's response.[2]

These are preceded by a box introducing key recent official speeches regarding the transition to risk-free rates. Other publications on the transition to risk-free rates are summarized in a box in the International Regulatory Digest section of this Quarterly Report.[3]

1. The end of 2021 is the date from which continued publication of LIBOR cannot be guaranteed.

2. For information on the transition of legacy LIBOR instruments to risk-free rates, please see the Quarterly Assessment on *The Transition from LIBOR to Risk-Free Rates: Legacy Bonds* in this Quarterly Report.

3. For information and publications on the transition from EONIA to €STR, please see the article *Euro risk-free rate reform* in the Fourth Quarter 2019 edition of this Quarterly Report.

Key official speeches regarding LIBOR and EURIBOR

- *LIBOR: Preparing for the End*, a speech by Andrew Bailey, Chief Executive of the FCA, given on 15 July 2019. Andrew Bailey noted that transition from LIBOR has made good progress across derivatives and securities markets, and transition in loan markets is a key next step. He set out the benefits to borrowers of the move to risk-free interest rate benchmarks and noted that UK lenders will need to begin engaging with borrowers about lending based on these rates. He also highlighted that the FCA expects the LIBOR panels to dwindle or disappear after end-2021, so firms must be able to run their business without LIBOR from this date and reduce the stock of "legacy" LIBOR contracts. Regarding legacy contracts that cannot be converted away from LIBOR or have fallbacks added (the "tough legacy" question), he said that, although legislative solutions are not within the gift of the regulators, "it is sensible to consider their pros and cons".
- *LIBOR: The Clock is Ticking*, a speech by John C. Williams, President and Chief Executive Officer of the Federal Reserve Bank of New York, given on 23 September 2019. The speech highlighted the urgency of the need to move away from LIBOR, progress made in adoption of SOFR and challenges ahead. Separately, in his remarks at a Managed Funds Association conference, John C. Williams addressed what the variability in repo markets means for SOFR. He said that the temporary SOFR spike in autumn 2019 was unsurprising because "SOFR reflects rates on real-world transactions," and he explained that financial contracts generally refer to an average of SOFR over time. He noted that the spike should not be used as an excuse to delay transitioning away from LIBOR because "like death and taxes, the end of LIBOR is unavoidable, and we must do all that it takes to prepare for a LIBOR-less future."
- *Join the Revolution! Why it Makes Business Sense to Move On from LIBOR*, a speech by Andrew Hauser, Executive Director for Markets, Bank of England, given on 27 June 2019. Andrew Hauser looked at the opportunities a post-LIBOR world could offer. He also set out how the Bank of England is adapting its own operations to the use of SONIA.
- The *Second Roundtable on Euro Risk-Free Rates* at the ECB on 25 September 2019 included an opening speech by Benoît Cœuré, Member of the Executive Board of the ECB.
- *Ongoing Reforms and Challenges Ahead*, a speech by Steven Maijoor, Chair of ESMA, given on 29 October 2019. The speech discussed ESMA's role under the EU BMR and more generally in the global reform of interest rates. He said: "There is a clear commitment by the administrator of EURIBOR and the public sector to sustain EURIBOR and the work will continue in the next years to ensure that the panel of banks contributing to EURIBOR is stable and representative. ... Just as for all benchmarks authorised under the Regulation, fallback clauses are needed for EURIBOR too. This is because users, and their clients, should be able to know in advance what will happen to their contracts if EURIBOR ceases to be provided."
- *Next Steps in Transition from LIBOR*, a speech by Edwin Schooling Latter of the UK FCA, given on 21 November 2019. The speech covered the key next steps in reducing the risks from continued use of LIBOR, highlighting "In sterling IRS (interest rate swap) markets, we will be encouraging market makers to make SONIA the market convention from Q1 2020" and "The sterling RFR Working Group has set a target of Q3 2020 to stop new lending using LIBOR." He also stated: "The conduct risks of striking new LIBOR-referencing transactions that endure beyond end-2021 are rising"; and he discussed pre-cessation triggers, noting that the arguments for a pre-cessation trigger seem persuasive.
- *Introductory Remarks* by Andréa Maechler, Board member of the Swiss National Bank, given on 12 December 2019, called upon market participants to implement the recommendations of the National Working Group on Swiss Franc Reference Rates in relation to the transition from CHF-LIBOR to SARON and noted that the successful transitioning away from CHF-LIBOR hinges on the development of more SARON-based cash products.

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Adoption of risk-free rates in the international bond market

There has been good progress in the adoption of risk-free rates in bond markets. Key developments include:

- The Working Group on Sterling Risk-Free Reference Rates (£RFR Working Group) published a *Statement on Conventions for Referencing SONIA in New Contracts and Summary of Responses to Discussion Paper* in August 2019. The Statement noted that the £RFR Working Group considers it sensible for cash market conventions to align with existing OIS market conventions where possible, namely compounded average settled in arrears. In addition, the £RFR Working Group views the 5-day lag period used in the SONIA bond market as sensible. Further information can be found in the article *Risk-Free Rates: Bond Market Conventions* in the Fourth Quarter 2019 edition of this Quarterly Report.
- The ECB published the €STR (the new €RFR) for the first time on 2 October 2019, reflecting trading activity on 1 October 2019. This first setting was determined as -0.549% and was reported as being based on 432 transactions from 32 active banks. Alongside this, on 2 October, EMMI, for the first time, published EONIA (for 1 October) under the reformed determination methodology (ie €STR + 8.5bp, giving a rate of -0.464%, as compared to an announced EONIA rate for 30 September of -0.451%). EMMI also announced that it had applied for authorisation of EONIA from the Belgian FSMA, under Article 34 of the EU BMR and subsequently, on 11 December, announced that this authorisation had been duly granted. EMMI published its *EONIA Benchmark Statement* on 18 December 2019. EMMI will continue to publish EONIA every TARGET day until 3 January 2022, the date on which this benchmark will be discontinued.
- The first bonds referencing €STR were issued after €STR publication began on 2 October 2019. The first benchmark transaction was issued by the European Investment Bank: a €1 billion 3 year €STR bond.
- In the US, the Alternative Reference Rates Committee (ARRC) released an Appendix to the SOFR FRNs *Conventions Matrix*. The Matrix, which was issued in August 2019, identifies considerations relevant to using SOFR – the ARRC's recommended alternative to USD LIBOR – in new FRNs and supplements the ARRC's paper *A User's Guide to SOFR* released in April 2019. In conjunction with the Matrix, the ARRC had also released the *SOFR FRNs Comparison Chart*, which outlines conventions already being used in the market. The Appendix builds upon these documents and is intended as an additional resource for market participants to consider.
- In addition, the Federal Reserve Bank of New York, in order to support a successful transition away from USD LIBOR, and as administrator of SOFR, in cooperation with the Treasury Department's Office of Financial Research, requested comments on a proposal to publish daily three compounded averages of SOFR with tenors of 30-, 90-, and 180-calendar days, and to publish daily a SOFR index that would allow the calculation of compounded average rates over custom time periods. This development was welcomed by the ARRC.
- In Asia Pacific, issuance of bonds referencing alternative RFRs has begun with, among others, Bank of China issuing a floating rate note based on SOFR and the South Australian Government Financing Authority issuing two floating rate notes based on AONIA.
- The Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks published a report on the results of its consultation on JPY interest rate benchmarks on 29 November, together with a summary of the main points and a press release. In respect of bonds, there was a general preference among respondents for term rates to replace JPY LIBOR, although for the bond market there were "a relatively large number of respondents" who envisaged using TONA compounded in arrears. However, responses indicated that a sufficient period for preparation would be necessary in order to make

necessary adjustments to business operations and systems, as well as trading practices, in order to use TONA compounded in arrears.

- In August 2019, the Association of Banks in Singapore and the Singapore Foreign Exchange Market Committee issued a consultation report that identified the Singapore Overnight Rate Average (SORA) as the alternative interest rate benchmark to the SGD Swap Offer Rate (SOR) (which is linked to USD LIBOR) and set out a roadmap for this transition. On the same day, the Monetary Authority of Singapore announced the establishment of a Steering Committee to drive transition from SOR to SORA.

Separately, the Loan Market Association published for its members exposure drafts of a compounded SONIA-based sterling term and revolving facilities agreement and a compounded SOFR-based dollar term and revolving facilities agreement in September 2019. The documents do not constitute recommended forms of the LMA; they have been published as exposure drafts which are open for comments from market participants.

Fallbacks

In addition to referencing risk-free rates in new bonds, authorities and market participants are also focused on fallbacks to IBORs and other reference rates:

- *GBP-LIBOR cash product fallbacks:* The £RFR Working Group published a *Consultation on the Credit Adjustment Spread Methodologies for Fallbacks in GBP LIBOR Cash Products* in December 2019. The paper considers four methodologies that could be used to calculate the credit adjustment spread for fallback language in sterling cash instruments. The deadline for responses is 6 February 2020.
- *USD-LIBOR cash product fallbacks:* The ARRC published a summary of its USD-LIBOR fallback language in November 2019.
- *EURIBOR fallbacks:* The Working Group on Euro Risk-Free Rates (Euro RFR Working Group) published high level recommendations for fallback provisions in contracts for cash products and derivatives transactions referencing EURIBOR in November 2019. The Euro RFR Working Group recommends that market participants consider incorporating fallback provisions in all new financial instruments and contracts referencing EURIBOR, regardless of whether they fall within the scope of the EU BMR. There are a set of general recommendations relating to the approach that may be taken in relation to EURIBOR fallbacks and some suggested language. The Euro RFR Working Group is also working towards the publication of certain consultations and resulting recommendations relating to EURIBOR fallbacks in H1 2020, as detailed in this timeline of deliverables of the Euro RFR Working Group.
- *€STR fallbacks:* The Euro RFR Working Group also published a report on €STR fallback arrangements in November 2019. The purpose of the report was to provide supervised entities with guidance on potential ways to comply with Article 28.2 of the EU BMR when using €STR as the euro risk-free rate in contracts.
- *IBOR fallbacks in derivatives:* ISDA published a report that summarises responses to a consultation on the final parameters of adjustments that will apply to derivatives fallbacks for certain IBORs in November 2019. The report follows two earlier consultations that found the overwhelming majority of respondents preferred the compounded setting in arrears rate to address differences in tenor between IBORs and overnight risk-free rates, and the historical mean/median approach to deal with differences in credit risk and other factors. Responses to the final parameters consultation show that a majority of participants preferred a historical median approach over a five-year lookback period. A majority also preferred not to include a transitional period in the spread adjustment calculation, not to exclude outliers, and not to exclude any negative spreads. For the compounded setting in arrears rate, a clear majority favoured a two-banking-day backward shift adjustment for operational and payment purposes. ISDA also announced in July 2019 that Bloomberg Index Services Limited had been selected to calculate and publish adjustments related to fallbacks that ISDA intends to implement for certain interest rate benchmarks in its 2006 ISDA Definitions.

  ISDA also launched in December 2019 a supplemental consultation on the spread and term adjustments that would apply to fallbacks for derivatives referencing euro LIBOR and EURIBOR, in the event those benchmarks are permanently discontinued, with a deadline of 21 January 2020. The consultation also covers technical issues related to the adjustment methodology and seeks feedback on whether the adjustments would be appropriate for lesser-used IBORs if ISDA implements fallbacks for those benchmarks in the future.
- *IBOR fallbacks in derivatives – pre-cessation issues:* ISDA also published a report summarising responses to a consultation on pre-cessation issues for LIBOR and certain other IBORs in October 2019. The responses indicated that a majority of market participants would generally not want to continue referencing a covered IBOR in existing or new derivatives contracts following a statement from a supervisor that it is no longer representative of the underlying market. However, the consultation did not reveal a consensus on how to respond to such a statement in the context of fallbacks

for derivatives contracts. This was followed by a letter dated 19 November 2019 from the Official Sector Steering Group of the FSB, which encouraged ISDA to add a "pre-cessation" trigger alongside the cessation trigger as standard language in the ISDA definitions for new derivatives and in a single protocol, without embedded optionality, for outstanding derivative contracts referencing key IBORs. According to the letter, this would help to reduce systemic risk and market fragmentation by ensuring that as much of the swaps market as possible falls back to alternative rates in a coordinated fashion. ISDA responded to the FSB's letter on 4 December 2019, calling for, among other things, greater clarity on certain points to assist market participants in understanding the implications of a "non-representative" LIBOR, including a confirmation from the FCA and the administrator for LIBOR that a "non-representative" LIBOR would only be published for a short period (ie a number of months, not years).

Regulatory, tax and accounting matters

The past six months have seen a high level of focus on regulatory, tax, accounting and other issues connected with the transition to risk-free rates from LIBOR. Key publications are summarised below:

- In July 2019, the Euro RFR Working Group wrote a letter to the International Accounting Standards Board (IASB) to inform IASB of the objective and status of the reform agenda regarding interest rates in the euro area and to express some concerns in relation to potential accounting issues triggered by the reform based on the analysis of the potential IFRS accounting issues.
- In September 2019, the IASB amended some of its requirements for hedge accounting to provide relief from potential effects of the uncertainty caused by the IBOR reform. In addition, the amendments require companies to provide additional information to investors about their hedging relationships which are directly affected by these uncertainties.
- In October 2019, the £RFR Working Group published letters to the UK Prudential Regulation Authority, UK Financial Conduct Authority, European Commission and Basel Committee on Banking Supervision regarding regulatory barriers to transition away from LIBOR. The letters request that the issues raised are considered and concrete actions are taken where necessary to ensure a smooth transition away from LIBOR. The £RFR Working Group also wrote to EIOPA in July 2019 to encourage EIOPA to remove the recognised Solvency II barriers to transition.

  Subsequently, the FCA answered key questions on conduct risk arising from LIBOR transition in November 2019, outlining (among other things) their expectation that firms have a strategy in place and take necessary action during LIBOR transition, and customers are treated fairly by following their rules and guidance.

  The PRA responded to the Sterling RFR Working Group's letter in December 2019. In particular, the PRA noted, in relation to AT1 and Tier 2 Capital, that it does not believe it is desirable to reassess the eligibility of instruments where the amendments are solely to replace the benchmark reference rate. The PRA has made this point at the Basel Committee on Banking Supervision and is making progress towards achieving an internationally consistent response. The PRA also noted that its rules on Contractual Recognition of Bail-In and Stay in Resolution could be considered relevant where legacy contracts are judged to have been materially amended. The PRA is considering possible implications of benchmark rate reform for those rules and plans to provide an update in spring 2020.
- In October 2019, the ARRC issued a press release welcoming the US Department of the Treasury and the Internal Revenue Service's release of proposed regulations providing tax relief related to issues that may arise as a result of the modification of debt, derivative, and other financial contracts from LIBOR-based language to alternative reference rates.
- In November 2019, the Financial Accounting Standards Board (FASB) approved an Accounting Standards Update (ASU) to provide temporary, optional guidance to ease the potential burden in accounting for, or recognising the effects of, reference rate reform on financial reporting. The Board is expected to issue a final ASU in early 2020.
- The Euro RFR Working Group released a report in November 2019 on the financial accounting implications of the transition from EONIA to the €STR, and the introduction of €STR-based fallbacks for EURIBOR. The report primarily focuses on the EU BMR implications for hedge accounting related topics, and challenges for non-hedge related topics, and sets out relevant key recommendations.
- In December 2019, the UK Financial Reporting Council issued *Amendments to FRS 102 – Interest Rate Benchmark Reform* to provide relief to aid the transition from LIBOR to SONIA. The amendments are effective for accounting periods commencing on or after 1 January 2020.

Term rates

While new bonds referencing risk-free rates have generally adopted an average setting in arrears approach, work is underway to develop term rates in the UK, US, euro area and Japan. It is understood that such term rates are expected to be used in a limited sub-set of financial products, such as certain loans and mortgages, trade and working capital, Islamic finance. Recent publications relating to the development of term rates include:

- The Euro RFR Working Group published a call to benchmark administrators for expressions of interest in producing a €STR-based forward-looking term structure in July 2019. Five administrators duly responded to the Working Group's call and their presentations are available on the ECB's website.
- The Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks released a statement soliciting potential future administrators of JPY term reference rates in October 2019. It subsequently closed the call for applications on 31 December 2019, as it had received sufficient applications from entities with relevant experience.

Developments in relation to the EU Benchmarks Regulation

There have also been several recent developments relating to the EU Benchmarks Regulation (EU BMR):

- The European Commission published a consultation paper requesting comments on various aspects of the EU BMR including in the areas of IBOR reform, orderly cessation of a critical benchmark, authorisation and registration of benchmarks, the scope of the EU BMR, third country, climate-related and commodity benchmarks in October 2019. For information on ICMA's response to this consultation, please see the box below.
- Also in October 2019, ESMA and the Australian Securities and Investments Commission (ASIC) announced that they had signed a Memorandum of Understanding setting out cooperation arrangements in respect of Australian benchmarks. In conformance with the EU BMR, this will allow benchmarks declared significant by ASIC (BBSW, S&P/ASX200, Bond Futures Settlement Price, CPI, and Cash Rate) to be used in the EU by EU-supervised entities.
- ESMA is publishing registers of administrators, with over 70 now duly registered, and third country benchmarks, with in excess of 80,000 benchmarks now duly registered, in accordance with the EU BMR. ESMA has also published a table, last updated on 8 October, showing which applicable EEA competent authorities comply, or intend to comply, with ESMA's *Guidelines on Non-Significant Benchmarks under the EU BMR*.
- Various amendments to the EU BMR as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and Sustainability-related disclosures for benchmarks were published in the *Official Journal* and entered into force in December 2019. As part of this package of changes, the maximum period of mandatory administration and contribution for critical benchmarks was extended from two years to five years and the transition period in the original EU BMR was extended from end 2019 to end 2021 for both critical and third country benchmarks.
- ESMA published updated *Q&A on the EU BMR* in December 2019, which included new Q&As related to, among other things, (a) the role and responsibilities of a legal representative under Article 32(3) of the EU BMR (Recognition of an administrator located in a third country) and (b) transitional provisions applicable to third country benchmarks.
- ESMA also published a *Briefing on the Implementation of the Recognition Regime under Article 32 of the EU BMR* in December 2019, which aims to clarify some aspects of the recognition application such as: (a) the means to determine the Member State of reference; and (b) the instances where cooperation arrangements between EU and third-country competent authorities are needed.
- Finally, ESMA published a statement regarding pending applications by EU administrators of benchmarks in December 2019. The statement includes a table of information shared by NCAs with ESMA in relation to the applications for authorisation and registration by EU administrators under Article 51.1 of the EU BMR for which the decision by the relevant NCA is still pending. Under Article 51.3 of the EU BMR, EU supervised entities can continue to use existing benchmarks provided by the administrators included in the table unless and until such authorisation or registration is refused.

Contacts: Charlotte Bellamy and Katie Kelly
charlotte.bellamy@icmagroup.org
katie.kelly@icmagroup.org