Recent publications on the transition to risk-free rates *by Katie Kelly*

RFR

This article is a summary of key publications in the UK, the US, the euro area and globally in the first half of 2019 on the transition from LIBOR and the other IBORs to risk-free rates. Further information can be found on the ICMA *Benchmark reform and transition to risk-free rates* webpage.

Recent publications in the UK

On 28 January, Edwin Schooling Latter, Director of Markets and Wholesale Policy of the FCA, gave a speech at the International Swaps and Derivatives Association (ISDA) Annual Legal Forum, in which he said: "it is entirely plausible that the end-game for LIBOR will include an assessment by the FCA that one or more panels have shrunk so significantly in terms of number of banks or the market share of the banks remaining, that it no longer considers the relevant rate capable of being representative. ... There is a powerful logic to avoiding contractual reliance on a benchmark that is no longer representative of an underlying market, at least for those market participants that can avoid that reliance. That's one clear reason to consider including a representativeness trigger in contractual fallbacks."

In March, the Working Group on Sterling Risk-Free Reference Rates (RFR Working Group) published a Discussion Paper: *Conventions for Referencing SONIA in New Contracts*. Addressed to market participants considering how to reference SONIA in new contracts, this Discussion Paper was intended to raise market awareness of the identified conventions for referencing SONIA. The Infrastructure Working Group of the RFR Working Group had previously published a paper which outlined provisional specifications for a calculator to support the adoption of SONIA-based instruments.

The RFR Working Group wrote to the International Accounting Standards Board (IASB) in March to extend its support to the IASB on risk-free rate transition. It welcomed the IASB's decision to add the "IBOR Reform and the Effects on Financial Reporting" project to its standard setting agenda, and its decision to prioritise the analysis of the accounting issues affecting financial reporting.

In May, the RFR Working Group published a *Statement to Update on Progress in the Adoption of SONIA* in sterling markets, providing an update on SONIA adoption, noting that SONIA referencing floating rate notes have rapidly become the "*market norm*" as well as highlighting the first distributed SONIA-referencing RMBS transaction. The Statement also provided an update on work underway to develop a term SONIA Reference Rate (TSRR). Three administrators have confirmed that they are working on the development of a TSRR; their respective presentations are available to view on the Bank of England's *Transition to sterling risk-free rates from LIBOR* webpage. Notwithstanding this work, in the Statement, the RFR Working Group "encourages market participants not to delay preparations to conduct new business using overnight rates while the development of a TSRR takes place."

In June, at a joint conference of the Bank of England, the FCA and the RFR Working Group hosted by the Bank of England (*Last Orders: Calling Time on LIBOR*), thematic feedback from firms in response to the FCA and PRA's Dear CEO Letter from September 2018 was shared. The feedback resulted in a number of key findings across eight areas (including identification of reliance on, and use of, LIBOR; quantification of LIBOR exposure; granularity of transition plans and their governance; identification and management of prudential and conduct risks associated with transition; scenario planning and transacting in new risk-free rates and building-in fallbacks). The authorities have asked firms to confirm their preparedness for the transition from IBORs to alternative risk-free rates in a number of other countries, including Hong Kong, Australia and The Netherlands (in Dutch).

The RFR Working Group also released a Roadmap at the *Last Orders* event, which sets out progress to date and a Roadmap for 2019-2021. The Roadmap sets out certain RFR Working Group Deliverables, as to which, three priority task forces have been set up, focused on the development of term rates, accounting treatment and regulatory dependencies.

In June, the Bank of England released a Discussion Paper: *The Bank of England's Risk Management Approach to Collateral Referencing LIBOR for Use in the Sterling Monetary Framework*. The Discussion Paper provides a brief background to both the LIBOR transition process and the Bank's collateral framework, describes some of the potential implications for the Bank's balance sheet from LIBOR transition, and outlines a number of possible risk management approaches currently under consideration by the Bank to ensure that it remains well-placed to provide liquidity insurance in support of financial stability. The deadline for responses to the Discussion Paper is 27 September 2019.

Recent publications in the US

The minutes from the Federal Open Market Committee's January meeting noted that Federal Reserve Bank staff have started work on publishing a series of backward-looking averages of SOFR, with plans to solicit public feedback on this effort later this year and initiate publication of these averages by the first half of 2020.

In February, Federal Reserve Board economists published a staff working paper, which details a potential methodology for calculating indicative forward-looking SOFR term rates. The paper only aims to demonstrate some of the basic properties as to how an eventual forward-looking SOFR term rate might behave. It presents *indicative* forward-looking term rates derived from end of-day SOFR futures prices, which are for information purposes only and do not comply with the IOSCO Principles for Financial Benchmarks and so are not appropriate for use as reference rates in financial contracts.

In April, the US Alternative Reference Rates Committee (ARRC) published a *User's Guide to SOFR*, to help explain how market participants can use SOFR in cash products. The ARRC User's Guide lays out a number of considerations for market participants, and the conventions pertaining to all.

In April, the ARRC released recommended contractual fallback language for US dollar-denominated floating rate notes and syndicated loans. This was followed by the release in May of recommended contractual fallbacks for US dollar LIBOR-denominated bilateral business loans and securitisations. The recommended contractual fallback language (with related guidance) is for voluntary use in new contracts that reference US dollar LIBOR and was developed with the goal of reducing the risk of serious market disruption in the event that LIBOR is no longer usable. The recommended language sets out a "waterfall" approach to determine the SOFR-based successor rate and spread adjustment that would apply to the successor rate. But notwithstanding the fallback language, Randal K. Quarles, Vice Chair for Supervision of the Federal Reserve Bank of New York, noted that "There is, however, also another and easier path, which is simply to stop using LIBOR ... Good as the fallback language may be, simply relying on fallback language to transition brings a number of operational risks and economic risks."

In June, the ARRC released a report detailing preliminary considerations for the use of risk-free rates in interdealer cross-currency swaps which currently reference LIBOR and other IBORs, and where it will be important to develop new structures that can be based on risk-free rates.

Recent publications in the euro area

In January, the Euro RFR Working Group published *Guiding Principles for Fallback Provisions in New Contracts for Euro-denominated Cash Products*. The paper considers some main features of the legal frameworks and market practices for retail and wholesale cash products with contracts referencing euro benchmarks, and outlines, at a high level, the main characteristics of existing fallbacks for typical, euro-denominated cash products. It then proposes a set of guiding principles for fallback provisions in new contracts for such products that market participants may wish to consider.

The European Money Markets Institute (EMMI, the current provider of EURIBOR and EONIA) released a public consultation in March on the recommendations for EONIA of the working group on euro risk-free rates (the Euro RFR Working Group). The results of that consultation were released in May, confirming that the EONIA methodology will change to €STR plus a spread on 2 October 2019. EONIA is expected to be discontinued on 3 January 2022. Also in May, the ECB announced a one-off spread between €STR and EONIA, to be used by EMMI in the new EONIA methodology as of 2 October 2019. The methodology used to calculate the spread (which will be 8.5 basis points) is based on the recommendations of the Euro RFR Working Group published on 14 March.

The Euro RFR Working Group also launched a public consultation in May on a legal action plan for the proposed transition from EONIA to €STR, including a set of draft recommendations which address the legal implications for new and legacy contracts referencing EONIA. A detailed summary of the responses to the legal action plan was released on 27 June, which concluded that, among other things, almost all respondents agreed that the €STR plus spread (8.5 basis points) should be the primary fallback rate to be included in new and legacy contracts referencing EONIA.

On 6 May, EMMI announced that it had applied for authorisation from the Belgian Financial Services and Markets Authority (FSMA) under the EU Benchmarks regulation (EU BMR). As a subsequent step, EMMI has started transitioning panel banks from the current EURIBOR methodology to the new hybrid methodology. In support of all this, EMMI has adopted a governance framework establishing the requirements and principles related to the provision of the EURIBOR benchmark under the hybrid methodology. The framework consists of the *EURIBOR Governance Code of Conduct*; the *EURIBOR Code of Obligations of Panel Banks*; the *EURIBOR Code of Obligations of Calculation Agent*; and the *Benchmark Determination Methodology for EURIBOR*. EMMI has also published its updated *Benchmarks Consultation Policy* and *Benchmark Changes and Cessation Policy*, applicable to all benchmarks administered by EMMI; and a document on *Data Transmission and Validation under the Hybrid EURIBOR Methodology*. Subsequently, on 3 July, it was announced that EMMI has been granted an authorisation by the FSMA under the EU BMR for the administration of EURIBOR.

On 28 May, EMMI announced National Bank of Greece's withdrawal from the panel of banks contributing to EURIBOR, with immediate effect. The FSMA, after consultation with the EURIBOR College of Supervisors, subsequently informed EMMI that it would not compel NBG to continue to contribute data because of NBG's low level of actual and potential participation in the market that EURIBOR intends to measure. Following this, the panel of EURIBOR contributing banks now consists of 18 contributors.

In view of ESMA's statutory role to build a common supervisory culture by promoting common supervisory approaches and practices, ESMA has established a process for adopting Q&A documents which relate to the consistent application of the EU BMR. The most recent update was published on 23 May. The new Q&As provide clarification on the following issues: the information included in the ESMA register of administrators of benchmarks; determination of the Member State of reference; and the role of IOSCO principles and of external audit in the recognition of 3rd country administrators.

On 19 June, ESMA issued the official translations of its Guidelines on non-significant benchmarks under the EU BMR. National competent authorities to which these Guidelines apply must notify ESMA whether they comply or intend to comply with the Guidelines, within two months of the date of publication by ESMA of the Guidelines in all EU official languages. The purpose of these guidelines is to ensure common, uniform and consistent application, for non-significant benchmarks, of: oversight function requirements; input data provision; transparency of the methodology provision; and governance and control requirements for supervised contributors' provision.

Regarding the EU BMR, ESMA is maintaining published registers of administrators, with over 40 now duly registered, and third country benchmarks, with almost 72,000 benchmarks now duly registered.

In June, ESMA wrote to the IASB and to the European Financial Reporting Advisory Group agreeing with certain of IASB's proposals to amend IFRS 9 and IAS 39, recommending certain clarifications and urging the IASB to proceed rapidly towards the finalisation of the proposed amendments.

Recent publications in Switzerland

At its February meeting, the National Working Group on Swiss Franc Reference Rates (the Swiss NWG) recommended using compounded SARON as a term rate alternative to Swiss Franc LIBOR wherever possible, and discussed options for using compounded SARON in cash products.

At its June meeting, the Swiss NWG presented a discussion paper on SARON-referencing FRNs, which included an assessment for different interest rate provisions and draft fallback language, and a paper on *IBOR to RFR Transition: Effects on Financial Reporting.*

Other recent publications globally

In March, ICE Benchmark Administration (IBA), the administrators of LIBOR, released the results of its *Survey on the Use of LIBOR* from December 2018, which set out to identify the LIBOR settings that are most widely used. Based on the results of the survey and other outreach work, IBA will work with globally active banks to seek to publish certain LIBOR settings after 2021 with their primary goal being seek to obtain sufficient banking industry support to publish certain LIBOR settings after 2021 in order to provide these settings to users with outstanding LIBOR-linked contracts that are impossible or impractical to modify. Any such settings will need to be compliant with relevant regulations and in particular those regarding representativeness.

In April, IBA announced the successful completion of the transition to the Waterfall Methodology for all LIBOR Panel Banks. IBA had previously announced (in April 2018) that it intended to begin the process of transitioning LIBOR Panel Banks to making submissions in accordance with their standardised Waterfall Methodology for making LIBOR submissions, based on transactions to the greatest extent possible, as set out in the LIBOR Output Statement.

The FSB's Official Sector Steering Group (OSSG) sent a letter to ISDA in March encouraging ISDA to ask for market opinion on, among other things, an additional trigger that would ensure a move to the spread-adjusted fallback rate in the event that the FCA found LIBOR to be non-representative in its capacity as the regulator of LIBOR. ISDA responded in a letter to the OSSG in April, providing, among other things, details of a consultation on the preferred approach for addressing pre-cessation issues in derivatives that reference LIBOR and potentially other IBORs, stressing the importance that any steps ISDA takes with respect to pre-cessation issues do not "jeopardize market-wide adherence to the protocol for inclusion of permanent cessation fallbacks in existing derivatives".

ISDA launched the corresponding consultation on pre-cessation issues for LIBOR and certain other IBORs in May. At the same time, they released a consultation on adjustments that would apply to fallback rates in the event certain IBORs are permanently discontinued. The deadline for responses for each consultation is 12 July 2019.

In June, the FSB published *Overnight Risk-Free Rates - A User's Guide* in June. This Guide provides an overview of risk-free rates, details of how they are calculated, the differences between compound and simple averaging, publication timing of the risk-free rates and the impact on when the interest payment is known (ie in advance or in arrear); and options on how overnight risk-free rates can be used in cash products (eg payment delay, lockout, lookback etc.).

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