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Summary of responses from consultation 1, Definition

Introduction

At the beginning of April, the Working group for alternative reference rates (Agar) published a consultation on how a nearly risk-free interest rate (RFR) for Swedish kronor could be defined. In order to successfully develop a new reference interest rate that is acceptable to the market, the Working group will be consulting the market on what could potentially constitute a successful strategy.

This document summarises the comments received. These are in part the comments received via written responses, but also include the responses received in the discussions with reference groups that the Working group held as part of the consultation. As the consultation also contained background information about the Working group and why this work is being carried out, a number of other useful comments were received regarding future stages of this work. The Working group will take these comments into account in its future work. A total of 11 written responses were received and discussions were held with 16 reference groups. No individual respondent will be referred to by name in this document and all will remain anonymous. Some responses are of course not entirely linked to a specific issue, but have relevance for the definition itself. The specific comments that have been received are reported in bullet point format. The Working group's response to the comments is highlighted in orange.

Selection criteria

Question 1: Are the selection criteria above appropriate for developing a transaction-based short-term reference rate (RFR)? What is not relevant? Which additional criteria could it be appropriate to include?

Most responses considered these selection criteria to be appropriate. Some had other views, however:

- One criterion could be how an interest rate (or the underlying transactions) would cope with a stress situation.

The Working group has discussed the possibility of analysing periods of greater stress. It would have been useful to have been able to analyse the situation during autumn 2008. The Working group established, however, that it would not have been possible to obtain such data. Nor is it certain that transactions executed so long ago would actually be comparable in a relevant manner to the transactions that took place during the period examined.

It has also been submitted that the analysis period (01/12/2015 to 31/12/2018) is exceptional and that the selection criteria may therefore be misleading. On a hypothetical level, it would not be unreasonable to conclude that the number of transactions would fall during a stress situation. This is likely to be very similar for all types of definition and is therefore not a factor that could help to make a distinction between the definitions. Unsecured transactions would very probably fall more than secured transactions. Another aspect raised by a respondent is that the interest rate level will be affected by one or more banks being in a stress situation; in other words, there is a credit aspect to the interest rate. The effect on the interest rate level should be reduced if the interest rate were to be based on secured transactions.

The Working group generally believes that a small country such as Sweden will have difficulty establishing a transaction-based interest rate that can still remain liquid during periods of financial stress. This must be dealt with in an appropriate manner in the fixing method so that it can be determined what happens if the volume of transactions is too small and solutions can be found where this is the case. Equally, what should happen if there are no transactions at all.

- The selection period is not representative and it is therefore not certain that the selection criteria used provide the most appropriate interest rate.

The Working group is aware that the time period selected for analysing appropriate definitions is exceptional. This is mainly because of the monetary policy implemented, which must be considered exceptional in a historical context. At the same time, it has been a period during which the reporting banks have not experienced any problems, profitability has been at an acceptable level and all reporting banks have had high and stable credit ratings. The Working group considered trying to capture longer periods of time but refrained from doing so because this would have been very time consuming and would make it more difficult to understand whether interpretations of the definitions have actually been constant over the entire period.

- One criterion should be that the definition should be consistent with the Benchmarks Regulation so that the interest rate can be used in financial contracts.

The Working group believes that if the administrator of the interest rate is subject to the Benchmarks Regulation, the interest rate must comply with these rules. However, it is more about the rules that result from the fixing method and this will be addressed at a later stage. It may be worth remembering, though, that the purpose of developing this interest rate is to establish a new, alternative reference rate, which naturally it must be possible to use.

- One criterion could be that the new interest rate must be able to act as a suitable fallback solution for existing Stibor contracts.

This could have been described in greater detail, but the idea was that there is a requirement for the proposed interest rate to be consistent with other definitions as far as possible. There are currently no obvious methods for how fallbacks from existing Ibors will work for any financial instrument. There are several drafts[1] but it is not currently possible to specify a criterion for how this will work for Stibor. The Working group considers it important to emphasise that Sweden should have the same opportunities to create fallback solutions that other countries will have. If an international standard is developed for how these fallback solutions will work from Ibor to RFR, this must work equally well in Sweden as it does in the USA or the UK. How this will work is not yet clear in any country, however. It also appears that the solutions could vary between product groups.

- One respondent feels it would be appropriate for there to be more reporting banks.

This is a desirable solution. It was not possible to obtain information from more banks during the analysis phase. The hope is that the number of reporting banks will be as large as possible so as to obtain the most complete market coverage possible.

- The transactions to be included in the underlying basis must be completed transactions and nothing else.

The Working group agrees.

- The interest rates to be selected must be based on the needs of the market. There is no reason to develop interest rates that are not in demand. However, if there are different needs within the market, then different reference rates must be developed.

The Working group agrees that there is no reason to develop reference rates that are not in demand. As the Working group comprises the biggest players on the markets where reference interest rates are used, the Working group is able to express which needs are greatest on the market. There may be more minor needs on the market,

[1] ISDA is the main organisation to have worked on different types of solutions in relation to fallbacks. See, for example: https://www.isda.org/2018/12/20/isda-publishes-final-results-of-benchmark-fallback-consultation/ The ARRC has also recently issued final recommendations on fallbacks for cash products: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-Apr-25-2019-announcement.pdf

however, which are not represented in the Working group. The Working group seeks to identify these needs through discussions with others on the markets.

The Working group does not believe it is possible to develop several different types of reference rates in Sweden and to be able to maintain liquidity in these. For this reason, there will only be one RFR.

Unsuitable candidates

Question 2: Do you support the Working group's conclusion that interest rates based on three-month transactions and T/N transactions do not fulfil the criteria for a suitable reference rate? Are there other reasons why any of these transaction-based rates should be proposed?

Most, and in fact almost all, of the respondents stated that they consider three-month and T/N transactions to be unsuitable candidates. There were some who disagreed, however:

- A high level of volatility in T/N cannot be seen as sufficient reason to exclude this term as a candidate.

The Working group agrees. However, the group takes a negative view of the volatility of a reference interest rate being too high. This is principally a problem for those who use the reference rate in cash products, such as loans and deposits, and is not a problem for derivatives. The problems with T/N have instead been that the market proved smaller than O/N, that it is primarily a repo market and that the market was not considered a suitable basis for the reference interest rate for SEK (see below). Another important factor was that T/N has not been used in any other known RFR and Sweden does not wish to deviate from other standards.

- A couple of respondents argued that transactions in the currency swap market should be used. No clear explanation was provided of how this should be done but the main point was that large transactions take place on this market and this could therefore provide a good basis. It has also been stated that a large proportion of the banks' financing takes place through foreign currency.

The Working group believes it will not be possible to establish a suitable reference interest rate using the currency swap market. It is not entirely obvious how the currency swap market could be included in the development of a new reference interest rate. The most important thing is that there must be a relevant interest rate for the currency from which the interest rate is to be swapped to SEK. This interest rate can be a bank's finance rate, but it can also be a different rate, such as the currency area's RFR. The Working group has not seen any coherent proposals for how this should be structured. The main reasons for the Working group's position on this are as follows:

- ✓ If each bank were to report borrowing in a foreign currency and what it costs, this borrowing would not necessarily take place in O/N money. Short-term currency swaps are made for reasons other than financing. There are insufficient matched transactions in the short-term market (O/N or T/N). An alternative method would be to use another country's RFR and swap this rate to SEK. This proposal was included in the Norwegian consultation[2] for new reference interest rates. It was not considered appropriate in Norway. It would be even more complicated for Sweden given that Sweden's foreign trade is more diversified. Such a solution would also mean that the RFR for SEK would follow principles that apply in one or more other countries and therefore be beyond the control of Sweden.
- ✓ The Working group is convinced that however a swapped interest rate is structured, it would be highly volatile. Nor is this a volatility that is SEK-related, but a volatility that is governed by the country from which the interest rate is derived. It will not be a Swedish interest rate. The interest rate would largely be governed by the foreign currency. Problems could be caused by the interest rate on the majority of all financial contracts in SEK not being governed by Swedish economic conditions.
- ✓ The Working group believes that the method for developing the reference interest rate would not be transparent. It would not be easy for those whose operations are remote from the market in question to understand how the interest rate is developed.

- One candidate has said that the reference interest rate must be based on secured transactions and not on unsecured transactions. It has also been highlighted by other respondents that there will be different types of reference interest rate depending on whether it is based on secured transactions or unsecured transactions. It has been requested that the Working group provide more details of why the repo market is not suitable as a basis for the transactions.

RFRs have been established in other countries based on both unsecured transactions (UK, eurozone) and secured transactions (USA, Switzerland). An interest rate based on unsecured transactions involves a certain element of credit risk. This means that the interest rate will rise when those operating on the market demand improved payment for lending to banks. In those cases where the reference interest rate is also based on lending transactions at the banks (which is not the case in the UK or the eurozone), this interest rate may include a credit element from borrowers. Generally speaking, this interest rate will have a credit cycle aspect. It can also be expected that if the financial sector experiences serious problems, the volume of transactions may reduce significantly. This type of reference interest rate may be

[2] https://static.norges-bank.no/contentassets/81885ab218dd4eeb9129f5cdb6c293fc/18_00938-4-konsultasjonsrapport-alternative-referanserenter2.pdf?v=10/22/2018091948&ft=.pdf

appreciated by lenders as they avoid having to include their own variation in credit risk in the spread that the borrower is required to pay.

If the reference interest rate is based on secured transactions, there is not considered to be any credit risk element in the interest rate. All credit risk will be eliminated by the securities that the lender in the market receives. This is usually said to favour the derivatives market, where there is no interest in including credit risk in derivatives. On the repo market, however, the interest rate is affected by the availability of securities and the quality of these assets. In Sweden, the largest transactions are made with securities in the form of government bonds and covered bonds. As the Swedish Central Bank has bought up large tranches of government bonds, there is *now* a distinct lack of securities to enable these repo transactions to be made. This may create temporary large movements in the interest rate in order to obtain securities. This has also been observed with the American RFR, which shows signs of temporary large movements in the interest rate, despite being based on a very large repo market. The Swedish repo market is smaller and because of the Swedish Central Bank's holdings of government bonds it is now exceptionally limited.

The Working group summarises this as there being smaller volumes on the secured market than on the unsecured market. The interest rate level is governed by underlying assets on the secured market and not by the price of money. The Working group takes the view that the derivatives market can handle the small credit risk that will arise in the new interest rate because it has so far used Ibors, which have a significantly larger credit element than the future interest rate will have. It would be more difficult for the loan market to handle the sudden movements in the interest rate that take place on the repo market.

There has also been discussion about the large size of the repo market in terms of one-week repos and the possible use of these transactions as a basis for a new reference rate. The Working group considers that an interest rate based on this type of transaction is not part of the assignment to develop a new RFR.

Suitable candidates

Question 3: Do you support the Working group's conclusion that option A (unsecured O/N transactions with banks, other financial institutions and the Swedish National Debt Office) and option B (unsecured O/N transactions with banks, other financial institutions and the Swedish National Debt Office, but based solely on transactions that generate borrowing at the reporting bank), fulfil the criteria for an alternative reference rate?

Almost everyone agrees that the proposed options are appropriate definitions of an RFR for SEK. Most have found it difficult to determine whether one option is better than the other.

Something several respondents have discussed is that option A has the largest underlying volume of transactions, while option B may be expected to be less volatile, which has not been the case during the period examined. It is assumed that option A could be more volatile when large excess liquidity in the banking system becomes less common. Many respondents also indicate that option B is the most in line with what others (UK, eurozone) have used.

One response received stated that the proposed interest rates are not suitable. The main argument here is that the reference interest rate must be based on secured transactions.

The Working group will soon publish a decision on the definition to be used as a basis for future work. This decision will include the reasons for the decision.

Other factors

Question 4: Do you think there are other factors that have not been addressed but which may strengthen the case for or against these options?

Many of the written responses and the discussions with groups in the market have produced several good suggestions, other than what was requested here. These mainly gave advice on how the fixing method should be structured. There was also a great deal of interest in the actual procedure for making the transition from one reference interest rate to another. The Working group will incorporate this advice and these questions in its future work and will return to this at the appropriate stage.