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AGAR: Consultation 2: Transition issues

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Introduction

In countries where most of the indications are that their main reference rate (LIBOR, Eonia) will cease to exist, the national working groups on alternative interest rates have focused largely on how the transition to the new nearly risk-free rate, RFR, will work. In communications of the Swedish working group with stakeholders in the markets, many have raised concrete questions about how the transition from Stibor to a new interest rate will be made. For these reasons, the Working Group on alternative reference rates has compiled a few questions in this regard for a consultation and would be happy to receive answers to these questions as well as other comments.

Answers to the questions and any other comments should be sent to the Swedish Bankers' Association at the e-mail address: info@swedishbankers.se before 31 October. Questions in relation to the consultation can be sent to jonny.sylven@swedishbankers.se.

Scenarios adopted by the Working Group

Sweden is not facing the same situation as the United States or the United Kingdom because there is no pressure from authorities to terminate Stibor as a reference rate, which there is in the United States and the United Kingdom. Because of the Benchmark Regulation (BMR), all benchmarks used in financial contracts within the EU must be approved. Since the EU has decided that Stibor is a critical benchmark, an application for approval of Stibor as a benchmark and approval of its administrator must be sent to Finansinspektionen before the end of 2021. The above application will be made. It is then up to Finansinspektionen (the Swedish Financial Supervision Authority, SFSA) to decide on whether to approve Stibor. Confidence in Stibor is good in the market and there is no evidence that market participants are looking at other reference rates.

The Working Group therefore notes that there is no immediate need to abandon Stibor as the main reference rate in Sweden. The Working Group assumes that Stibor can remain as a reference rate if it is approved.

When the Working Group began its work, there was a clear perception in the world that all interbank rates (Ibors) would be abandoned for nearly risk-free interest rates (RFR) in line with the recommendations made by the Financial Stability Board (FSB) in 2014. This recommendation expressed a desire to abandon Ibors in favour of RFR unless there was evidence that the Ibor used was transaction based. It is now clear that at least Euribor will remain. The determination methodology for Euribor has been changed so that at present it is almost entirely transaction based. For this reason, it can be said that Euroland complies with the FSB's recommendations. Since Euribor will remain, a number of smaller currency areas have also planned to keep their Ibors.

The Working Group therefore notes that the global financial market is not facing an imminent change where all Ibors would be abandoned and all currency areas would use the RFR as their main reference rate.

However, a number of major currency areas will, in the coming years, replace their dependence on Ibors with RFR. This concerns primarily the United States, the United Kingdom, and Switzerland. During this period, therefore, the global financial market will have to work with different interest rate systems. Countries with large financial flows with these countries are more likely to adopt RFR than countries that do not have as extensive financial relations with these countries. Proliferation will probably take place through various forms of financial products that use several currencies (foreign exchange swaps, syndicated loans, etc.). We cannot predict how quickly this proliferation will take place or what may affect it.

The Working Group expects certain types of financial contracts from the countries where the RFR has been introduced will have a proliferation effect.

The second paragraph of Article 28 of the Benchmark Regulation provides that supervised entities must have action plans in the event benchmarks cease to exist and that this must be reflected in the contractual relationship with customers. This can be interpreted to mean that there must be fallback solutions in contracts with references to an interest rate. Since the Benchmark Regulation has been in force from the beginning of 2018, fallback solutions in line with this requirement should already exist. However, contracts could potentially be simplified if an actual reference rate can be identified instead of referring to various alternative solutions.

The Working Group believes that the Swedish RFR should be able to act as a fallback rate that could apply to the contract if Stibor ceased to exist. Similar solutions exist in other countries.

Questions:

1. Do you think that the Working Group's descriptions of factors influencing the transition are consistent with your view of the situation regarding reference rates? Please explain if you disagree.

Fallbacks

As used herein, the term fallbacks means contract provisions regarding how the parties to the contract will transition from one reference rate to another reference rate. Recently, it has been discussed internationally how a transition from an Ibor to an RFR should be made if the Ibor ceases to exist, is not representative, or otherwise no longer functions as intended when the contract was concluded.

Working groups and different organisations have chosen to indicate provisions they believe stakeholders should include in contracts regarding a transition from the existing reference rate. ISDA[1] was the organization that first described this and that has been most explicit about how such a transition should be made. The US Alternative Reference Rates Committee, ARRC[2], has also written a lot about this and given recommendations on how fallbacks can work for a range of product families. They have made specific recommendations for virtually all product groups, except for derivatives where they refer to the work of the ISDA. The European Central Bank

[1] International Swaps and Derivatives Association
[2] Alternative Reference Rate Committee

(ECB), the Bank of England (BoE) and other working groups have also written about how fallbacks can be a way to introduce the new interest rate into the market.

The Benchmark Regulation (BMR), a regulatory framework that has been in use since the beginning of 2018, provides for what applies if a reference rate ceases to exist. Accordingly, here it will be discussed how fallbacks could be designed in new contracts.

Based on the writings of the ISDA, there are two areas of concern that are important in fallback recommendations: what should trigger a transition from the existing reference rate to a new reference rate in the contract and how should the adjustment between interest rates be calculated.

In relation to triggers, initially discussions were held about a competent authority declaring that the existing benchmark rate will or has ceased to exist. This may be announced by the administrator's supervisory authority, the central bank or the administrator itself. However, it has also been pointed out that it should be possible to change the reference rate in a contract when the interest rate can no longer be considered representative. It has also been pointed out by Euroland that one reason for switching may be that the reference rate does not comply with legal requirements. This can be seen in the light of the Benchmark Regulation which confers powers on supervisory authorities to withdraw the benchmark permit if it no longer lives up to the requirements set out in the BMR or is no longer representative of its underlying market. It seems reasonable that a provision in a contract regarding when a change of reference rate should take place should be consistent with applicable legal requirements.

It is not considered entirely obvious that it should be possible to replace an Ibor with an RFR. Since an RFR has a shorter term than most other Ibors and in many cases can be said to lack any credit risk aspect, it is natural to believe that RFR is lower than Ibor. Therefore, it has been proposed that an adjustment be made to the RFR for the remaining term of the contract to make it comparable to the Ibor by adding a maturity factor and a credit risk factor. So far, for the ISDA this has resulted in a proposal that the maturity factor should be managed by calculating the interest rates based on compounded rates, while the credit risk factor is identified as a historical difference between the Ibor and the compounded rate for RFR for the same tenor. The ISDA assumes that only the question of the compounded rate method should be applied to create coupons.

AGAR believes that there are no grounds for Sweden to adopt a different recommendation than the one developed by the ISDA. AGAR also recommends that this adjustment be used regardless of the type of product.

The interest rate adjustment could be calculated at the fallback time as an exact value expressed in points which then remains constant over the entire remaining contract term. Since RFR is short term, it is much more dependent on the monetary policy conducted. However, it will not include future expectations as to monetary policy, as can be seen in Ibors. Another difference is that Ibors take account of stress in the financial system in a completely different way than an RFR. For these reasons, the adjustment made at the fallback time itself does not necessarily determine whether the new interest rate is fair in relation to the interest rate adopted when the contract was concluded.

Questions:

2. Do you think that there are grounds for the Working Group to make recommendations on the design of fallbacks? What should such a recommendation include?
3. How should the reasons for a change of reference rates be expressed in a recommendation?

Need for future action

In countries where the existing reference rate will most likely cease to exist, the working groups have been working on measures to stimulate interest in the new interest rate. This has also been reinforced in these countries by measures taken by authorities aimed at abandoning references to the old interest rate.

The Working Group is not convinced that these measures are necessary in Sweden at the moment although they may be needed in the future. If and when Stibor is to be abandoned. Many of these issues relate to operations that require establishment of markets that do not exist today. This whole section is therefore speculative. It has been included because questions have been asked about these parts and they are frequently discussed in other countries.

Establishment of marketplaces

Establishment of derivative markets for the new interest rates, mainly in the form of OIS and futures markets, has been considered as a way to stimulate the use of a new interest rate. Marketplaces are often established by those who operate them, using standards and guidelines developed by the working groups.

The Working Group is of the opinion that it is currently not possible to establish any marketplaces for the use of an interest rate that is not established. When the interest rate is published, marketplaces can be established if there is an interest in creating such marketplaces. These marketplaces may then use the conventions and standards proposed by the Working Group. It may also be the case that the marketplace will be based on its own conventions (see below) if there is a greater demand for such solutions.

Questions:

4. Do you agree that marketplaces should be established only once there is an interest in them?

Help with calculations

As RFR does not have the long maturities that Ibors do, the interest rate cannot be used in the same way. In countries where RFR has been developed, it has been noted that it is necessary to continue with a coupon period of three months or similar. For example, it has been considered important for issuers to be able to continue to issue bonds with fixed-interest rates over three months, FRN. However, these bonds have not been designed with forward-looking interest rates, but rather they are built up during the coupon period and are therefore said to be backward-looking. In the UK, the coupon rates have been calculated using a compound interest rate calculation while issuers in the USA originally used simple averages during the coupon period. However, the US has now increasingly transitioned to the compound rate calculation.

To facilitate this procedure, it has been suggested that the administrator of the interest rate should also publish variants of the current compound interest rate variant for different coupon periods. This is not a way to eliminate the problem of calculating compound interest rates. Rather, the proposal relates to the need for conventions on when the calculation of the coupon should start and end (see below on conventions and standards). This can create standards for how the current interest rate for different coupon periods is calculated. However, the calculation is backward-looking so the relevant compounded interest rate for a specific maturity is the one applicable to the period up to that date.

Questions:

5. Do you think it would be valuable if the administrator were to publish what an RFR rate would be compounded over various maturities?

Establishment of standards and conventions

The Working Group could set up conventions regarding the calculation of certain elements of this interest rate. Work in other currency areas has indicated that this concerns how interest rate that can be used as a coupon rate should be calculated. However, this work has not led to a greater uniformity of calculation methods between countries. It is possible that the calculations could be done in the same way in the currency area regardless of the product.

The advantage of producing a standard that is followed is that comparison of products and hedging might become easier. The problem of developing standards for an interest rate that does not exist is that it is not possible to say with certainty what the interest is in a particular type of standard.

In order to calculate the coupon rate, i.e., an interest rate that could serve as an alternative to today's three-month Stibor or similar, a number of areas can be emphasised:

- Average Calculation Method: The interest rate should be an average of O/N interest rates during the coupon period. Generally, this has involved the common arithmetic mean of all values during the period and compounded interest calculation of all interest rates during the period. It has also been discussed that there are different methods of calculating compounded rates. It seems, however, that compounded interest rate is the winning standard which appears to be liked by the market. In Sweden, the compounded interest rate method is currently used to calculate interest rates in Stina and Riba contracts.
- Payment Date: There have been different variants of which day the coupon must be paid. If it is not known what the interest rate will be until the coupon day, it is not realistic to believe that payment will be made on that day.
- Lag: Several of the FRN issued publicly have had an interest rate calculation period starting one or a few days before the actual coupon period started and also ending the same number of days before the coupon period ends. This is to make it clear at the time of payment how large the coupon will be for both the payor and the recipient of the coupon.
- Freezing: A method that has been used is that it is assumed that the interest rate applicable a number of days before the coupon payment applies to all days until the coupon payment date.

There have also been different variants of how these can be combined. The last three points are interdependent and therefore they can be seen as interchangeable to some extent.

In addition, a normal interest rate convention may be needed.

Questions:

6. Do you see a need for the Working Group to produce standards in accordance with the discussion above? Please explain why.
7. What aspects of interest rate calculations do you think are the most important to standardise?

Summary of questions

1. Do you think that the Working Group's descriptions of factors influencing the transition are consistent with your view of the situation regarding reference rates? Please explain if you disagree.
2. Do you think that there are grounds for the Working Group to make recommendations on the design of fallbacks? What should such a recommendation include?
3. How should the reasons for a change of reference rates be expressed in a recommendation?
4. Do you agree that marketplaces should be established only once there is an interest in them?
5. Do you think it would be valuable if the administrator were to publish what an RFR rate would be compounded over various maturities?
6. Do you see a need for the Working Group to produce standards in accordance with the discussion above? Please explain why.
7. What aspects of interest rate calculations do you think are the most important to standardise?