Association for Financial Markets in Europe

AFME Members' Briefing

IBOR Transition – where are we now?

23rd October 2019

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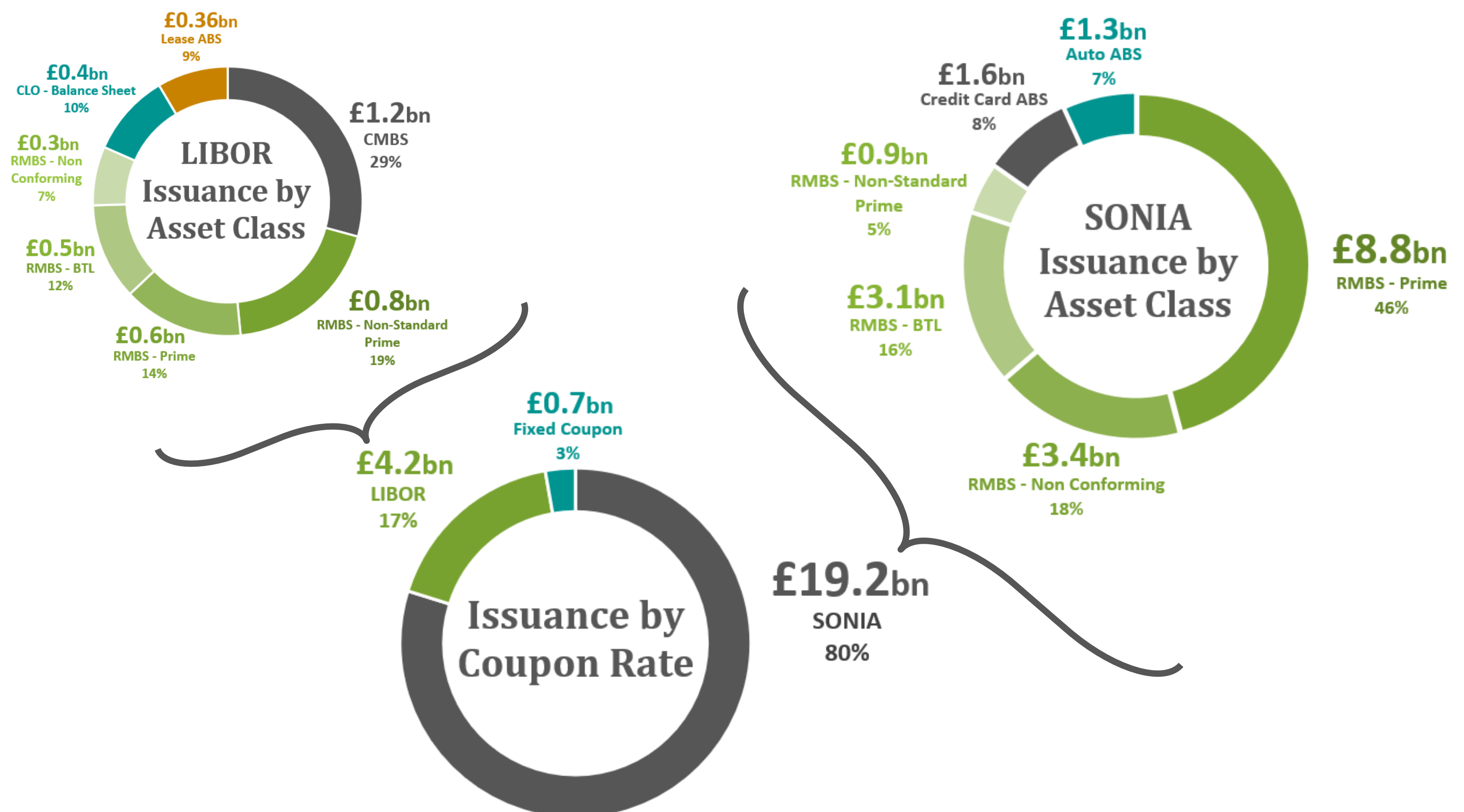
AFME's role in Ibor transition

- AFME is closely engaged with regulators and policymakers in the UK and the Eurozone
- Working Group on Risk Free Rates of Bank of England
  - Bond Market Sub Group, with a focus on securitisation
  - AFME model wording for new issues of securitisation bonds to help facilitate transition ("negative consent" language)
- Working group on euro risk-free rates
  - Subgroup 3 - contract robustness
  - Subgroup 5- cash products and derivatives
  - Subgroup 6 – financial accounting and risk management
- Our affiliate SIFMA sits on the US Alternative Rate Reference Committee (ARRC) of the New York Fed
- Our affiliate GFMA works closely with AFME and SIFMA and co-ordinates from a global perspective

In 2019 year to date, there have been 44 securitisations in the UK with total issuance volume £24.1bn



Source: NatWest Markets, data as of 4th October 2019

ISDA IBOR Fallback Update

October 2019

ISDA IBOR Fallbacks: Implementation in ISDA Documentation

- Amendments to relevant floating rate options in Section 7.1 of the **2006 ISDA Definitions**
  - Amended and restated floating rate options will generally include:
    - The existing price source information;
    - A statement identifying the objective triggers for a 'permanent cessation' that would activate the selected fallbacks; and
    - A description of the fallback that would apply upon the occurrence of that trigger, which will be the adjusted RFR plus the spread adjustment
- Floating rate options in the 2006 ISDA Definitions are generally incorporated by reference into confirmations for uncleared interest rate derivatives and the rulebooks of CCPs that clear interest rate derivatives
- Amendments will be implemented via a 'Supplement' to the 2006 ISDA Definitions (currently almost 60 supplements)
- Upon publication of the Supplement amending the relevant floating rate option, all *new* derivative transactions that incorporate the 2006 ISDA Definitions will include the fallbacks (counterparties will *not* have to take any additional steps)

ISDA IBOR Fallbacks: Implementation in ISDA Documentation

- ISDA will also publish a **Protocol** to facilitate inclusion of the amended definitions (i.e. the definitions with fallbacks) into *existing* derivative transactions that were entered into prior to publication of the relevant Supplement
  - Will apply to existing derivatives transactions that incorporate either the 2006 ISDA Definitions or the 2000 ISDA Definitions
- Adherents to the Protocol will agree that derivatives transactions that they have entered into *with other adherents* prior to publication of the relevant Supplement will be based on the relevant amended floating rate options in the 2006 ISDA Definitions, notwithstanding of the dates of the transactions
- Existing derivatives transactions entered into prior to the date of the relevant Supplement amending the 2006 ISDA Definitions between counterparties that do not *both* adhere to the protocol, or otherwise (e.g. bilaterally) agree to include the amended definitions in their transactions, will not include the fallbacks

ISDA May 2019 Fallback Consultations Results – Supplemental Consultation

2019 Supplemental Consultations on spread and term adjustments for fallbacks in derivatives referencing USD LIBOR, CDOR, and HIBOR (and certain aspects of fallbacks for SOR):

- Consultation ran May 16-July 12, 2019
- This supplemental consultation built on the 2018 consultation regarding spread and term adjustments for fallbacks in derivatives referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR, and BBSW.
- ISDA received feedback from 85 entities in a variety of jurisdictions, including banks, asset managers, pension funds, insurance companies, central counterparties (CCPs) and government entities. Consistent with the 2018 Consultation, the overwhelming majority of respondents preferred the "compounded setting in arrears rate" for the adjusted risk-free rate (RFR) and the "historical mean/median approach" for the spread adjustment.
- Respondents cited both support for the substance of these approaches and a strong desire to use the same adjusted RFR and spread adjustment across all benchmarks covered by the supplemental consultation and last year's consultation (as well as potentially other benchmarks such as EUR LIBOR and EURIBOR, for which ISDA expects to launch a supplemental consultation at EoY 2019 or Q1 2020).
- Based on the foregoing and subject to the ongoing work and ultimate decision of the ISDA Board Benchmark Committee, ISDA expects to proceed with developing fallbacks for inclusion in its standard definitions based on the compounded setting in arrears rate and the historical mean/median approach to the spread adjustment for USD LIBOR, CDOR and HIBOR.

Term and Spread Adjustments

- The **Compounded Setting in Arrears Rate** is the relevant RFR observed over the relevant IBOR tenor and compounded daily during that period
  - Need to calculate and publish for each relevant IBOR tenor
  - Need to analyze and address technical adjustments necessary to fallback from a forward-looking term rate that is available at the beginning of the period to a compounded rate that is not available until the end of the period (including, e.g., adjustments to payment dates, lock-out periods)

- The **Historical Mean/Median Approach** to the spread adjustment is based on the mean or median spot spread between the IBOR and the adjusted RFR calculated over a significant, static lookback period prior to the relevant announcement or publication triggering the fallback provisions
  - Need to calculate and publish for each relevant IBOR tenor based on historical differences between the IBOR for that tenor and the relevant RFR compounded over the relevant tenor (so, the spread will differ across different tenors for the same IBOR)
  - Need to determine final parameters, including whether to use the mean or the median, the length of the relevant lookback period, whether to use a transitional period (as described in the recent consultation) and whether to apply any other variations (some of which are described in the summary of consultation results)

ISDA September 2019 Consultation – Final Parameters

ISDA September 2019 Consultation on Final Parameters

- Seeks input on the final parameters related for the (1) compounded setting in arrears rate and (2) historical mean/median approach to the spread adjustment
- *Compounded setting in arrears rate*
  - Is it necessary to apply a backward-shift, lockout or similar adjustment to avoid making payments on the same date as the date on which the fallback rate is known?
  - If so, what adjustment should apply?
  - Related technical questions
- *Historical mean/median approach to the spread adjustment*
  - Two primary options based on responses to 2018 consultation and 2019 supplemental consultation:
    - Median with five-year lookback period from announcement regarding cessation
    - Trimmed with ten-year lookback period from announcement regarding cessation
  - Related technical questions
- **Open through October 23, 2019 – *<u>Feedback on open issues is critical</u>***

ISDA May 2019 Fallback Consultations Results – Pre-Cessation Issues

2019 Pre-cessation Consultation for LIBOR and Certain Other Interbank Offered Rates:

- Consultation ran May 16-July 12, 2019
- Anonymized and consolidated summary of feedback published 21 October 2019
- ISDA received responses from 89 entities in a variety of jurisdictions, including a variety of market participants including banks and broker-dealers, insurance companies, asset managers, government/federal entities and CCPs.
- Respondents expressed a wide variety of views regarding whether and how to implement a precessation trigger related to "non-representativeness" for derivatives.
- In general, the respondents fell into three categories, without a clear majority in any one category:
  - Those who supported adding a pre-cessation trigger to the permanent cessation triggers in the "hard wired" amendment to the 2006 ISDA Definitions and related protocol.
  - Those who supported use of the pre-cessation trigger provided that it was implemented with optionality and flexibility (or indicated that their support for the trigger depended on a number of factors).
  - Those who opposed the pre-cessation trigger.
- Respondents also expressed a number of issues for consideration related to the potential precessation trigger itself and how to implement such a trigger.

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IBOR Fallbacks: ISDA's 2019 Work Plan

- Supplemental consultation on the term and spread adjustments for USD LIBOR, CDOR and HIBOR – *Completed July 2019 and final results published September 2019*
- Consultation seeking further input on the preferred approach for addressing pre-cessation issues in derivatives that reference LIBOR and potentially other IBORs, including in the context of a regulator's statement that the relevant IBOR is no longer representative – *Completed July 2019 and preliminary results published August 2019*
- Selection of vendor to publish term and spread adjustments – *Completed July 2019 (Bloomberg was selected in a competitive RFP)*
- Consultation on open issues associated with the final parameters for the term and spread adjustments. This consultation will cover all previous consulted IBORs – *Outstanding and comments are due* ***October 23, 2019***
- Publication of anonymized summary of responses to consultation on pre-cessation issues – *published 21 October 2019*
- Publication of amended definitions and protocol for all covered IBORs except EUR LIBOR and EURIBOR – *Q4 2019 (with effective date in H1 2020)*
- Supplemental consultation on the term and spread adjustments for EUR LIBOR and EURIBOR – *TBD (likely Q4 2019 or Q1 2020)*

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IBOR Transition: GBP Markets Perspective

23 October 2019

HSBC

PUBLIC

Development of fallbacks

Various different models have emerged as transition has gathered pace

Extraordinary resolution vs negative consent

Initial phase focused on active transition of LIBOR instruments

No form of language is entirely mechanistic

A single permanent fallback approach across market segments has not been and may not be established …

Challenge is to preserve present value neutrality, and avoid/reduce frictional barriers between markets

Loans

Bonds & ABS

Derivatives (ISDA)

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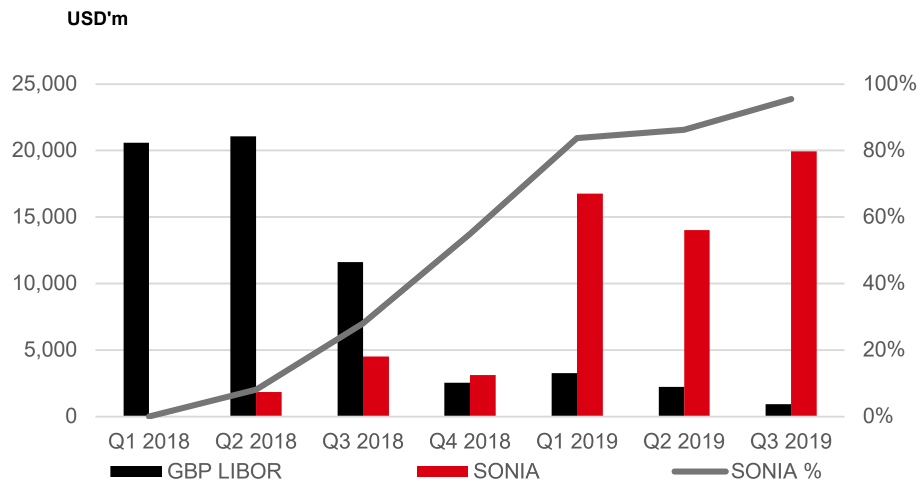
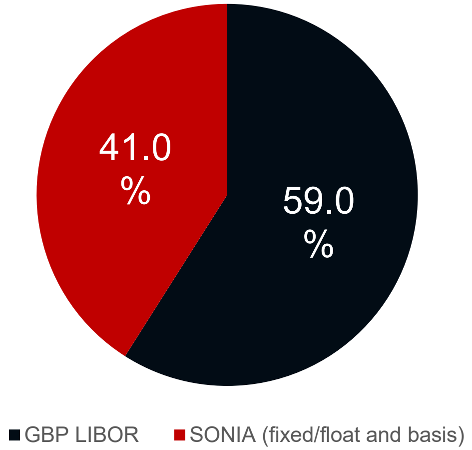
Market adoption of SONIA

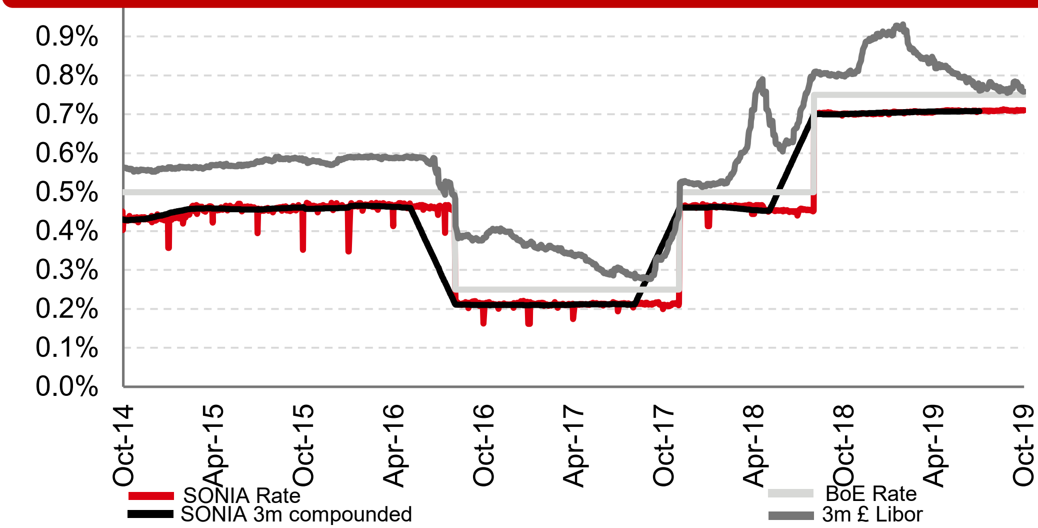
SONIA vs. GBP LIBOR FRN Issuance



Swaps Notional YTD



SONIA and Other GBP Interest Rates



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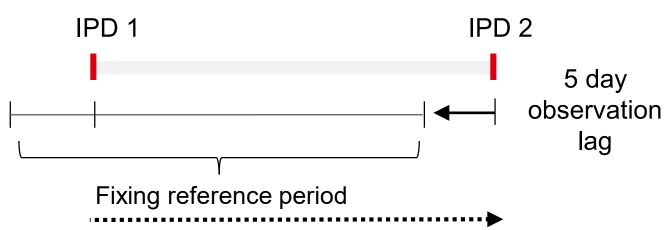
Source: Bloomberg, ISDA SwapsInfo, HSBC Analysis

Calculation Methodologies

	Compounding	Average	Term RFRs
Usage/ Application	**SONIA, recent SOFR and €STR**	**Agency SOFR**	**TBD**
Daycount	Act / 365	Act / 360	TBD
Reference Period	[2-5] day observation lag	[2-4] day lockout period	TBD
Payment Forecast	✓	✓	✓
Accrued	✓	✓	✓
Matches OIS	✓	×	×

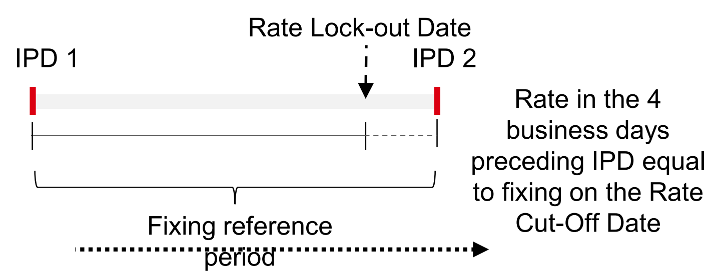
Fixing Illustration – SONIA vs SOFR

Observation Lag (SONIA, SOFR, €STR)



Compounded since the end of the previous reference period

Lock-out (SOFR)



Average (average interest rate of daily spotting in Interest Period)

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Basis Adjustment Between LIBORs and RFRs

Existing IBOR Reference — **3 month GBP LIBOR**

Risk Free Rate — **SONIA**

+

Term Adjustment — **Adjust from overnight rate to 3 month tenor**

+

Spread Adjustment — **Incremental spread over risk free rate for bank risk**

Ongoing developments on methodology and application

- **Compounded Setting in Arrears**
- **Historical Mean/Median (ISDA)**
- **Forward Interpolation (LM)**

Different applications may require different approaches – active transition vs market wide

Liability management processes emerging, including:

- **Associated British Ports, Lloyds Banking Group, Nationwide BS, Santander UK,**

Resolution of Legacy

"This brings me to the difficult issues of legacy LIBOR contracts. I can offer no certainty to those who have not taken steps to move off LIBOR by end-2021. Many market participants strive for certainty in their contractual arrangements. In order to achieve it, you do need to transition.

But I want to be very clear – none of the options except that of cessation can be relied upon to be deliverable. Those who can transition should do so.

[We] think that any firms still delaying transition until term rates arrive are making a mistake."

Speech by Andrew Bailey, Chief Executive of the FCA, at the Securities Industry and Financial Markets Association's (SIFMA) LIBOR Transition Briefing in New York, USA, July 2019

- **Bilateral amendment / renegotiation?**
- **Liability management?**
- **Synthetic LIBOR?**
- **Legacy LIBOR?**
- **Legislative relief / safe harbours?**
- **Doing nothing – what happens, is this feasible?**

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EONIA to €STR Legal Action plan and EURIBOR fallback provisions

José Carlos Pardo (Checa)
Global Economics and Public Affairs, BBVA
Coordinator of the subgroup of contract robustness (SG3) in the working group on euro risk free rates

October 2019

01 EONIA to €STR Legal Action Plan

EONIA to €STR legal action plan

On 2nd October, EONIA modified its methodology to become €STR plus a fixed spread

&

At the end of 2021, EMMI will cease publication of EONIA

On 16 July 2019, the working group on euro risk-free rates published the recommendations on the EONIA to €STR Legal Action Plan

Objective

The legal action plan proposes a **range of recommendations** to all market participants to address the legal implications for **new & legacy contracts referencing EONIA**.

Scope

It covers **all asset classes** (derivatives & cash products) for new and legacy contracts

EONIA to €STR legal action plan - main recommendations

1 From 2 October 2019, whenever feasible and appropriate, market participants should consider **avoiding entering into any new contracts referencing EONIA**, in particular those maturing after Dec’21.

2 In **new contracts still reference EONIA** and, mature after December 2021 or fall within the scope of the EU Benchmarks Regulation, market participants should **include robust fallback provisions**.

3 For **legacy contracts referencing EONIA** and maturing after Dec’21, market participants should consider **replacing EONIA** as soon as possible, or **embed robust fallback clauses**.

The working group recommends the **€STR plus the 8.5 basic points spread as the EONIA fallback rate** for all products and purposes

EONIA to €STR legal action plan - comprehensive view

For a comprehensive analysis of the legal implications and recommendations to ensure a smooth transition from EONIA to €STR, market participants should consider three documents.

1 Public Consultation - 15 May

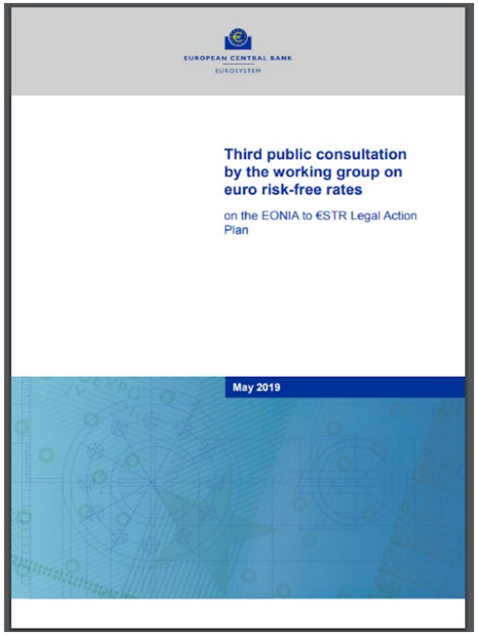
https://www.ecb.europa.eu/paym/pdf/cons/euro_risk-free_rates/ecb.consultation_details_201905.en.pdf

2 Summary of feedback received - 28 June

https://www.ecb.europa.eu/paym/pdf/cons/euro_risk-free_rates/ecb.summaryofresponses01_201906.en.pdf

3 Final Recommendations - 16 July

https://www.ecb.europa.eu/paym/pdf/cons/euro_risk-free_rates/ecb.eurostr_eonia_legal_action_plan_20190716.en.pdf

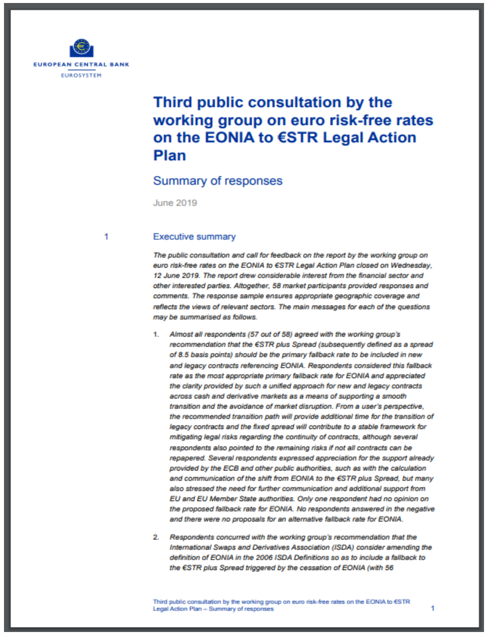


EUROPEAN CENTRAL BANK
EUROSYSTEM

Third public consultation by the working group on euro risk-free rates

on the EONIA to €STR Legal Action Plan

May 2019



EUROPEAN CENTRAL BANK
EUROSYSTEM

Third public consultation by the working group on euro risk-free rates on the EONIA to €STR Legal Action Plan

Summary of responses

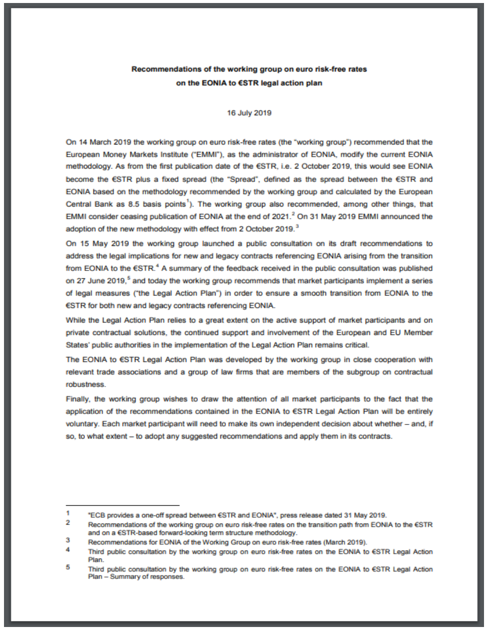
June 2019

1 Executive summary

The public consultation and call for feedback on the report by the working group on euro risk-free rates on the EONIA to €STR Legal Action Plan closed on Wednesday, 12 June 2019. The report drew considerable interest from the financial sector and other interested parties. Altogether, 58 market participants provided responses and comments. The response sample ensures appropriate geographic coverage and reflects the views of relevant sectors. The main messages for each of the questions may be summarised as follows.

1. *Almost all respondents (57 out of 58) agreed with the working group's recommendation that the €STR plus Spread (subsequently defined as a spread of 8.5 basis points) should be the primary fallback rate to be included in new and legacy contracts referencing EONIA. Respondents considered this fallback rate as the most appropriate primary fallback rate for EONIA and appreciated the clarity provided by such a unified approach for new and legacy contracts across cash and derivative markets as a means of supporting a smooth transition and the avoidance of market disruption. From a user's perspective, the recommended transition path will provide additional time for the transition of legacy contracts and the fixed spread will contribute to a stable framework for mitigating legal risks regarding the continuity of contracts, although several respondents also pointed to the remaining risks if not all contracts can be repapered. Several respondents expressed appreciation for the support already provided by the ECB and other public authorities, such as with the calculation and communication of the shift from EONIA to the €STR plus Spread, but many also stressed the need for further communication and additional support from EU and EU Member State authorities. Only one respondent had no opinion on the proposed fallback rate for EONIA. No respondents answered in the negative and there were no proposals for an alternative fallback rate for EONIA.*
2. *Respondents concurred with the working group's recommendation that the International Swaps and Derivatives Association (ISDA) consider amending the definition of EONIA in the 2006 ISDA Definitions so as to include a fallback to the €STR plus Spread triggered by the cessation of EONIA (with 56*

Third public consultation by the working group on euro risk-free rates on the EONIA to €STR Legal Action Plan – Summary of responses 1



Recommendations of the working group on euro risk-free rates on the EONIA to €STR legal action plan

16 July 2019

On 14 March 2019 the working group on euro risk-free rates (the "working group") recommended that the European Money Markets Institute ("EMMI"), as the administrator of EONIA, modify the current EONIA methodology. As from the first publication date of the €STR, i.e. 2 October 2019, this would see EONIA become the €STR plus a fixed spread (the "Spread", defined as the spread between the €STR and EONIA based on the methodology recommended by the working group and calculated by the European Central Bank as 8.5 basis points[1]). The working group also recommended, among other things, that EMMI consider ceasing publication of EONIA at the end of 2021.[2] On 31 May 2019 EMMI announced the adoption of the new methodology with effect from 2 October 2019.[3]

On 15 May 2019 the working group launched a public consultation on its draft recommendations to address the legal implications for new and legacy contracts referencing EONIA arising from the transition from EONIA to the €STR.[4] A summary of the feedback received in the public consultation was published on 27 June 2019,[5] and today the working group recommends that market participants implement a series of legal measures ("the Legal Action Plan") in order to ensure a smooth transition from EONIA to the €STR for both new and legacy contracts referencing EONIA.

While the Legal Action Plan relies to a great extent on the active support of market participants and on private contractual solutions, the continued support and involvement of the European and EU Member States' public authorities in the implementation of the Legal Action Plan remains critical.

The EONIA to €STR Legal Action Plan was developed by the working group in close cooperation with relevant trade associations and a group of law firms that are members of the subgroup on contractual robustness.

Finally, the working group wishes to draw the attention of all market participants to the fact that the application of the recommendations contained in the EONIA to €STR Legal Action Plan will be entirely voluntary. Each market participant will need to make its own independent decision about whether – and, if so, to what extent – to adopt any suggested recommendations and apply them in its contracts.

1 "ECB provides a one-off spread between €STR and EONIA", press release dated 31 May 2019.
2 Recommendations of the working group on euro risk-free rates on the transition path from EONIA to the €STR and on a €STR-based forward-looking term structure methodology.
3 Recommendations for EONIA of the Working Group on euro risk-free rates (March 2019).
4 Third public consultation by the working group on euro risk-free rates on the EONIA to €STR Legal Action Plan.
5 Third public consultation by the working group on euro risk-free rates on the EONIA to €STR Legal Action Plan – Summary of responses.

02 EURIBOR Fallback Provisions

EURIBOR Reform and fallback provisions

The situation for EURIBOR is different from EONIA or LIBOR as **EURIBOR is not scheduled to be discontinued**

Contracts and financial instruments referencing **EURIBOR do not need to transition** to a new rate,…

… but instead **introduce of fallback provisions** to comply with BMR (*), where applicable, and follow the IOSCO's recommendations.

*"Fostering a wide adoption of reliable and effective fallbacks, across different asset classes, would surely **promote stable and orderly financial markets** that can deal with worst-case scenarios in relation to benchmarks.*

***Fallbacks are needed for EURIBOR** because users, and their clients, should be able to know in advance what will happen to their contracts if EURIBOR ceases to be provided*".

Steven Maijoor, Chair of the European Securities and Markets Authority (25 September 2019)

(*) Article 28 (2) of the Benchmarks Regulation requires supervised entities "*to produce and maintain robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided. Where feasible and appropriate, such plans shall nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives. The supervised entities shall, upon request, provide the relevant competent authority with those plans and any updates and shall reflect them in the contractual relationship with clients.*"

EURIBOR Reform and fallback provisions

Fallback provisions, where present, were often originally intended to address the temporary unavailability of EURIBOR

The **development of more robust fallback language contracts which reference EURIBOR** can help to enhance legal certainty to deal with a worse-case scenario and comply with the European regulation, when applicable

EURIBOR fallback provisions should consider the following….

1. New contracts should include **permanent and temporary** cessation triggers setting out the actions that would take in the event that a benchmark ceases or changes materially.
2. New contracts should include a **EURIBOR fallback provision compliant with BMR** and any applicable national law.
3. New contracts should consider the introduction of **adjustment spreads** to account for the differences between EURIBOR and the fallback rate.
4. It should be considered risk management implications of **inconsistencies in fallback provisions by asset class**

Q&A

Useful links

- AFME Ibor transition page
- AFME model wording for securitisation new issues
- Working Group on Risk Free Rates of Bank of England
- Working group on euro risk-free rates
- SIFMA Ibor transition page
- Alternative Rates Reference Committee of the New York Fed
- GFMA Ibor transition page

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