SG#5 - Cash & derivatives products

Presentation for the EUR RFR Working Group Meeting

2 July 2020

Agenda

1. **IFRS 9/IAS39 hedge accounting implications with regard to different EURIBOR fallback measures**
2. IFRS 9 SPPI implications with regard to different EURIBOR fallback measures
3. €STR rate/index and market conventions
4. Update on EURIBOR fallbacks
5. Spread adjustment
6. Next steps
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1. IFRS 9/IAS39 hedge accounting - the implications

Market participants use hedging techniques to manage financial risks within the boundaries of their risk appetite statement and to avoid P&L volatility

- Hedged items: (portfolios of) mortgages/loans, bonds and issued debt
- Hedging instruments: derivatives

- **EURIBOR fallback measures to be included in the hedged item and hedging instrument should ideally align**

- However, there could be strong arguments for certain cash products to deviate from EURIBOR fallback measures that will be included in ISDA hedging derivatives

- ISDA will use the *backward-looking lookback* methodology for the rate calculation and the five-year historical median approach for the spread adjustment

- Therefore the use of *forward-looking* and the *backward-looking last reset* methodologies in hedged items could cause unintended hedge ineffectiveness and even discontinuation of hedge relationships under IAS39

1. IFRS 9/IAS39 hedge accounting - the solutions investigated by SG5

1. Use ISDA supplements for hedging derivatives that mimic EURIBOR fallback measure included in the hedged product – **DISCARDED BY SG5**
   - *Could contradict FSB guidance, i.e. use of backward-looking rates for derivatives*
   - *Will result in fragmentation across the ISDA derivatives landscape, across jurisdictions, which contradicts with outcome ISDA consultations*
   - *Will be difficult to implement for legacy contracts*

2. Including basis swaps in hedge relationships at moment EURIBOR fallback measures will be triggered – **TO BE DISCUSSED WITH IASB**
   - *SG5 considers this basis swap market to develop if there is demand for it, where market participants should be informed that this will be a single-sided basis swap market that will come at a cost.*
   - *Requires further discussion with IASB staff as the basis swap solution is currently not envisaged in reliefs within IFRS IBOR Reform Phase 2 (14, 28-30), which deviates from relief provided by FASB in Reference Rate Reform (BC52/53).*

3. De-designate existing hedge relationships and set-up new hedge relationships to include new hedging derivatives that mimic EURIBOR fallback measure included in the hedged product – **ALTERNATIVE TO SOLUTION 2/ DISCARDED BY SG5**
   - *Could contradict FSB guidance, i.e. use of backward-looking rates for derivatives*
   - *Will result in fragmentation across the ISDA derivatives landscape, across jurisdictions, which contradicts with outcome ISDA consultations*
   - *Will result in complex operational/system challenges in order to avoid day-1 P&L impact and any future P&L volatility*

1. IFRS 9/IAS39 hedge accounting - the next steps

1. Does the WG Euro RFR see strong arguments for certain cash products to deviate from EURIBOR fallback measures that will be included in ISDA hedging derivatives?

   Yes, in particular for SME/retail consumers and certain asset classes there seems to be a preference to know the interest rate at the start of the interest period. In some EU countries, consumer protection law might not allow for "in arrears" methodologies.

2. Does the WG Euro RFR expect that a basis swap market will develop in event EURIBOR permanently ceases to exist?

   A. Basis swap market between *FWD-looking* and *BWD-looking lookback*

      Yes, this basis swap market might develop if there is demand for it, however the expectation is that it could be mainly a one-sided market which will come at a cost.

   B. Basis swap market between *BWD-looking last reset* and *BWD-looking lookback*

      No, non-overlapping calculation and interest rate periods of the last reset methodology would introduce convexity and complex to manage. Therefore, SG5 suggests that the last reset methodology should be disregarded as fallback in the context of hedge accounting.

3. If the WG Euro RFR agrees, the basis swap solution will be discussed with the IASB

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2. IFRS 9 SPPI testing - the implications

All financial assets in Hold-to-Collect and Hold-to-Collect & Sale need to be tested for Solely Payment of Principal and Interest (SPPI) at initial recognition on the basis of the contractual terms over the life of the instrument

- **The *backward-looking last reset* methodology could result in failing SPPI test, because it includes a modified time value of money**

- In particular if this EURIBOR fallback measure is going to be used as fallback for longer EURIBOR tenors, such as 6-months or 12-months, there is a risk that the interest payable in a period could be disconnected significantly from the interest period because of volatility in the market

- **If the financial asset fails the SPPI test, it will have to be measured at fair value through profit and loss going forward**

2. IFRS 9 SPPI testing - the solution

1. A public authority to become the administrator of €STR-based *backward-looking* rates

    - *IFRS9 recognises that in some jurisdictions, the government or a regulatory authority sets interest rates.*
    - *In those cases, a regulated interest rate is considered to be an accepted proxy for the time value of money if it (1) is broadly consistent with the passage of time; and (2) does not introduce exposure to risks or volatility in cash flows that are inconsistent with a basic lending arrangement.*

If the WG Euro RFR considers the *backward-looking last reset* methodology as a viable EURIBOR fallback measure, further guidance on regulated rates will be required from the IASB to explore if this is a viable solution

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3. Market conventions – for validation from the WG (1/2)

Convention	SG5 proposal	Is global consistency needed?	Comments
Compounding RFR vs. Simple RFR in arrears	Compounding RFR (daily)	Yes	Simple averaging ignores the fundamental principle of time value of money. The proposal is consistent and compatible with the standards used in EURO money markets and derivatives markets.
Compounding RFR vs. Compounding (RFR + spread)	Compounding RFR only	Yes	The benchmark administrator could also decide to publish a rate that includes a margin or spread in addition to the €STR compounded rates considering the market needs for some specific asset categories.
Compounding the rate vs. Compounding the balance	Compounding the rate	Preferable	**Compounding the rate**: interest on interest amount is ignored. **Compounding the balance**: interest on the unpaid accrual amount continues to be calculated until the end of the period. No fundamental difference in calculation, compound the balance does however more explicitly use the notion of interest on interest. Topic is very specific for the loan market where interest is only allocated to any holders of the loan at the end of the accrual period.

3. Market conventions – for validation from the WG (2/2)

Convention	SG5 proposal	Is global consistency needed?	Comments
Tenors	1-week, 1-, 3-, 6-, 12-months	No	Working Group for general discussion / Administrator as to details of publication (e.g. on what date the calculation should start) End date defined by the index reference date. Starting date, when not unique, has to be calculated considering business day calendar and a specific business day conventions.
Index Starting value	Preference: 100	No	Working Group for general discussion / Administrator as to details of publication The choice influences the number of decimals to be considered for the rounding
Lag vs. Observation shift	Observation shift	Preferable	Dirven by the Index. Usage of the Index obliges to set the convention to the observation shift (otherwise separate indexes would be required for each different Lag).

Flooring: The application of a floor should be defined at product/instrument level. No floor is expected to be applied to the Index that should represent the money market. It might be expected that associations will need to look at this in the context of documentation.

3. Market conventions – to be decided by the Administrator (1/2)

	Convention	SG5 proposal TBD by the administrator	Is global consistency needed?	Comments
RFR comp. average	**Tenors**	1-week, 1-, 3-, 6-, 12-months TBD	No	End date defined by the index reference date. Starting date, when not unique, has to be calculated considering business day calendar and a specific business day conventions.
	Rounding	TBD	Preferable	Currently countries follow different conventions
Index	**Starting value**	Preference: 100 TBD	No	The choice influences the number of decimals to be considered for the rounding
	Rounding	TBD	Preferable	Currently countries follow different conventions

3. Market conventions – to be decided by the administrator (2/2)

Convention	SG5 proposal TBD by the administrator	Is global consistency needed?	Comments
Business day calendar	Underlying rate of the index Money Market day count convention TBD	No	Consistent with the money market convention of underlying rate (€STR) of the Index. It's linked to the STR rate/index publication.
Business Day Convention	"Modified Following Business Day Convention" TBD	Yes	The adjusted date is the following good business day unless the day is in the next calendar month, in which case the adjusted date is the preceding good business day.
Daycount	ACT/360 (money mkt convention) TBD	No	Consistent with the money market convention of underlying rate (€STR) of the Index. (i.e. ACT/360).

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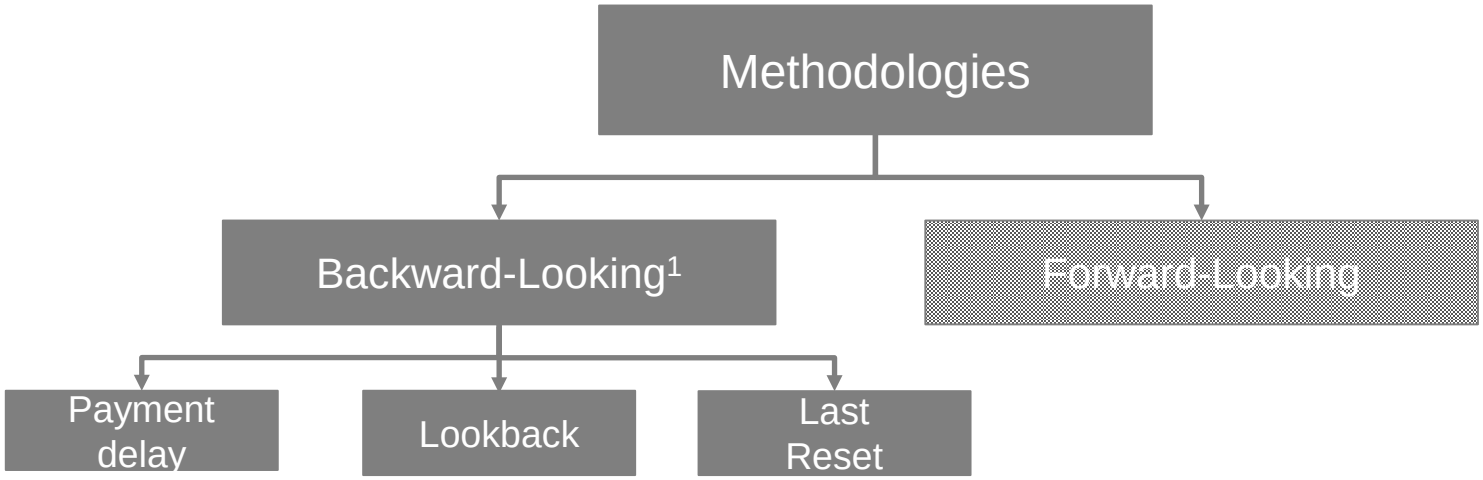
4. Scope & Framework of EURIBOR fallbacks public consultation (PC)

- Fallback options are analysed based on the assumption of a **permanent cessation** of the whole EURIBOR curve. A temporary unavailability of the curve as a whole or of single tenors is not considered.
- Only **viable *backward-looking* methodologies** (see output of SG2) were considered for the analysis.
- **Forward –looking term rate methodology** is analysed as a possible fallback for EURIBOR. The second public consultation showed that "*For each asset class considered, and in particular for corporate lending, floating rate notes, securitisation structures, and retail loans and mortgages, the majority of respondents viewed a forward-looking term rate methodology as a fallback for EURIBOR to be essential or desirable*."
- All methodologies are being assessed as possible alternatives without assuming or developing any waterfall structure. In the opinion of the public authorities acting as observers of the WG, the WG should follow a prudent approach if recommending rates that are not yet available, i.e. if recommended, they should be introduced via a waterfall approach.



4. Selection criteria to be confirmed by the WG Euro RFR

- **Robustness/availability:** This criterion refers to representative rates anchored in active, deep and liquid underlying markets, including in more adverse market conditions. It also refers to its immediate and daily availability to market participants.
- **Operational ease**: It refers to the level of operational implications and systems that need to be updated/integrated to accommodate the analysed methodology.
- **Client acceptance**: It evaluates the risk associated with an understanding and acceptance of the analysed methodology by the client. The level of acceptance can vary based on client needs and whether the client is a sophisticated market player or retail/SME consumer.
- **Hedging ease**: It assesses whether hedging of the analysed product category can be easily implemented, also considering that the analysed methodology can lead to some hedging inefficiencies.
- **Consistency with other jurisdictions/across asset classes**: It evaluates the level of consistency between the analysed methodology and other methodologies used for asset classes or in other jurisdictions.
- **Financial Accounting impacts**: It evaluates whether the analysed methodology may create any economic impact under IFRS.
- **Risk management impacts**: It evaluates whether the analysed methodology may have any impacts on risk models, procedures and other aspects affecting risk management activities. When evaluating this criteria market participants should bear in mind the economic equivalence between Euribor and its proposed fallback. Economic equivalence between EURIBOR and its proposed fallback exists when cash flows calculated under the analysed methodology have the same economic impact in terms of value; timing and period congruency compared to the current practice in use and could easily be exchanged for one another. The economic equivalence in terms of value would expected to be achieved through an adjustment spread. However, in order to achieve the economic equivalence in terms of timing and period congruency, risk management technics might need to be introduced.

4. Overview of the analysis at this stage

Assessment	Forward-looking	Backward-looking		
		Payment delay	Lookback	Last reset
Robustness/Availability	🟠 / 🔴	🟢	🟢	🟢
Operational ease	🟢	🟠	🟠	🟡
Client acceptance				
Professional market players	🟢	🟢	🟢	🟢
Corporates	🟢	🟠	🟠	🟢
SME/Consumers	🟢	🔴	🔴	🟢
Hedging ease	🟠	🟢	🟢	🔴
Consistency with other jurisdictions/asset classes	🟠 / 🔴	🟠	🟢	🟠
Accounting impacts	🟠	🟡	🟢	🔴
Risk Management impacts	🟠	🟠	🟠	🔴

Colour code meaning	
Feasible	🟢
Feasible with some minor changes/drawbacks	🟡
Feasible with some relevant changes/drawbacks	🟠
Questionable feasibility	🔴

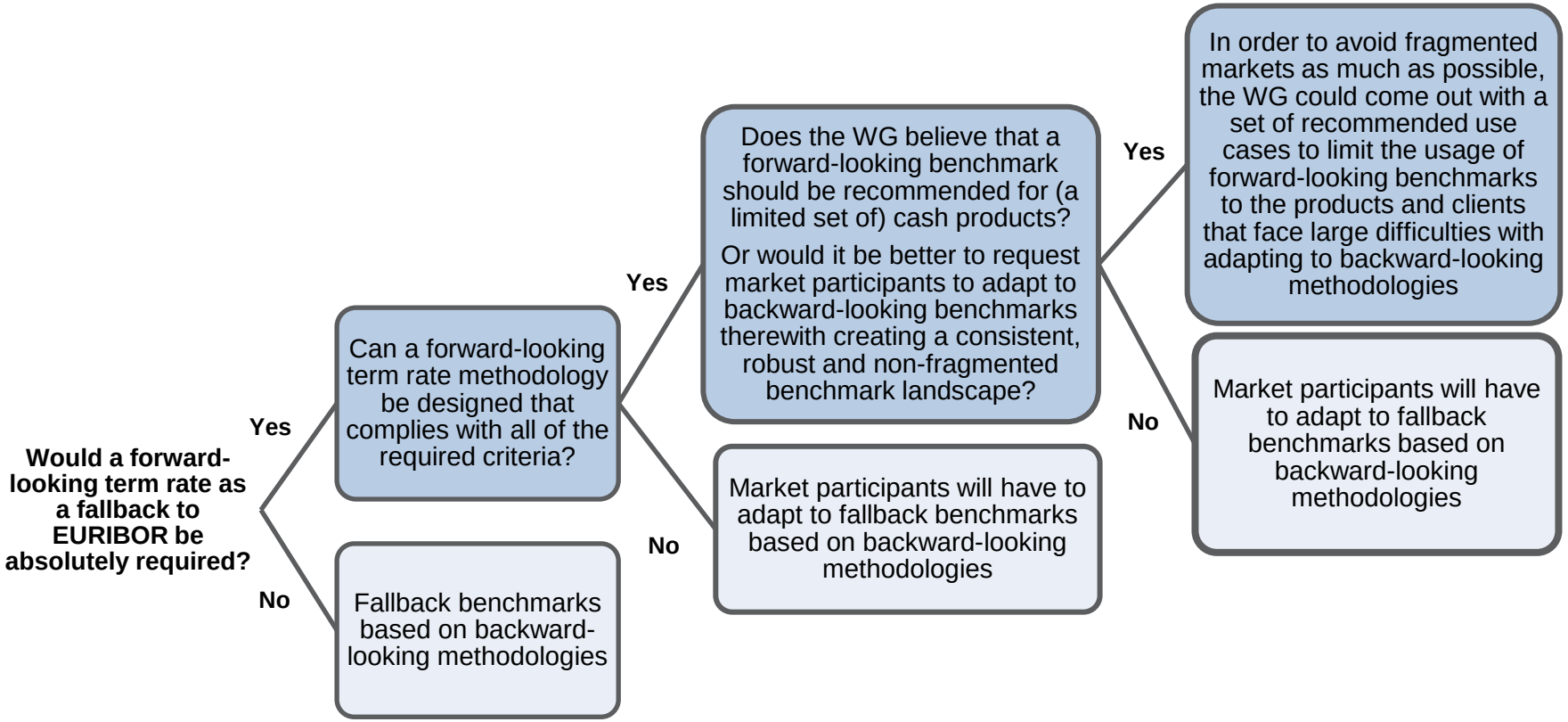
4. Dilemma around backward and forward-looking rates

Dilemma at hand:

- Backward-looking rates provide the most robust solution as fallback benchmarks for EURIBOR and, since the derivatives under ISDA documentation will fall back to a backward-looking rates, the usage of only backward-looking benchmarks in cash products would avoid market fragmentation.
- Feedback from the market however seems to point at a preference for forward-looking term rates especially for the less sophisticated/non-professional market participants, so-called **use cases**.

Question is now how to balance the preferences of certain market participants whilst striving for a consistent, non-fragmented and robust benchmark landscape?

- In order to answer this question, we should answer the questions posed below in the decision tree:



4. Cash products

ASSET CLASS/PRODUCT/ MODEL	• **Capital market products**	• **Retail / Consumer products** • **Asset classes/products** for which the rate must be known in advance
MOST IMPORTANT CRITERIA TO BE FULLFILED	• **No need to know the rate in advance** • **Hedging needs** • **Consistency across global markets**	• **Rate must be known in advance** • **Operational ease**

PROPOSED FALLBACK RATE	**Lookback / Payment delay**	**Forward-Looking / Last Reset (*See point 1 on Hedge accounting*)**
QUESTION TO BE DISCUSSED		***Should we propose a waterfall structure?***

4. Derivatives

- The results of ISDA Supplemental Consultation on Spread and Term Adjustments, including Final Parameters thereof, for Fallbacks in Derivatives Referencing EUR LIBOR and EURIBOR, as well as other less widely used IBORs showed there was broad market support for ISDA's proposed fallbacks to be applied to EURIBOR and EUR LIBOR ISDA's derivatives. Therefore the working group adopts ISDA's results and these will not become subject to this public consultation.

- There is a small set of products for which additional amendments may be required. SG5 to work in close co-operation with ISDA ensuring a unified approach:

    - Coupons referencing a EURIBOR tenor which is longer than the accrual period (for example, 1M EURIBOR paid weekly).
    - Coupons with so-called Asian features i.e. the payment with respect to a given interest period is a function of several EURIBOR fixings.
    - Coupons containing a range accrual feature.
    - Coupons where the EURIBOR reset is at the end of the calculation period (for example, EURIBOR fixed in arrears).
    - Forward rate agreements (FRAs).

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5. Spread adjustment: General considerations for the PC

1. SG5 to take into account - and refer to - the studies and consultations already completed on this topic, by ISDA for derivatives, and by the ARRC and UK RFR Working Group for cash products

2. SG5 to avoid 3 pitfalls:
   - Taking some *key concepts* for granted ‘as they have already been presented elsewhere’
   - Overloading respondents with all exisiting information and litterature
   - Overlooking euro specificities

Key concepts that will be explained include:

- ‘Why an additional spread ?’ / ‘the notion of adjusted RFR’
- Desirable features of the spread and methodologies
- The pros and cons of each methodology
- Specific considerations for cash products (e.g. spread amortizing for retail, compatibility of methodologies with both forward looking and backward looking rates)

Refrences to ISDA / ARRC / UK RFR WG work will mostly be through links to documents that respondents can consult, while analysis previously performed by SG2 on spread adjustments will be integrated in the body of the consultation as ‘specific EUR RFR WG work’.

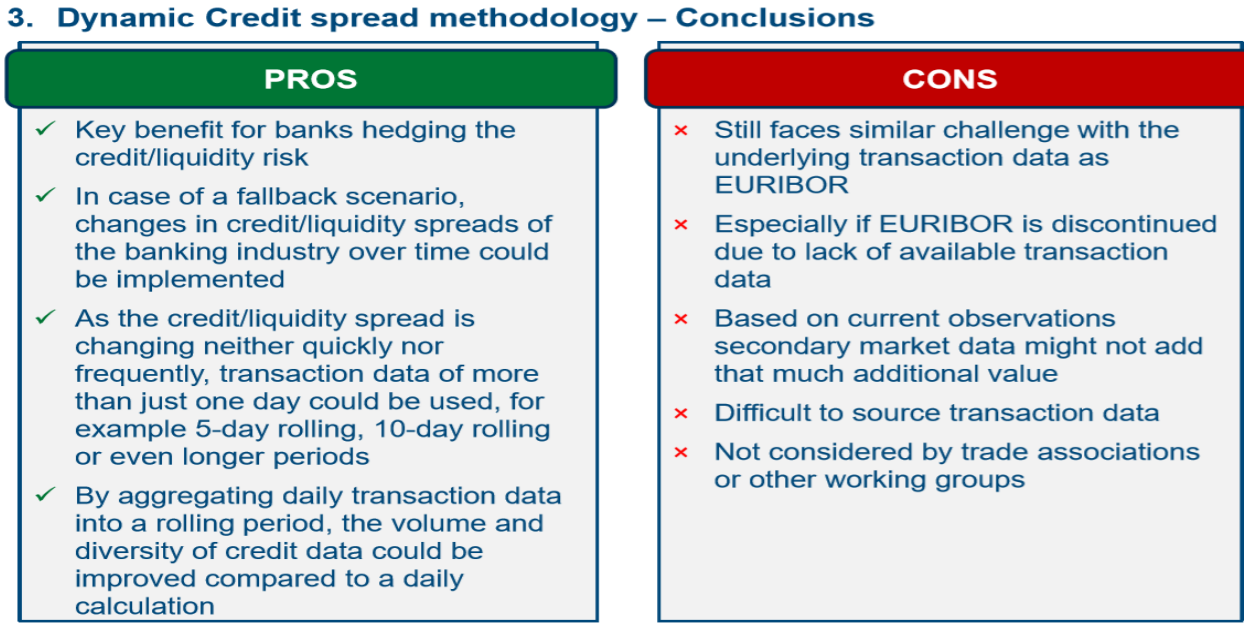
5. Spread adjustment: EUR RFR WG specific points (1/3)

EUR RFR Specific point #1: Why only fixed adjustment spreads and no dynamic spread?

The creation a dynamic spread has not been studied by the WG* for below reasons:

- Since there is no end date for EURIBOR, there is no incentive for any administrator to work on the topic
- It is a very complex topic
- It is not obvious at all that such a new dynamic spread, reflecting the term value of credit and liquidity but different from the EURIBOR/€STR spread, can be created

Below conclusions reached by the WG on the topic will be featured in the consultation

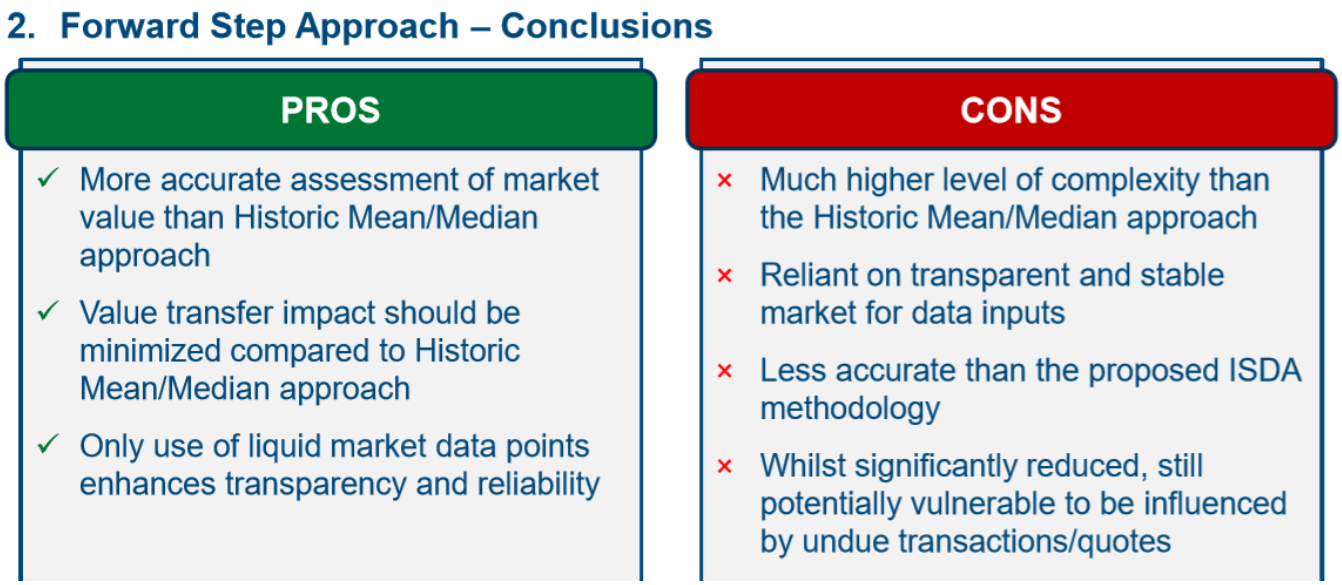


* In the US the creation of a dynamic spread for USD is being discussed in the Credit Sensitivity Group workshops

5. Spread adjustment: EUR RFR WG specific points (2/3)

EUR RFR WG specific point #2 –Forward Step methodology:

- SG5 is planning to include its analysis of the modified 'Forward step methodology' to only take into account most liquid points, instead of the original ISDA Forward methodology.
- However, SG 5 will point out that this method has not been retained for derivatives and it would therefore not be recommendable for cash products as creating inconsistencies in markets.



5. Spread adjustment: EUR RFR WG specific points (3/3)

EUR RFR WG specific point #3 – What to retain from ISDA, ARRC and the UK RFR WG analyses?

From ISDA's consultations on spread methodologies for derivatives, which served as a reference for all subsequent Working Groups consultation on spread methodologies for cash products:

- Additional spread and adjusted RFR concepts
- Original spread methodologies explanation
- Result of consultations on the topic, leading to the 5 year historical mean/median being chosen

From ARRC's consultations on fallbacks and additional spread for cash products – arguments and questions re:

- The amortizing of the spread for retail products
- Whether spread computation methodology can be the same irrespective of whether the fallback rate is backward or forward looking
- Results of consultations on the topic

From the UK RFR consultation on cash products

- Results of consultation

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6. Next steps

1. **Seek guidance from the IASB on:**
   A. IFRS9/IAS39 hedge accounting – relief for basis swaps solution, similar to FASB
   B. IFRS9 SPPI testing – regulated rates

2. **Finalisation of the consultation paper for next WG meeting/call of 10 September, 2020**

Tentative timeline

SG5 to present a final draft of the public consultation to the WG	10/09/2020
Finalisation of the public consultation	11/09/2020 to 25/09/2020
WG written procedure and agreement on the final version	28/09/2020 to 16/10/2020
Preparation of the final document for publication	19/10/2020 to 13/11/2020
Publication	Mid-November 2020
Deadline for sending replies to the public consultations (2 months for comments)	8 January 2021
Publication of the summary of responses	Beginning of February 2021
Discussion of the outcome of the public consultation	Mid-February 2021
Final recommendations	End February 2021

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Annex A. Public consultation: structure & content

Provides an **overview** of the **methodologies under analysis** and explain the choice of the viable options

Explains the criteria used for the analysis perform in this chapter and reports methodologies' pros&cons common to all products. Provides a wide introduction to the sub-sections listed below

Explains pros&cons of the methodologies by product and identifies most appropriate fallbacks which the market will be consulted on

Provides descriptions of the proposed methodologies for the rate and the index, proposes a list of conventions