Shifting benchmarks, shifting the rate curve

1. Context

In many films, stories frequently start by once upon a long time ago there were questions about the soundness and robustness of the major benchmark rates: LIBOR, EURIBOR and EONIA. The time referred to is the culprit of the financial crisis; this happened during that period where at least two of these three benchmarks were subject to what is diplomatically “necessary adjustments” to mitigate the hectic trading.

In practice, given that these benchmarks based on contributions, actual trades, and the rates reported were sometimes diverging from market prices. The supervisory authorities were displeased with the situation that lead to the near collapse of LIBOR.

Several decisions were taken, among these was the creation of a benchmark regulation, the profound review of benchmark’s governance and the seeds of the need to rely on market prices instead of contribution was ingrained.

Assuming that the idea to move from one benchmark to another was shared by a small group of authorities, which was not the case for the majority of users and part of the supervisory authorities. The underlying reasons were as ows; the timing was inappropriate, on the back of the crisis, and above all that potentially moving from these benchmarks meant impacting several hundreds of trillions of euros and contracts linked to the benchmark rates, every floating rate, be it for a loan, derivative or saving was concerned.

The project was deferred on several occasions until the right time. Now, the right time has arrived.

2. Proposals

Firstly, the benchmark regulation fully applicable from January 2020 requires that benchmarks must be based on facts, market prices and not on pliable information such as contributions. Then coupled with a reasonable time elapsed since the financial crisis and the will of large regulatory authorities, came the proposal to abandon LIBOR, EURIBOR and EONIA.

Amending the benchmark governance was not radical enough, therefore ECB, FCA (and EU Commission) came out with their idea of market based/price based benchmarks. The rationale is similar, current benchmarks replaced by new versions constructed using market references. The operators would be the ECB replacing EONIA by ESTER, the FCA replacing LIBOR by SONIA, the new name if any for EURIBOR is not known yet, although EMMI the entity in charge of producing it is busy reviewing it governance to make it fully compatible with the benchmark regulation.

Concretely, both ESTER and SOFI will abide based on market prices from the previous day, a form of double weighted average computed in the case of ESTER by the ECB. The methodology will exclude the extreme rates (first and last quartile), and then an arithmetic transaction size weighted average will be calculated and released as the reference for the short-term rate.

ESTER should be computed as a rate that reflects the wholesale euro unsecured overnight borrowing costs of euro area banks. The rate published for each TARGET2 business day based on transactions conducted and settled on the previous day; the data will come from daily confidential statistical information relating to money market transactions collected in accordance with the MMSR regulation.

SONIA although built on market prices are created differently from the most feasible and robust methodology for the production of a TSRR in the near-term is the weighted average mid-point of the best, firm bids and offer quotes for listed SONIA-OIS products on a central limit order book.

In terms of availabilities, ESTER will become the reference rates from October 2019 onward, unless there are implementation challenges. However, given the need to comply by January 2020 to the benchmark regulation, it is unlikely that there will be considerable delays, although such a move might require more than a year for the entire industry to shift to the new environment.

On its side, SONIA has been a bit more prudent as the move is for 2021. Nevertheless, depending on Brexit obligations, it might be that the change has to occur earlier than expected. (In case of a transition phase during which EU regulation will remain applicable).

There is for these changes in reference rates two major hurdles to overcome in a time frame of about a year:

1. Because of their design, the rate they display will be different from the benchmark they replace, but because there are already contracts on LIBOR, EONIA and EURIBOR arises the question of how to deal with differences. Taking the case of derivative, even a few basis points might mean several thousand euro of difference, the same with mortgage indexed on floating rates.
2. Then there is the need to adapt all systems and contracts with the new references, probably a massive operational challenge, identifying contracts, data points… and changing them with the new feed and reference.

Identify all areas of concerns in details might depend on each organization specificities and products or services, but each time a reference to one of these three benchmark is used will create the circumstances for change. From a high level perspective, among the most impacted business line are:

- Rate based derivatives
- Floating rates deposits
- Floating rates loans, including mortgages
- Securitized or packaged bonds indexed fully or partially on these rates
- And any benchmark used in Discretionary Portfolio Management or Asset management
- Funds, UCITS and AIFs relying on current LIBOR, EURIBOR and EONIA (including Money Market Funds)

The final element to note is that as these indices are multi-currency these changes might have no other possibilities but to apply for all currency, and this will create odd situations notably when there is no or not enough trades to define the daily rate for a currency.

3. Outcome and actions

Trying to be pragmatic, at Deloitte we propose a three pronged-approach to gain the support and commitment of the entire firm.

Boards should consider the following three steps for setting up a benchmark rate transition program:

a) Mobilize a cross-business unit and geography transition program with C-level sponsorship

Given the degree of uncertainty and complexity, benchmark rates transition being likely to be one of the (if not the) biggest transformation programs many firms will have to undertake. Boards should establish a coordinated, centralized and senior Steering Committee (SteerCo) to manage and oversee it. Appointing a senior manager to oversee and take accountability for the program is imperative for firms to set the right tone from the beginning to master the change in the required time.

Firms need to clarify the individual accountabilities for the SteerCo and other program stakeholders from the outset. In addition to accountabilities for the transition outcomes and activities, this should include accountabilities for decision-making; for example, decisions on the timing of new product launches, or when to engage and transition specific customers.

b) Set out a transition roadmap

Benchmark rates transition programs should include the following key blocks of activity: (i) identifying financial exposures and defining the approach to transition; (ii) launching Risk Free Rate (RFR)-linked products and building RFR volumes; (iii) transitioning the back book/legacy trades; and (iv) switching off from benchmark rates processes and infrastructure.

Identifying key market and regulatory developments and associated milestones (for example, the identification of term RFRs and developments concerning fallback language), and continuing to track these, is crucial. It may not be possible to take certain decisions or actions until specific developments occur, which will affect the pace of transition. Something the transition envisaged under the Benchmark regulation for non-available index might be a guide on how to handle and communicate with clients.

c) Identify the risks and implement mitigants early

There are significant risks for benchmark rates transition that the Board should be confident are being addressed. An early activity is to acknowledge the mitigants to these risks and, subsequently, ensure that the effectiveness of the mitigants is reported to the Board. Delivery risks include: (i) the creation of "winners and losers" which may result in reputational damage and claims by clients for redress; (ii) clients' unwillingness to transition, which may result in benchmark rates exposures continuing to grow; and (iii) the effects on financial performance which may result in shortfalls against financial plans.

4. Risk factors

Given the widespread nature of the change there are several areas to consider minimizing economic, legal and reputational risks.

At this stage, we can foresee a series of risks among which:

- Continuity of contract, probably theoretical as there will be no alternative but stop a contract with all Potential consequences
- Triggering a tax event in case of gain or loss that might be considered as a revenue
- Manage staff information on time
- Inform all clients without which that can constitute a breach of a significant part of the contract
- Consider potential accounting impact, how to manage differences stemming from the two rates and reconcile

5. Next steps

Every journey starting with the first step, the priority should be to set up a group to deal with this change, and then identify the current situation and areas where these benchmarks are used. The next logical step should be to identify the relevant benchmark of replacement, implement the changes within the firm and communicate internally with clients.

Because even if the underlying rates change, the underlying business remain, the same game with different rules.

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