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Newsletter IBOR Reform 08/2023

Compilation by the Helaba IBOR Task Force

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Foreword by Helaba IBOR Task Force

Ladies and Gentlemen,

Welcome to the last edition of our IBOR Reform Newsletter. The era of the LIBOR rates that have accompanied us since the mid-80s has steadily come to an end over the past years in favour of a more stable financial system.

Since 1 January 2022 new business is only possible on the basis of new risk-free successor benchmarks. Market participants have become accustomed to the special backward-looking nature of the Risk Free Rates and the few forward-looking alternatives. The long farewell from USD LIBOR – extended until 30 June 2023 for the transition of legacy business - is now officially over. In exceptional cases a synthetic, SOFR based USD LIBOR rate is available until 30 September 2024.

As the continuance of the EURIBOR had been secured early on by the reformation of its methodology, the focus in EUR-transactions had been on the transition from EONIA to risk-free €STR. €STR, especially with its developing term rates, provides alternative and robust fallback solutions for EURIBOR.

Although IBOR Transition has not yet ended, broad parts of the markets can lean back with a „successfully made it“ after a decade of preparations and transitions. Ongoing reformation processes or respectively transitions to successor reference rates (e.g. CIDOR or WIBOR) relate to smaller market volumes. To maintain the newly created and improved stability of the financial system, it is important that market participants learn from the LIBOR transition experience and adopt the most robust reference rates and fallback mechanisms in all their transactions.

After more than 2.5 years of reporting on IBOR Transition we would like to take this opportunity to say goodbye and thank you very much for your attention. We hope that our compilations of market information and observations supported you on the transformation route to the new reference rates. We will monitor upcoming market developments and continue being available to you as sparring partner in the future.

In case of any questions, please do not hesitate to contact your relationship manager.

Highlights and Market Observations since 28 April 2023 (1/5)

- In the final weeks of the USD LIBOR legacy business transition regulatory bodies and working groups pleaded for a timely transition until 30 June 2023 and informed about a potential use of synthetic 1-/3-/6 months USD LIBOR rates for English-law tough legacy business until 30 September 2024.

  https://www.fsb.org/2023/04/fsb-statement-to-encourage-final-preparations-for-the-usd-libor-transition/

  https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Meldung/2023/meldung_2023_05_03_Referenzzinssatz_LIBOR.html

- On 3 July 2023, the board of IOSCO (International Organization of Securities Commission) made two key statements regarding its assessment of alternative reference rates as successor for USD LIBOR rates. Previously, the IOSCO had analysed four reference rates – two Credit Sensitive Rates (CSRs) and two Term SOFR rates - in line with its principles (a.o. benchmark design, data sufficiency, transparency) and had compared these rates to Overnight SOFR.

  1. The review confirmed that some CSRs exhibit the same weaknesses as LIBOR. Without modification their use may threaten market integrity and financial stability. In view of liquidity risks, low volume and market data they are not sufficiently deep, robust and reliable.

  2. While the Term SOFR reference rates were somewhat better placed, these rates were rated as not as robust as (Overnight) SOFR as they derive from derivative transactions. Term SOFR rates rely on the continued existence of a deep and liquid derivatives market based on overnight SOFR. Consequently, their use should be limited as also recommended by the Financial Stability Board (FSB), working groups and regulators. The use of Term SOFR rates in derivatives markets should remain limited so that these rates can remain sustainably available for more limited appropriate use cases. If reference to Term SOFR rates were to become too widespread, at the expense of trading in the underlying SOFR derivatives (i.e., futures or swaps) markets, it would undermine the Term SOFR rates themselves.

  https://www.iosco.org/library/pubdocs/pdf/IOSCOPD738.pdf

Highlights and Market Observations since 28 April 2023 (2/5)

- In its final reflections on LIBOR transition on 28 July 2023, the FSB addressed two key messages to the market participants:
  - In order to avoid the need to repeat the decade-long LIBOR transition exercise, the FSB encourages all market participants to use the most robust reference rates, anchored in deep, credible and liquid markets. Using Credit Sensitive Rates (excessive use of expert judgment and limited reliance on anchored transactions) risks undermining the market-wide progress made through the transition to risk-free or nearly risk-free rates. In some cases there may be a role for risk-free rate (RFR) derived term rates. Therefore, the FSB has set out the circumstances where the limited use of RFR-based term rates would be compatible with financial stability. Market participants should not become over-reliant on term rates outside of these limited circumstances, as this carries risks of undermining the robustness of these rates due to the potential for illiquidity in the underlying markets that enable and sustain term RFRs. Consequently, the FSB emphasis again that in the interest of sustaining robust reference rates and financial stability going forward, the use of term rates must be in line with official sector and national working group best practice recommendations.
  - The transition of LIBOR reference rates has underscored the importance of robust, workable fallback provisions. Previously, many contracts, across asset classes, did not contain adequate provisions for the permanent cessation of panel-based LIBOR, or for its loss of representativeness. While some FSB jurisdictions have laws and regulations obliging market participants to incorporate robust and suitable fallback provisions into their contracts, the FSB encourages all market participants to learn from the LIBOR transition experience and to adopt robust fallback mechanisms in all cases. ISDA incorporated explicit fallback rate mechanisms for both IBORs and RFRs referenced contracts in its IBOR Protocol and new definitional booklet.

https://www.fsb.org/2023/07/final-reflections-on-the-libor-transition/

Highlights and Market Observations since 28 April 2023 (3/5)

- At the July 28 Financial Stability Oversight Council (FSOC) meeting, FSOC Principals discussed the LIBOR transition and emphasised that going forward, market participants should ensure that they include robust fallback language in their contracts and use appropriately robust reference rates, avoiding the problems created with LIBOR. The Council noted that the successful transition to SOFR bolstered the resiliency of the financial system and was the result of a public-private partnership spanning nearly a decade.

  https://home.treasury.gov/news/press-releases/jy1656

- In their meeting on 31 July 2023 members of the Alternative Reference Rates Committee (ARRC) characterised the passage of the 30 June 2023 LIBOR transition milestone as smooth and uneventful.

  The Loan Syndications and Trading Association (LSTA) highlighted the significant upwards trend in loan fallback amendments (i.e. change in reference rates occurring via fallback) in June. In addition, LSTA emphasised that most leveraged loans and collateraliszed loan obligations (CLOs) have transitioned to SOFR going forward but will continue to pay LIBOR until their next rate reset date (which will generally be one or three months after LIBOR cessation).

  The implementation of fallbacks and LIBOR replacements under the LIBOR Act occurred without issue.

  International Swaps and Derivatives Association (ISDA) noted smooth implementation of the ISDA 2020 IBOR Fallbacks Protocol.

  The ARRC highlighted its continued believe that SOFR is the most appropriate reference rate for widespread and long-term adoption as, among other factors, it is centred on transactions in the Treasury repo market, a market which features both extensive depth and breadth.

  While the Committee plans to wind down its work in due course, it stressed that its best practice recommendations remain in place/are permanent to help support a robust reference rate environment going forward and promote financial stability.

  https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2023/ARRC-Readout-June-2023-Meeting.pdf

Highlights and Market Observations since 28 April 2023 (4/5)

- While the derivative business has been uniformly transitioned to SOFR Compounded in line with ISDA guidelines, on the credit side we have observed a renewed trend in Europe for the use of Term SOFR in new USD business in recent months. In addition, Term SOFR became a topic in the transition of legacy business that was not linked to a direct hedge and therefore was not required to transition to SOFR Compounded.
- Borrowers ask themselves the question which SOFR reference rate is suitable especially in view of product and handling. In joint workshops at this year's financial symposium in Mannheim and an online event organised by the Association of German Treasurers (VDT), Helaba experts reviewed the questions together with Brenntag SE from different angles. Using the example of Brenntag's USD promissory note (based on SOFR Compounded) and Brenntag's syndicated financing (using Term SOFR) they discussed the choice of a suitable reference rate as well as current market developments and debated how companies can position themselves with USD financings. The workshop recording can be viewed on our website. Our experts are also available for a bilateral exchange if required.

  https://www.helaba.com/de/ueber-uns/rechtliche-hinweise/ibor.php

  https://www.helaba.com/int/about-us/legal-notice/ibor.php

- Despite the above described remaining regulatory risk and currently higher hedging costs many treasury departments view Term SOFR as the more attractive rate. Due to its forward-looking nature, interest rate and interest amount can be determined at the beginning of an interest period. Other than with backward-looking SOFR Compounded where this information is available at the end of the interest period, Term SOFR allows processes to remain widely unchanged from handling USD LIBOR. For some corporates this might be a key selection criteria. Depending on hedging requirements and product selection it might also be a good choice to work with different SOFR types in different constellations. This is clearly dependent on the individual situation of a company.

Highlights and Market Observations since 28 April 2023 (5/5)

- With the new risk free rate EFTERM EMMI as EURIBOR administrator has provided a risk free rate, that fulfils all EU benchmark regulations and that could replace EURIBOR one day.
- However, it is still too early for an assessment of EFTERM and also Refinitiv's forward-looking Term €STR prototype rate as replacement and fallback reference rates for EURIBOR. Acceptance by the market as well as market standards still have to evolve around EFTERM and Term €STR, which will take some time. As first step we would expect EFTERM to find its way over time as fallback rate into facility agreements that contain EURIBOR fallback provisions. The issue might be taken up at refinancings or in new transactions. At the moment, we do not see any requirements for un-scheduled contract amendments as the existing EURIBOR fallbacks still work and market standards still have to be established, also documentation-wise.
- Within the scope of further advancement of its Term €STR rate, Refinitiv seeks market participants' feedback on the new methodology it introduced to its prototype. The consultation ran until 21 July 2023.

  The new methodology incorporates trillions of euros of €STR executed trade data sourced from the LCH clearing house group in addition to the data sources already in use in the previously announced Refinitiv Term €STR rate. This new approach effectively blends LCH executed trades with Tradeweb quotes across a longer collection window to produce a more robust rate.

  Following completion of the public consultation and pending necessary approvals, Refinitiv intends to transition its Term €STR rate in September 2023 from a prototype to a regulated production rate for use in financial contracts.

  https://www.refinitiv.com/en/media-center/press-releases/2023/refinitiv-commences-public-consultation-and-incorporates-executed-trade-data-into-forward-looking-estr-term-rate

  https://www.refinitiv.com/content/dam/marketing/en_us/documents/methodology/refinitiv-term-estr-prototype-methodology.pdf

  https://www.refinitiv.com/content/dam/marketing/en_us/documents/methodology/consultation-paper-june-2023.pdf

Useful sources of information for current developments

For latest information as well as general details on the transition from IBORs, please also refer to information published by supervisory authorities, working groups and other industry organisations. A selection of the most important websites can be found here:

	€STR: European Central Bank EURIBOR: Emmi Working Group on Euro Risk-Free Rates
	Bank of England Financial Conduct Authority
	Federal Reserve Bank of New York The Alternative Reference Rates Committee (ARRC)
	SIX Swiss Exchange National Working Group on Swiss Franc Reference Rates (SNB)
	Bank of Japan Cross-Industry Committee on Japanese Yen Interest Rates Benchmarks
	ISDA Loan Market Association (LMA) LSTA

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