CONSULTATION PAPER ON IBOR TRANSITIONS

EIOPA-BoS-21/197
30 April 2021

European Insurance and
Occupational Pensions Authority

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Responding to this paper

EIOPA welcomes comments on the Consultation on IBOR transitions.

Comments are most helpful if they:

- respond to the question stated, where applicable;
- contain a clear rationale; and
- describe any alternatives EIOPA should consider.

Please send your comments to EIOPA using the EU Survey tool by Friday, 23 July 2021, 23:59 CET by responding to the questions under the following link:

https://ec.europa.eu/eusurvey/runner/Public_Consultation_on_IBOR_transitions_2021

Contributions not provided using the EU Survey tool or submitted after the deadline will not be processed.

Publication of responses

Your responses will be published on the EIOPA website unless: you request to treat them confidential, or they are unlawful, or they would infringe the rights of any third-party. Please, indicate clearly and prominently in your submission any part you do not wish to be publicly disclosed. EIOPA may also publish a summary of the survey input received on its website.

Please note that EIOPA is subject to Regulation (EC) No 1049/2001 regarding public access to documents[1] and EIOPA's rules on public access to documents[2].

Declaration by the contributor

☐ I consent to publication of all information in my contribution in whole ☐ /in part – as indicated in my responses ☐, including to the publication of my name/the name of my organisation, and I declare that nothing within my response is unlawful or would infringe the rights of any third party in a manner that would prevent the publication.

Data protection

Please note that personal contact details (such as names of individuals, email addresses and phone numbers) will not be published.

They will only be used to request clarifications if necessary on the information supplied. EIOPA, as a European Authority, will process any personal data in line with Regulation (EU) 2018/1725[3]. More information on how personal data are treated can be found in the privacy statement at the end of this survey.

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1 Regulation (EC) No 1049/2001 of the European Parliament and of the Council of 30 May 2001 regarding public access to European Parliament, Council and Commission documents (OJ L 145, 31.5.2001, p. 43).

2 Decision (EIOPA-MB-11/051) of the Management Board concerning public access to documents available at link

3 Regulation (EU) 2018/1725 of the European Parliament and of the Council of 23 October 2018 on the protection of natural persons with regard to the processing of personal data by the Union institutions, bodies, offices and agencies and on the free movement of such data, and repealing Regulation (EC) No 45/2001 and Decision No 1247/2002/EC (OJ L 295, 21.11.2018, p. 39).

1. Overview

1.1. IBOR transitions is a change driven by a new legal requirement which seeks to increase the robustness and reliability of financial benchmarks. In Europe, the new EU Benchmark Regulation (EU BMR)[4] came into force in 2018 and requires financial benchmarks to be transparent and to measure the underlying economic reality in a representative way. In addition to this, the administrator of LIBOR, ICE[5], announced that the majority of the Libor panels will cease at end of 2021.

1.2. Currently the 'world' is split into currencies that are expected to change benchmarks at the end of 2021 (GBP, CHF and the JPY), currencies for which the change is postponed from the previous stated timetable (for the USD the change moved to mid-2023) and currencies for which a date has not yet been set (EUR).

1.3. EIOPA produces risk free rate term structures that for many currencies have been based on IBOR based swaps. Based on the new legal requirement these structures would need to be changed as they can no longer be based on existing instruments. Therefore, EIOPA intends to adjust its risk-free rate (RFR) production to the new reality by adopting a common approach for all currencies on the transition to the new rates.

1.4. EIOPA's RFR methodology seeks to produce consistent RFR term structures based on: (a) Replicability (b) Market consistency of the RFR term structures produced (c) Stability for insurance undertakings (d) Interests of policyholders and (e) capability of being implemented via EIOPA's production process. Consequently, EIOPA wants to remain transparent, follow rather than lead the market and avoid unnecessary material impact on undertakings, arising from a technical change due to IBOR transitions.

1.5. The proposal included in this consultation is generic and can be applied to all currencies allowing at the same time some degree of flexibility on when to perform the switch.

1.6. Recent market developments as well the responses received to the discussion paper have enabled a new opportunity which we believe will facilitate the switch to the new instruments in a way that the impact can be minimised to the extent possible. EIOPA presents a modified approach of the instant change option included in the discussion paper published in 2020. Furthermore, proposals on (i) the treatment of the credit risk adjustment (CRA), (ii) the impact of the Deep Liquid and Transparent (DLT) assessment and (iii) the long term average spreads (LTAS) are also considered.

1.7. The focus of this consultation is to address the issues identified within EIOPA's RFR methodology and production and to propose solutions for consultation. Additional issues related to the IBOR transitions, which emerge outside the RFR environment and may affect directly or indirectly the insurance industry and the policyholders are not covered in this consultation.

1.8. It has to be noted that this consultation is referring to existing concepts related to the way RFR production is currently taking place. The 2020 review proposes additional changes in the methodology which are under review.

[4] https://www.esma.europa.eu/policy-rules/benchmarks
[5] https://www.theice.com/iba/libor

2. Transition from IBOR to new OIS term structures

2.1. In 2020, EIOPA published a discussion paper where three options for the transition to new OIS were considered[6]. Back then, and given the existing market conditions, the proposal of EIOPA was a blending option which would enable the IBOR curve to gradually converge to the new OIS subject to market liquidity.

2.2. However, during 2020 market conditions changed. On many occasions, the differences between the new OIS rates and the IBOR rates decreased. This situation enabled a new opportunity which would facilitate the switch to the new instruments in a way that the impact can be minimised to the extent possible. EIOPA's proposal deals also with the difficulty of hedging against a blended curve as mentioned by some responses received to the discussion paper.

2.3. Based on the market analysis performed, EIOPA is now in a position to propose a modified version of the instant change option included also in the discussion paper. This option is generic and can be applied to all currencies allowing at the same time some degree of flexibility for EIOPA on when to perform the switch.

2.4. The proposed option has the advantage that the change can take place quickly and, subject to two specified preconditions, the drawback of a potentially significant impact could be mitigated. EIOPA will be in a position to partly control when the change takes place and communicate it to the undertakings timely when found appropriate.

Definition of the two preconditions

2.5. a) Liquidity precondition

The swaps traded under the new OIS would need to be 50% of the total traded volume[7]. From this point onwards, the majority of the plain vanilla swap market would be represented by the new OIS instrument. This condition is in line with EIOPA's methodology of market consistency of the RFR term structure. EIOPA does not propose to change until at least half of the swap market is using the new OIS swap instruments. Currently the only instruments which approach this threshold are the GBP OIS (SONIA).

2.6. b) 'Proximity precondition'

The timing of the switch should be restricted to a point in time when there is close alignment between IBOR and OIS curves in order to reduce the impact of the switch.

2.7. Based on the observed monthly volatility in the rates, our proposal is to perform the switch when the difference of the two curves is smaller than the monthly variations, which already exist using the current RFR curve observations. Ideally the Deep Liquid and Transparent (DLT) points of the new curve would need to be as close as possible to old curve up to the Last Liquid Point (LLP).

2.8. It is EIOPA's intention that a trigger is set once the proximity condition is fulfilled. This will be the situation where the difference between the IBOR and the OIS curves is no more than the average interquartile range of month-to-month changes[8]. In addition, this condition would have to be met for a least three consecutive months if there is no end-date for IBOR curve.

2.9. This way, when the switch takes place, undertakings would face a change smaller than they face 50% of the time from monthly shifts in the existing curve. Based

[6] An instant switch option and a blending option with two variations.
[7] We refer to the total traded volume of fixed floating or plain vanilla swaps which can be only IBOR or new OIS based.
[8] Please refer to Annex I (a) for an additional explanation on how the 'proximity' condition is defined.

on this we would be able to identify an optimal timing when undertakings will be able to absorb to a certain extent the impact of the switch without serious disturbance in their balance sheet positions.

What does this mean specifically for the five major currencies in which the great majority of EU insurers' liabilities are denominated:

2.10. For the EUR and the USD: As long as the EURIBOR and LIBOR USD remain liquid no change is anticipated for the term structures. EIOPA will monitor market volumes and once increased liquidity is observed EIOPA will start looking into the proximity condition in order to identify in advance as much as possible the appropriate timing. Stakeholders will be notified via a news alert.

2.11. The GBP, CHF and JPY LIBOR curves will cease to exist by the end of 2021. However, based on the EIOPA's monitoring, not all pre-conditions are expected to be met.

2.12. More specifically, the liquidity for the CHF and the JPY new OIS is currently very low. Once the IBOR curve no longer exists EIOPA will have to apply the existing methodology and use a curve which is DLT in order to continue producing consistent RFR terms structures as required by the legislation. In this case the switch to government bonds is expected to take place for both currencies. The alternative is to base the RFR production on non-liquid instruments which would subsequently lead to a market inconsistent outcome.

Questions to stakeholders:

Q1: Do you agree with the overall approach of the immediate switch subject to the two preconditions?

Q2: Do you agree with the way the 'liquidity' condition is defined?

Q3: Do you agree with the way the 'proximity' condition is defined?

Q4: Do you believe the 'proximity' condition has to be met for three consecutive months or a shorter period would be sufficient?

Q5: Do you think there is another condition EIOPA would need to consider for the immediate switch to the new OIS term structures?

Q6: Do you believe that the foreseen changes in the RFR methodology due to IBOR transitions and the method of switching the underlying instruments (depending on the proximity and liquidity condition) could have an impact on the market rates itself, and if so, with what impact and how might this be mitigated?

3. The approach towards the Credit risk adjustment (CRA)

3.1. As described in the discussion paper, EIOPA considers the new OIS rates to be practically risk-free. Given they no longer reflect credit risk, the credit risk adjustment is no longer needed. The impact of continuing to apply the CRA on the new OIS based term structures would be at least 10 basis points and its application would result in lower and market inconsistent RFR term structures.

3.2. EIOPA proposes not to apply the CRA to term structures based on the new OIS instruments. IBOR swaps and government bonds embed credit risk so for these the CRA will continue to be applied.

3.3. Applying a negative CRA to the new OIS term structures, as requested by some respondents of the discussion paper, will result into an artificially higher curve. However, such solution makes no economic sense since there is no credit risk to adjust for and if it were to be considered it would require amendments in the delegated regulation.

3.4. The calculation of the CRA for all currencies is described in detail in the RFR Technical documentation (page 33). However, this section does not yet take into consideration the existence of the new OIS instruments which will have a CRA set equal to zero. Based on the current wording, the removal of the CRA of the EUR and the USD will create a chain reaction and affect the CRAs applied to other currencies too. Since both the EUR and USD CRA are not expected to change in the short term this will be addressed at a later stage.

Question to stakeholders:

Q7: Do you agree with the overall approach regarding the CRA?

Q8: Is there any alternative option you believe EIOPA would need to consider regarding the treatment of the CRA?

Q9: Would you have a view on how to treat the CRA for those currencies for which the CRA is currently being derived from either the CRA for the EUR or the CRA for the USD?

4. Impact of the DLT assessment and treatment of the Long Term Average Spreads (LTAS)

(a) DLT assessment

4.1. In order for the curve to be considered DLT, the majority of the DLT tenors (including especially the LLP and the first liquid point) for each curve must be liquid. In order to ensure an assessment that is consistent across currencies the applied criteria in terms of thresholds are objective and clearly specified[9].

4.2. The starting point for the assessment are the following initial thresholds for depth and liquidity per tenor:

- The average daily notional amount traded is at least EUR 50 000 000,

- The average daily number of trades is at least 10.

4.3. EIOPA is performing continuous monitoring of swap market volumes in order to determine if, and to what extent, the new OIS instruments satisfy the Deep Liquid and Transparent criteria (DLT).

4.4. Based on EIOPA's recent market observations, once the IBOR curves are no longer used, changes are expected in the LLPs of certain currencies as well as in the type of instrument used due to non-liquidity of certain new OIS instruments. It has to be noted that the change of instrument is not some special IBOR specific measure but it must take place for any currency in which the swap market is not DLT as mentioned in article 44 paragraph 2 of the delegated regulation.

4.5. These changes will have to be taken into account from the point of the transition onwards. It is expected that the change of these parameters will have an additional impact which will have to be quantified through the impact assessment.

4.6. More specifically the following changes are expected based on current market observations:

a) GBP LLP to change from 50 to 30 years

b) USD LLP to change from 50 to 30 years

c) JPY change from swaps to government bonds (LLP would remain unchanged to 30 years)

d) CHF change from swaps to government bonds and LLP would shift from 25 to 15 years.

4.7. The impact of these changes will result into slightly steeper and lower term structures for the GBP and the USD. For the CHF the term structure will be also lower up to the LLP but then it will increase due to the extrapolation to the Ultimate Forward Rate (UFR). Finally for JPY a small drop in the term structures is expected. These changes will be subject to additional changes in the coming years based on market developments.

(b) Determination of the LTAS

4.8. The LTAS is an input to the calculation of the fundamental spread (FS) for the Matching Adjustment and Volatility Adjustment measures. Spreads over the basic

[9] These thresholds can be found in the Delegated Regulation (EU) 2017/583, Annex III, Table 5.1, row "Fixed-to-Float 'single currency swaps' and futures/forwards on Fixed-to-Float 'single currency swaps'" available at this link).

RFR for assets of the same duration, credit quality, and asset class data over a 30-year period enter the LTAS calculation.

4.9. EIOPA proposes that the LTAS calculation should recognise the change in spreads that results from transitioning the RFR to the new OIS from the point of transition onwards, and that the historic spreads (over IBOR-based RFR) already embedded in the LTAS calculation would remain unadjusted.

4.10. Currently there are insufficient reliable data from the new OIS instruments to adjust historic spreads over a period of 30 years and reflect the change in the RFR from the IBOR to the new OIS.

4.11. The same approach regarding the LTAS was also followed when there was a change in the market data provider from Bloomberg to Refinitiv in 2019. Historic calculations remained unadjusted.

Questions to stakeholders:

Q10: What is your opinion about the proposed changes in the LLPs and the use of government bonds for the JPY and CHF?

Q11: What is your view on the proposed treatment of the LTAS?

5. Annex I

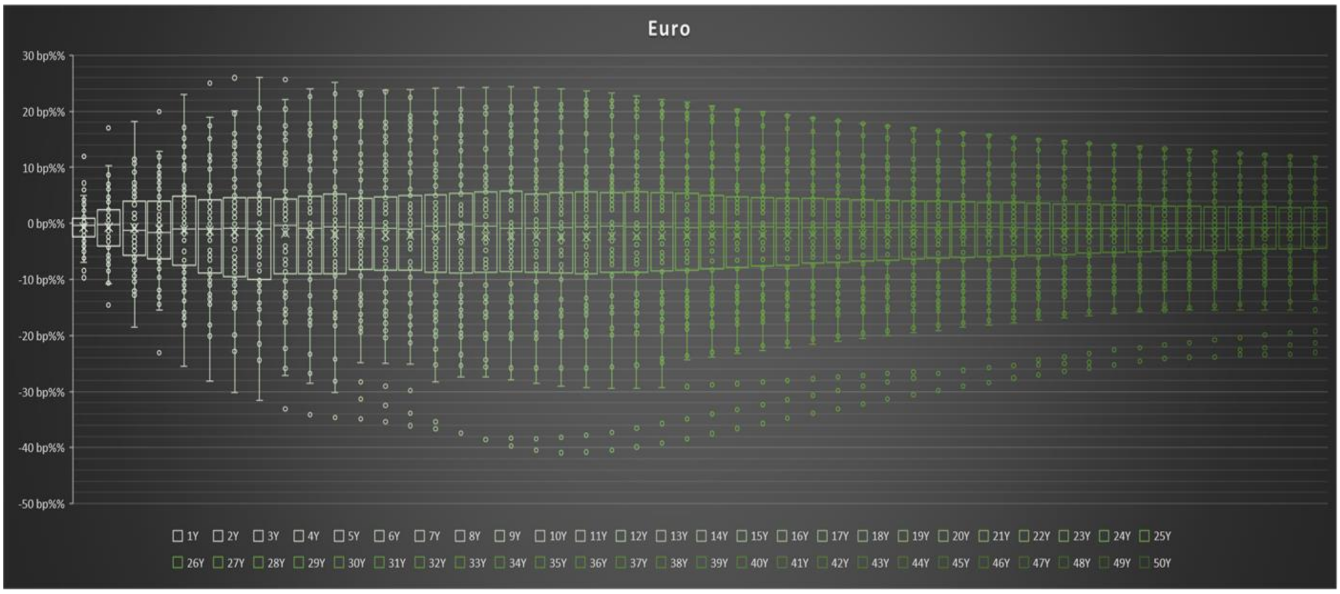
a) Interquartile range analysis

5.1. Below you may find the monthly deviations of RFR rates for the five currencies which form most of the liabilities of EU insurers. Based on all published curves (without VA) since the start of SII EIOPA has created the following Box-plots showing the monthly deviations for the first 50 tenors.

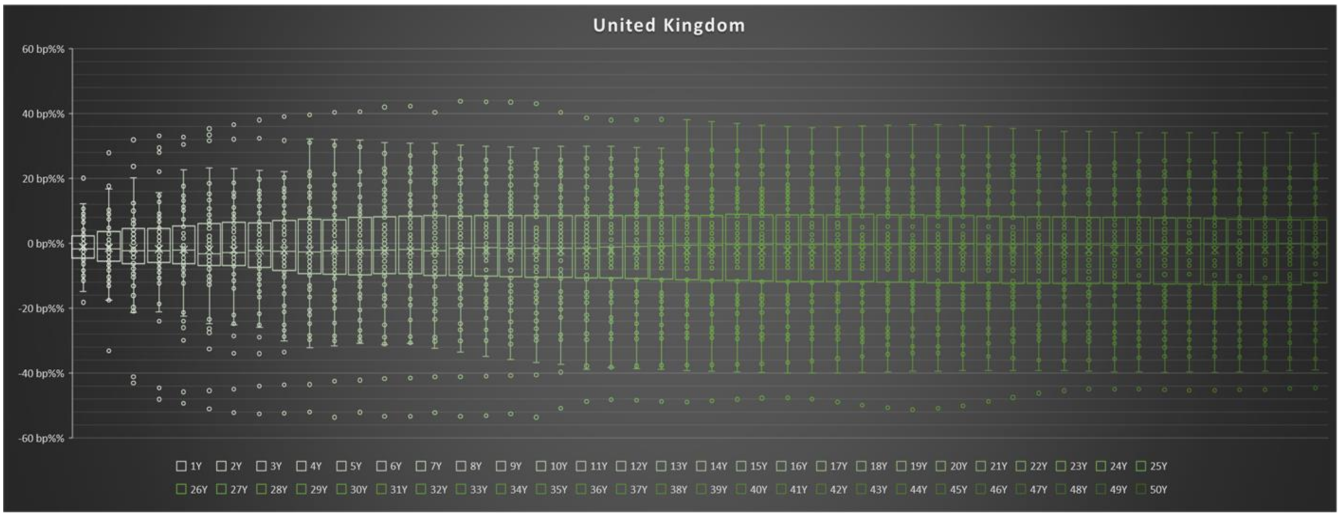
5.2. The box-plots show the mean (X), median and the 25% and 75% percentiles (Q1 and Q3) as well as any outliers outside 1.5 times the IQR (interquartile range: Q3-Q1). Due to the use of the Smith Wilson extrapolation the right side of the graphs after the Last Liquid Point will show a squeezing behaviour due to the enforced convergence to the UFR. On the y-axis, we see the variation in absolute terms measured in basis points (bps).

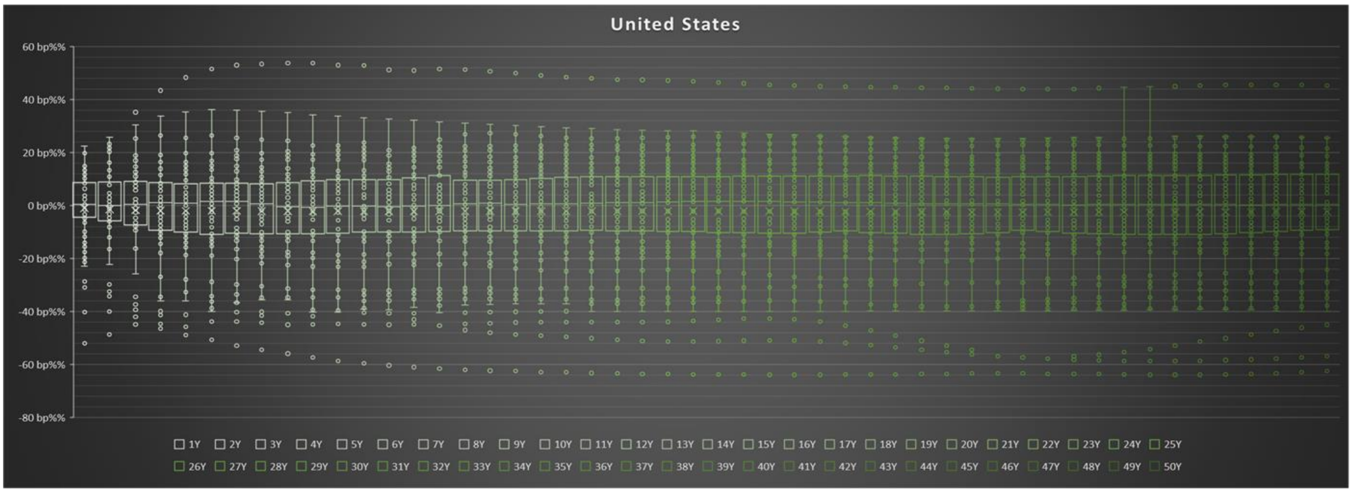
5.3. The plots show the monthly volatility in the rates in question. This info can be used for identifying the optimal timing for the switch to the new OIS curves.

EURO



LIBOR denominated currencies

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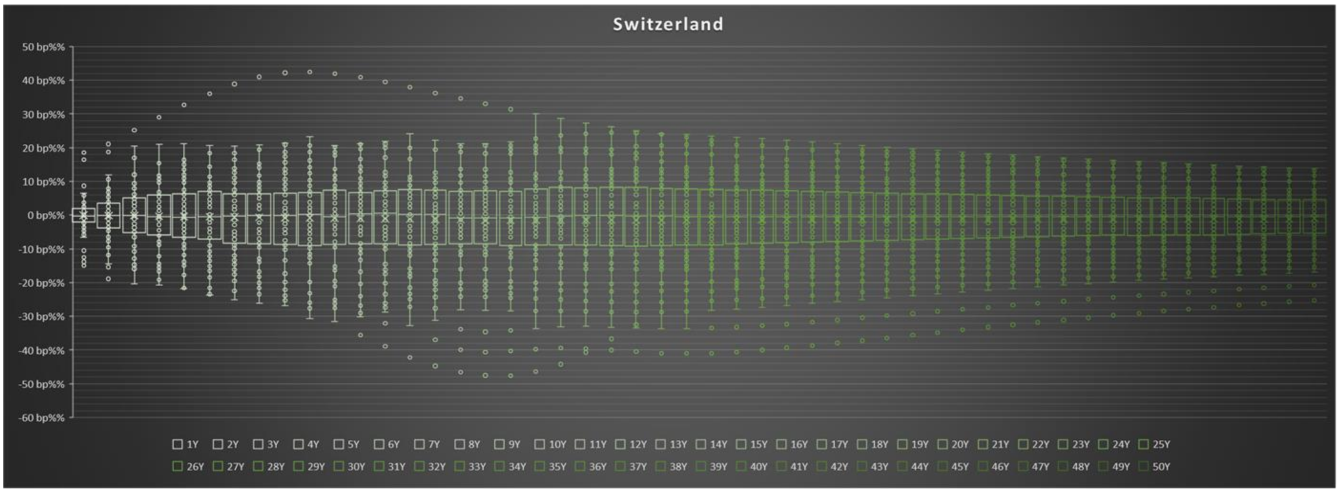
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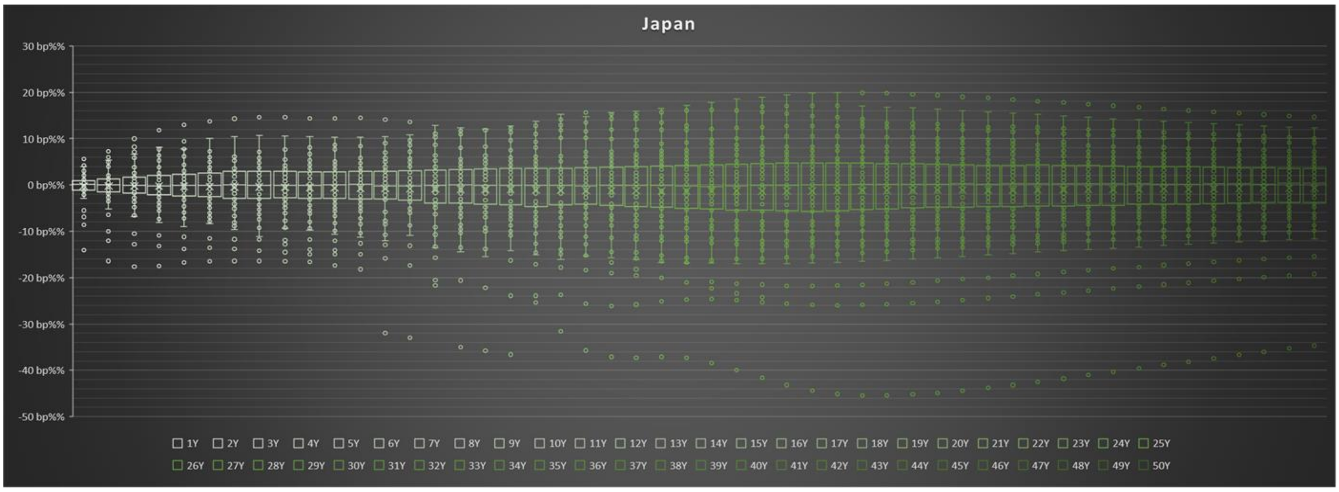
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b) Articles of the Delegated Regulation[10] referring to the Credit Risk Adjustment (CRA)

Article 44

Relevant financial instruments to derive the basic risk-free interest rates

1. For each currency and maturity, the basic risk-free interest rates shall be derived on the basis of interest rate swap rates for interest rates of that currency, adjusted to take account of credit risk.

2. For each currency, for maturities where interest rate swap rates are not available from deep, liquid and transparent financial markets the rates of government bonds issued in that currency, adjusted to take account of the credit risk of the government bonds, shall be used to derive the basic risk free-interest rates, provided that, such government bond rates are available from deep, liquid and transparent financial markets.

Article 45

Adjustment to swap rates for credit risk

The adjustment for credit risk referred to in Article 44(1) shall be determined in a transparent, prudent, reliable and objective manner that is consistent over time. The adjustment shall be determined on the basis of the difference between rates capturing the credit risk reflected in the floating rate of interest rate swaps and overnight indexed swap rates of the same maturity, where both rates are available from deep, liquid and transparent financial markets. The calculation of the adjustment shall be based on 50 percent of the average of that difference over a time period of one year. The adjustment shall not be lower than 10 basis points and not higher than 35 basis points.

[10] Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 12, 17.1.2015, p. 1).

6. Annex II - Summary of Questions to Stakeholders

Questions to stakeholders:

Q1: Do you agree with the overall approach of the immediate switch subject to the two preconditions?

Q2: Do you agree with the way the 'liquidity' condition is defined?

Q3: Do you agree with the way the 'proximity' condition is defined?

Q4: Do you believe the 'proximity' condition has to be met for three consecutive months or a shorter period would be sufficient?

Q5: Do you think there is another condition EIOPA would need to consider for the immediate switch to the new OIS term structures?

Q6: Do you believe that the foreseen changes in the RFR methodology due to IBOR transitions and the method of switching the underlying instruments (depending on the proximity and liquidity condition) could have an impact on the market rates itself, and if so, with what impact and how might this be mitigated?

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Q9: Would you have a view on how to treat the CRA for those currencies for which the CRA is currently being derived from either the CRA for the EUR or the CRA for the USD?

Q10: What is your opinion about the proposed changes in the LLPs and the use of government bonds for the JPY and CHF?

Q11: What is your view on the proposed treatment of the LTAS?

7. Annex III – Privacy Statement related to Public (online) Consultations

Introduction

1. EIOPA, as a European Authority, is committed to protect individuals with regard to the processing of their personal data in accordance with Regulation (EU) No 2018/1725 (further referred as the Regulation).[11]

Controller of the data processing

2. The controller responsible for processing your data is EIOPA's Executive Director.

3. Address and email address of the controller:

   Westhafenplatz 1, 60327 Frankfurt am Main, Germany

   fausto.parente@eiopa.europa.eu

Contact details of EIOPA's Data Protection Officer

4. Westhafenplatz 1, 60327 Frankfurt am Main, Germany

   dpo@eiopa.europa.eu

Purpose of processing your personal data

1. The purpose of processing personal data is to manage public consultations EIOPA launches and facilitate further communication with participating stakeholders (in particular when clarifications are needed on the information supplied).

2. Your data will not be used for any purposes other than the performance of the activities specified above. Otherwise you will be informed accordingly.

Legal basis of the processing and/or contractual or other obligation imposing it

3. EIOPA Regulation, and more precisely Article 10, 15 and 16 thereof.

4. EIOPA's Public Statement on Public Consultations.

Personal data collected

5. The personal data processed might include:

[11] Regulation (EU) 2018/1725 of the European Parliament and of the Council of 23 October 2018 on the protection of natural persons with regard to the processing of personal data by the Union institutions, bodies, offices and agencies and on the free movement of such data, and repealing Regulation (EC) No 45/2001 and Decision No 1247/2002/EC

- Personal details (e.g. name, email address, phone number);
- Employment details.

Recipients of your personal data

5. The personal data collected are disclosed to designated EIOPA staff members.

Transfer of personal data to a third country or international organisation

6. No personal data will be transferred to a third country or international organization.

Retention period

7. Personal data collected are kept until the finalisation of the project the public consultation relates to.

Profiling

8. No decision is taken in the context of this processing operation solely on the basis of automated means.

Your rights

9. You have the right to access your personal data, receive a copy of them in a structured and machine-readable format or have them directly transmitted to another controller, as well as request their rectification or update in case they are not accurate.

10. You have the right to request the erasure of your personal data, as well as object to or obtain the restriction of their processing.

11. For the protection of your privacy and security, every reasonable step shall be taken to ensure that your identity is verified before granting access, or rectification, or deletion.

12. Should you wish to access/rectify/delete your personal data, or receive a copy of them/have it transmitted to another controller, or object to/restrict their processing, please contact [legal@eiopa.europa.eu]

13. Any complaint concerning the processing of your personal data can be addressed to EIOPA's Data Protection Officer (DPO@eiopa.europa.eu). Alternatively you can also have at any time recourse to the **European Data Protection Supervisor (www.edps.europa.eu).**

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