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Corporate Clients

IBOR-Reform

Background, impact and need for action

The world's most important interest rate benchmarks, the so-called IBORs, are to be revised by the end of 2021. This also affects LIBOR, EONIA and EURIBOR, which are used to determine the level of variable interest payments.

The value and interest rates of a wide range of financial contracts such as derivatives, bonds, loans, securitisations and deposits are directly dependent on IBORs. Up to now, they have been calculated using expert assessments by certain panel banks. This method has been the subject of criticism for not being transparent. In 2013, the G20 nations therefore commissioned the Financial Stability Board (FSB) to conduct an analysis of interest rate benchmarks and to develop proposals for reforms and alternatives. This was the starting point for the IBOR reform, which consists of various coordinated initiatives involving supranational organisations, regulators and central banks with the aim to find alternative risk-free rates (RFRs).

Impact

The revision of reference interest rates requires adjustments along the entire value chain – from market segments to downstream units such as settlement, risk and finance. It directly affects almost all variable-rate products. In addition, some fixed rate products also contain dependencies on the relevant benchmarks. Corresponding processes, systems, models and contracts – existing and new – need to be reviewed and, if necessary, modified.

Current status of the IBOR reform in various jurisdictions

The methodological approaches and the timing of their implementation vary considerably from country to country.

In 2016, **the European Union** adopted the EU Benchmark Regulation (BMR), prohibiting the use of benchmarks not calculated in a process approved by the regulator from 2020. The regulation 2019/2089 of the European Parliament has extended the transitional period for significant benchmarks until the end of 2021. As a consequence many reference interest rates, including EONIA and EURIBOR using their previous methodology, will not be admissible as of 2022.

The euro overnight interest rate benchmark EONIA will cease to exist and will be replaced by €STR, a newly defined overnight money reference interest rate published by the European Central Bank (ECB) from 2 October 2019. EONIA will be published on a transitional basis until the end of 2021 using an adjusted methodology (€STR plus 8.5 basis points).

The EURIBOR methodology was adapted to meet the requirements of the EU Benchmark Regulation. The European Money Market Institute (EMMI), the administrator of EURIBOR, obtained regulatory approval for the new 'Hybrid Approach' calculation methodology, which aims to incorporate as much market data from real transactions as possible. The reformed EURIBOR can be used until further notice.

Whether and, if deemed necessary, how EURIBOR will be completely replaced remains uncertain. The International Swaps and Derivatives Association (ISDA) suggests a fallback solution for derivatives based on compounded €STR rates. If this was not extended to cash transactions such as loans and bonds, new basis risks between cash and derivatives would occur. ISDA and the ECB working group are engaged in a close exchange concerning methods to replace or adjust EONIA, EURIBOR and LIBOR benchmarks and to define robust fallback rates.

Other jurisdictions have already established alternative overnight risk-free rates (RFR) (see table).

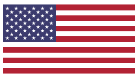
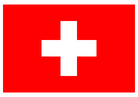
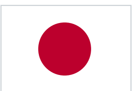
From 2022 onwards, the British Financial Conduct Authority (FCA) will no longer require banks to participate in the calculation of LIBOR indices, meaning that these indices will probably cease to be published. The Federal Reserve (FED) in the US also made clear that they see no future for LIBOR reference interest rates after 2021. USD and GBP LIBOR reference interest rates would then no longer be available for either new business or existing contracts. They presumably will be replaced by term interest rates derived from SOFR or SONIA.

How Commerzbank is preparing for the reform

Commerzbank is analysing the possible effects of various scenarios and continuously monitoring further developments. Commerzbank intends to keep its customers informed on technical and economic implications as soon as regulatory uncertainties diminish. The bank prepares for the discounting change of derivatives by June 2020 and for possible discontinuations of interest rate benchmarks by January 2022, respectively.

If you have any questions, please send an email to IBOR_Transition_Client_Questions@commerzbank.com.

Overview of newly defined overnight money reference interest rates in other jurisdictions

Responsibility[1]	Alternative RFR	Description	Type	Data/Transaction source	Market instrument for RFR
	**SOFR:** Secured Overnight Financing Rate	– Fully transaction-based – Encompasses a robust underlying market – Risk-free overnight reference rate	Secured	Tri-party repos, FICC* GCF** repo, FICC bilateral treasury repo	✓
	**SONIA:** Reformed Sterling Overnight Index Average	– Fully transaction-based – Encompasses a robust underlying market – Risk-free overnight reference rate	Unsecured	Unsecured overnight sterling transactions negotiated bilaterally and brokered in London by WMBA***	✓
	**SARON:** Swiss Average Rate Overnight	– Repo rate reflecting interest paid on interbank overnight repo transactions – First SARON future trades took place	Secured	CHF repo transactions in the interbank market[2]	✓
	**TONAR:** Tokyo Overnight Average Rate	– Fully transaction-based for uncollateralised overnight call rate market – Rate is published by the Bank of Japan on a daily basis using the information provided by Tanshi (money market broker) – Calculated as an average, weighted by the volume of transactions corresponding to the rate	Unsecured	Data provided by money market brokers	✓

* Fixed Income Clearing Cooperation (FICC)
** General Collateral Financing (GCF)
*** Wholesale Markets Brokers' Association
1 Except Switzerland all rates are managed by the respective central bank. In Switzerland this task is performed by the SIX Swiss Exchange
2 As well as non-binding rates published on the Six repo trading platform

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