Reform of the reference interest rates. What the changes mean for you.

More transparency, additional stability.

WHAT IS A REFERENCE INTEREST RATE AND WHY IS IT IMPORTANT?

A "benchmark" is a pre-determined standard against which the performance of financial investments and lending costs are measured.
A benchmark can be used to measure the performance of an index, a security or even an investment manager. For example, mutual fund performance is often compared to changes in the "benchmark" Standard & Poor's 500 Stock Index. A benchmark can also be used to define the asset allocation of a portfolio or for computing the performance fees.
A benchmark can be used as a useful basis for cash products (corporate loans, consumer loans, mortgages overdrafts) and non-cash products (other more complex financial transactions such as derivatives).
Banks use benchmarks for interest rates when they calculate interest on loans, notes and deposits. For example, banks might lend money at an agreed interest rate that is indexed to a particular benchmark rate plus a spread. If the spread is set at 1%, then the interest paid will be 1% more than the current benchmark rate. So, the cost of the loan goes up if the benchmark rate goes up and vice versa. In this case, the benchmark can be a reliable, independent, and relatively simple reference for all the involved parties.
Interest Rate Benchmarks are crucial to financial stability and therefore play a central role in financial markets because they are widely used by individuals and organizations throughout the economic system. The most common interest rate benchmarks are the EURIBOR and the London Interbank Offered Rate (LIBOR). They form a basis for lending and borrowing prices for the global financial system.

BACKGROUND OF IBOR (INTERBANK OFFERED RATE) REFORM.

In 2013, the G20 asked the Financial Stability Board (FSB) to undertake a fundamental review of major interest rate benchmarks and develop plans for possible changes to ensure that these benchmarks are robust, reliable, and appropriately used by market participants.
In July 2014, the FSB published its recommendations, which essentially set out two core objectives: (1) reform IBORs (Interbank Lending Rates, of which LIBOR is one of the most commonly used) to strengthen existing methodologies, and to make them more grounded on actual transactions; and (2) develop alternative reference rates meeting the requirement for robust reference rates.
In this context, the FSB called for significant and sustained efforts by regulators and by financial and non-financial firms across many jurisdictions to transition away from all London Interbank Offered Rate (LIBOR) at latest by end-2021 in order to mitigate potential risks arising from the expected cessation of LIBOR.

EU BENCHMARK REGULATION (BMR).

The EU Benchmark Regulation 2016/1011 (BMR) – which took effect January 1st 2018 – made the EU among the first areas to impose a comprehensive, legally binding regulatory regime governing financial benchmarks. BMR prohibits EU-supervised users from using a benchmark unless its administrator is approved by a national regulator in one of the EU Member States and appears on the benchmarks register maintained by the European Securities and Markets authority (ESMA), an EU supranational supervisory authority.
More importantly for borrowers and lenders, BMR requires that such contracts and agreements include sustainable fallback arrangements, which state what benchmark rate parties will use if the initially agreed benchmark rate is no longer available.

BMR AMENDMENT.

On 22nd Jan 2021 the European Commission and the Council of Europe Union issued amendments to the Benchmark Regulation (EU) 2016/1011, entered in force on 13 February 2021. The Amended BMR empowers the European Commission to designate a replacement of critical benchmarks and other relevant benchmarks (should their termination significantly disrupt the financial markets of the EU or no longer reflects the underlying market or economic reality), by means of delegated acts. Such a replacement by law ("Statutory Replacement Rates ") will affect any contract or any financial instrument governed by the law of one of the EU Members States that reference a benchmark. Also contracts subject to the law of a third country are in scope where all the parties are established in the EU and where the law of that third country does not provide for an orderly wind-down of a benchmark. The Statutory Replacement Rates shall replace all references to that benchmark in such contracts and financial instruments if they do not contain a suitable fallback clause.
Statutory Replacement Rates will be defined by European Commission after a public consultation considering the recommendations of National RFR Working Group (e.g.
Alternative Reference Rates Committee for USD Libor, Working Group on Sterling Risk-Free Reference Rates for GBP Libor).
Moreover, the amendment also extends the current transition period for third country benchmarks until the end of 2023.

REFORM AT A GLANCE.

As financial markets transition from the use of LIBOR to an alternative, affected market participants need to prepare in a timely manner so that the transition can occur smoothly. Below is a brief overview.

EURIBOR: CAN CONTINUE TO BE USED AS A BENCHMARK UNDER BMR RULES.

The Euro Interbank Offered Rate (EURIBOR) is an unsecured market benchmark rate calculated by a panel of selected banks, and administrated and published by the European Money Markets Institute (EMMI) for several maturities (one week, and one, three, six and twelve months).
In order to satisfy the requirements of the European Benchmark Regulation, EMMI has developed a new calculation methodology (so called "Hybrid Methodology"). Under the new Hybrid Methodology, EURIBOR is calculated using real transactions whenever such transactions are available.

FROM EONIA TO €STR.

The calculation methodology of EONIA would have become non-compliant with the EU BMR, given the scarcity of underlying transactions and high concentration of volumes among a small number of contributors.
In order to maintain EONIA for a transitional period and until its discontinuation on January 3rd 2022, its methodology has been changed and, since October 2nd 2019, EONIA has been computed as €STR plus a fixed spread of 8.5 basis points. The €STR reflects the wholesale euro unsecured overnight borrowing costs of largest euro area banks and is based exclusively on real transactions reported to the ECB.
EONIA will be published for the last time on January 3rd 2022 and discontinued thereafter; all contracts maturing after this date and referring to EONIA must have a written fallback clause providing for its substitution.

FROM LONDON INTERBANK OFFERED RATE (LIBOR) TO ALTERNATIVE REFERENCE RATE (ARR).

LIBOR, the London Interbank Offered Rate, is currently produced centrally in London by ICE Benchmark Administrator in seven tenors (or lengths), from overnight up to 12 months, for 4 currencies (see the table below) and the UK's Prudential Regulation Authority (PRA) is responsible for its regulation.
The Financial Conduct Authority (FCA) has made it clear that the publication of LIBOR is not guaranteed beyond 2021 and thus firms must transition the existing contracts to Alternative Reference Rates before this date (ARRs).
ARRs are overnight nearly risk-free reference rates, which have been identified as alternative benchmarks for the existing key interbank offered rates (IBORs). Such rates are robust and are anchored in active, liquid underlying markets.

A selection of possible alternatives to LIBOR around the world:

LIBORS	ARRS
LIBOR USD	**SOFR** Secured Overnight Financing Rate (Secured Transactions)
LIBOR GBP	**SONIA** Sterling Overnight Index Averarge (Unsecured Transactions)
LIBOR JPY	**TONAR** Tokyo Overnight Average (Unsecured Transactions)
LIBOR CHF	**SARON** Swiss Average Rate Overnight (Secured Transactions)

LIBORS.

On March, 5th 2021 "the FCA has confirmed that all LIBOR SETTINGS will either cease to be provided by any administrator or no longer be representative: immediately after 31 December 2021, in the case of all sterling, euro, Swiss franc and Japanese yen settings, and the 1-week and 2-month US dollar settings; and immediately after 30 June 2023, in the case of the remaining US DOLLAR SETTINGS ".
The FCA will hold consultations on a proposal to require continued publication of the most representative tenors (1M, 3M and 6M) of GBP, JPY and USD LIBOR rates on a synthetic basis aimed at smoothing legacy contracts transition.

CONTRACTUAL REGULATION OF A SUCCESSION INDICATOR.

To address the risk that one or more LIBORs or benchmarks are discontinued while market participants continue to have exposure to that rate, financial institutions and clients are encouraged to define successor indicators in the contracts, i.e. ARRs that serve as substitute interest rates.
The fallback rates are being developed to ensure contracts' continuity once LIBOR is discontinued. Furthermore, market participants must ensure that the contracts align as closely as possible to the original agreement after the fallback kicks in, resulting in a rate that is predictable, transparent and fair.
Work is underway across numerous jurisdictions to develop contractual fallbacks to mitigate the risk associated with the uncertainty of LIBOR's existence post-2021 and therefore to reduce potential uncertainties if it ceases to be used.

THE IMPACTS FOR OUR CLIENTS.

The IBOR reform impacts existing/new contracts, and particularly credit agreement and financial contracts indexed to a LIBOR. Whilst LIBOR will continue to be published until the end of 2021, the Bank of England and the Financial Conduct Authority and the Working Group on Sterling Risk-Free Reference Rates expect all UK-based financial institutions to cease issuing new LIBOR-based products maturing beyond 2021 by the end of 1Q 2021. Consequently, UniCredit will review its offer according to which benchmark rates are available on the markets and within the regulatory framework.

UNICREDIT AT WORK.

UniCredit set up a dedicated working group aimed at ensuring compliance with the European Benchmark Regulation (BMR) and managing an orderly transition from LIBOR to ARRs. Moreover, UniCredit is taking part in several international working groups to foster the IBOR transition process.
In order to further promote education and awareness on IBOR transition, in line with best recommended practices, UniCredit Group through its RESEARCH TEAM publishes flash news, WEB CAST on UNICREDIT RESEARCH PORTAL.

MARKET DEVELOPMENT IN DERIVATIVES BUSINESS.

In the area of OTC derivatives, the International Swaps and Derivatives Association (ISDA) launched its IBOR Fallbacks Supplement to the 2006 ISDA Definitions and accompanying ISDA 2020 IBOR Fallbacks Protocol both effective as of January 25, 2021. UniCredit Spa, UniCredit Bank AG and UniCredit Bank Austria AG adhere to it in February 2021.
The IBOR Fallbacks Supplement introduces a set of specific fallbacks that apply in case IBOR becomes non-representative or ceases to be provided. Trades that reference ISDA´s standard interest rate definitions gain contractual certainty of replacement rates which are based on currency-specific risk-free overnight rates, compounded in arrears plus a spread adjustment. The Relevant IBORs covered by the ISDA IBOR Supplement are: GBP LIBOR, CHF LIBOR, USD LIBOR, EUR LIBOR, EURIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR, BBSW, CDOR, HIBOR, SOR and THBFIX.
Derivative contracts which reference the ISDA 2006 Definitions entered into force on or after January 25, 2021, will contain the terms of the IBOR Fallbacks Supplement automatically. The ISDA 2020 IBOR Fallbacks Protocol permits a party to amend its non-cleared legacy IBOR denominated contracts with other adhering parties to include the terms of the IBOR Fallbacks Supplement. Derivative contracts concluded on the basis of the Austrian Master Agreement for Financial Derivate Transactions shall be adjusted individually by means of a clause in the trade confirmation or by means of a so-called bridge solution with reference to the ISDA-IBOR Supplement. The ISDA 2020 IBOR Fallbacks Protocol applies solely to existing transactions between counterparties that both have adhered to the protocol. Relevant contracts and trades are those traded before 25 January 2021 and are included in the list of various documentation types ("Protocol Covered Documents") within the ISDA IBOR Fallbacks Protocol.
Further information on the ISDA 2020 IBOR Fallbacks Supplement and Protocol, related documentation and ISDA's initiatives on benchmark reform and transition from IBORs is available on ISDA WEBSITE.
ISDA has published the FOLLOWING STATEMENT in response to FCA announcement on March, 5 2021 on the future cessation and loss of representativeness of the LIBOR benchmarks "the fallback spread adjustment published by Bloomberg is fixed as of the date of the announcement for all euro, sterling, Swiss franc, US dollar and yen LIBOR settings".

EXTERNAL SOURCES.

Further useful information relating to the IBOR reform can be found on the websites of the national working groups and industry bodies.

THE WORKING GROUP ON EURO RISK-FREE RATES

ALTERNATIVE REFERENCE RATES COMMITTEE (ARRC)

THE WORKING GROUP OF STERLING RISK-FREE REFERENCE RATES

THE NATIONAL WORKING GROUP ON SWISS FRANCE REFERENCE RATES

CROSS-INDUSTRY COMMITTEE ON JAPANESE YEN INTEREST RATE BENCHMARKS

INTERNATIONAL SWAPS AND DERIVATES ASSOCIATION, INC (ISDA)

LOAN MARKET ASSOCIATION (LMA)

DISCLAIMER.

The content of this page reflects UniCredit's current understanding of the IBOR Transition and are subject to change. Please note that the overview provided here is not meant to be complete nor exhaustive. It is not intended to substitute a thorough assessment by independent professionals how these developments may impact you or your organization and does not constitute advice or recommendation. UniCredit will seek to update this page periodically and/or provide communication relating to market developments on the benchmark interest rate reform.

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Errors and misprints excepted.
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