MILLIMAN BRIEFING NOTE

IBOR Transitions Updates – Latest from EIOPA and Others

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EIOPA

The European Insurance and Occupational Pensions Authority (EIOPA) recently published its first, and a long-awaited, discussion paper on IBOR transition. The paper centred on the challenges to be faced by EIOPA, and insurers under Solvency II, in the continued production of the Risk-Free Rate (RFR) during the IBOR transition period.

Key topics covered in the discussion paper are:

1. ***Credit Risk Adjustment (CRA)***; logically, the need for a CRA falls away if the risk-free curve is based on Overnight Index Swap (OIS) rather than Interbank Offered Rates (IBOR), but insurers have previously been concerned that a change to the Solvency II Delegated Regulation would be required to remove the minimum 10bps floor on the CRA under Article 45.

   In the discussion paper, EIOPA supported the proposal of setting the CRA to zero for an RFR based on OIS swaps, arguing that under Article 44 the need for a CRA doesn't arise if the swaps are risk-free, so Article 45 doesn't apply. However, they acknowledged that an alternative would be maintaining a minimum 10bps CRA to the term structure.

2. ***RFR production***; three options for the continued production of the RFR term structure during the IBOR transition period have been put forward by EIOPA. They are:

   - an instant and automatic switch to a new OIS based RFR, with a notice period, when a pre-defined Deep Liquid and Transparent (DLT) trigger was met;
   - a phased switch, with a blended RFR based on IBOR and OIS with a single weight; and
   - a phased switch, with a blended RFR based on IBOR and OIS with a weight which has a term structure.

   EIOPA supported option 2), where the weights would be based on relative trading volumes across all tenors, which had the advantage, in EIOPA's view, of avoiding data breaks in the RFR structure, but invited feedback from all stakeholders. The transition to a fully OIS based curve would be completed when the trading volumes in OIS reached 85% of the total.

Our observations:

1. *EIOPA's view on their ability to remove the CRA for OIS based curves without needing to amend the Solvency II Delegated Regulation is consistent with our own.*
2. *EIOPA requires OIS to be deemed DLT across the whole curve to Last Liquid Point (LLP), e.g. 50 years for GBP, before it can be taken into account at all. At this moment, this is, in their view, not true in any market. However, in our view the liquidity could shift materially and rapidly (e.g. as a result of the consultation outcome) and that liquidity in GBP is likely to shift quicker than in EUR.*
3. *EIOPA state that they have a tool to monitor depth and liquidity in the IBOR versus OIS markets. We believe that publishing this data would aid the transparency of the transition process.*
4. *EIOPA stated their intent to only reflect the developments in the market in the context of RFR production, as opposed to leading it. This is understandable, although it is expected that the final outcome of the RFR methodology consultation can itself potentially create an incentive for insurers to transition to OIS, which in turn creates the need liquidity and depth.*
5. *EIOPA's consultation does not address the issues of basis risk capital in internal models, for differences between hedges and the risk-free rate, and of how transitional may be impacted. However, we see that as more in the scope of the national supervisors, e.g. PRA in the UK.*
6. *For UK insurers, the power to set the risk-free rate will, in any case, move to the PRA following the end of the transitional period, currently scheduled for 1 January 2021. The PRA may be influenced by decisions made by EIOPA, depending on the status of equivalence discussions, but are generally more likely to wish to facilitate a switch to OIS based discounting.*

The closing date for the response to the discussion paper is set for April 30th, 2020.

Other recent developments

The Bank of England (BofE), together with the Financial Conduct Authority (FCA) and the Working Group on Sterling Risk-Free Reference Rate (RFRWG), have made significant progress in steering the UK's market practisers' preparation and actions in IBOR transition.

A considerable amount of useful material and information had been published on the BofE's website.

The most important developments, in our view, include:

1. BofE and FCA jointly announced to encourage UK's market makers to change the market convention for sterling interest rate swaps from LIBOR to SONIA in Q1 2020, and also to encourage all market participants to prioritise SONIA over LIBOR from March 2nd, 2020, and onwards, with a key milestone set for ceasing GBP issuance of LIBOR-based loans by Q3 2020.
2. BofE, FCA and RFRWG issued a joint statement to announce the publication of a set of documents to highlight key milestones to reduce company's LIBOR exposure ahead of end-2021. Within the statement, BofE and FCA offered their support to RFRWG's priorities and the work so far, and welcomed the publication of various documents by RFRWG along the statement.

In addition, the International Swaps and Derivatives Association (ISDA) announced a re-consultation on pre-cessation fallbacks following a failure to reach a market consensus on this topic back in October 2019. The re-consultation, which is expected to be published later this February, follows the publication of letters from the FCA and ICE Benchmark Administration on the time for which LIBOR might be published following a regulatory statement that it is no longer a representative benchmark. It will propose updated approaches and protocols to be applied on both pre-cessation and permanent cessation bases.

The LCH announced a consultation on rulebook change to use the adjusted RFR with a credit spread adjustment approach in scenarios of both pre-cessation and permanent cessation events. The closing date for this consultation is March 23rd, 2020.

How Milliman can help

While the publication of the above statements and documents, from both the UK and EU regulators, provides welcome clarification, it accelerates the need for insurers to have robust transition plans in place, including for legacy hedging programs.

Milliman consultants have been involved in the IBOR reform process since 2017, including working with investment banks and insurers and issuing insightful thought pieces in GBP and USD markets. Milliman is also a member of the ECB's EUR RFR Working Group.

Milliman Financial Risk Management LLC provides investment advisory, hedging and consulting services on over $150 billion in global assets (as of December 31, 2019). This includes managing interest rate swap hedge portfolios on a range of different IBOR currencies for its global client base, and provides Milliman with hands-on experience of how its global clients are contending with these key issues.

To discuss this note or any related topics please contact Neil Dissanayake, or Sihong Zhu, or your usual Milliman consultant

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