EUROPEAN INSURANCE
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IBOR transitions

Discussion paper overview

- Following the new EU Benchmark Regulation (EU BMR), EIOPA addresses for the first time the subject of the ongoing changes to the new benchmark rates (or IBOR transitions).

- IBOR transitions are a big challenge for both the regulators and the industry since they will affect:
  (a) Liability valuations
  (b) Derivative valuations
  (c) The structure of numerous (existing and new) financial and insurance products

- The focus of this discussion paper is to address the issues identified within the EIOPA Risk free rate (RFR) environment.

- We are building on the existing EIOPA RFR methodology and we try to propose options and solutions for consideration.

Approach

- IBOR transitions is a market driven change. EIOPA seeks to adopt a common approach across the EU to the transition to the new rates.

- EIOPA's approach against the IBOR transitions seeks to reflect current market conditions rather than leading them.

- The aim is to continue producing consistent RFR term structures.

- According to the RFR methodology, the choices proposed by EIOPA, are designed to secure the following objectives:
  - (a) Replicability of the methodology by undertakings
  - (b) Market consistency of the RFR term structures produced
  - (c) Stability for insurance undertakings
  - (d) Interests of policyholders (not applied in this case)
  - (e) Feasibility of the implementation within the RFR framework
- All criteria have been considered thoroughly.

Impact on RFR Methodology

Impact on Credit Risk Adjustment (CRA)

- Benchmark rates, in particular IBORs, embed credit risk. In order to adjust for this credit risk, EIOPA is applying the CRA.

- The calculation of the CRA has been developed in accordance with recital 20 and Article 45 of the Delegated Regulation (Article 45, see Annex) which states:

"…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…."

- Within some jurisdictions, it has been decided that the specific IBOR based swap instruments will cease to exist and markets will adopt new OIS based swap instruments.

- OIS rates are considered to be risk free. Therefore, when the floating rate of the interest rate swap is changed from IBOR to OIS, based on the definition of the CRA, the spread of the two rates would become zero and hence no credit risk adjustment would be needed.

Impact on RFR Methodology

- However, the Solvency II delegated regulation prescribes a minimum credit risk adjustment of 10 bp and a maximum adjustment of 35 bp

- This will lead to the paradoxical situation in which a credit risk adjustment would be applied to what is considered a risk-free rate

We see two possible options in order to address the CRA issue within the RFR methodology:

- Option (1): Do not perform any change and continue applying a minimum 10 bps to the RFR term structure.

- Option (2): Leave the corridor '10 to 35 bps' unchanged for IBOR based swaps and set the CRA to zero for the fully OIS based swaps.

Impact on the DLT assessment

- Continuous monitoring of market volumes is taking place in order to determine if and to what extent the new OIS instruments satisfy the Deep Liquid and Transparent criteria (DLT) for all maturities up to Last Liquid Point (LLP). The DLT test is an additional prerequisite for the new instruments before they can be included in the RFR term structure production.

Impact on RFR Production

- Due to the IBOR transitions, the existing interest rate swap (IRS) products will become less liquid due to being (gradually) transformed into new/reformed IRS products.

- This will change the available tenors of IRS for the construction of the relevant risk-free rate term structures.

- Once the DLT status of the RFR term structure based on the new swaps has been determined, the new instruments would need to enter in production.

- During the 'transition' period from the old to the new swap instruments there are likely to be two liquid term structures (the old and the new), for an unknown period of time.

- Three options on the way this issue can be addressed are proposed:

Impact on RFR Production

Option 1 - Replace the whole old curve of a specific currency with the new one once the total volume of the swaps traded under the new rate reach a specific pre-defined threshold (e.g. 55%, 65% or 75% of total) for all deep, liquid and transparent (DLT) points of the term structure.

Options 2 and 3 – Gradually replace the curves of a specific currency based on the old rate with a combination of instruments of old and new rates. The transition will occur progressively for each currency subject to the volumes traded and data availability.

Option 2 - Total volume based approach - The ratio of the total volume of all DLT points for OIS instruments to the total volume of all DLT points for both instruments is calculated and applied as a weight to the tenors of the curve

Option 3 - Tenor bucket volume approach - The whole curve is divided into buckets of 10 tenors, i.e. 1-10Y, 11-20Y, etc. The ratio of the total volume of all DLT points in one bucket for OIS instruments to the total volume of all DLT points in one bucket for both instruments is calculated and applied as a weight to the tenors of the curve for this specific bucket

Next steps

- Stakeholders will be invited to provide EIOPA with their feedback the end of April

- Based on this feedback, EIOPA will produce a consultation paper, which will include policy recommendations on the subject of IBOR transitions within the RFR environment.

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Thank you for your attention!