Background Note

Agenda Item: 4

To: Solvency II Working Group

From: Prudential Team

Meeting:

Reference: ECO-SLV-19-109

Subject: Risk-free rate transition and its impact on Solvency II

Objective
For information and discussion

Member's input requested
Members will be requested to:
- provide feedback on the secretariat's analysis of the potential implications for Solvency II arising from the expected changes to benchmark risk-free rates;
- provide guidance to the secretariat on any next steps.

Comments
The reform of benchmark reference interest rates such as EURIBOR and LIBOR is a global initiative, proposed by the Financial Stability Board (FSB) in 2014 because of the decline in the interbank lending markets after the global financial crisis and the series of market manipulation and false reporting scandals.

While work has been ongoing in various jurisdictions for several years, recently there has been renewed impetus from some central banks and supervisors for financial market participants to ensure they are ready for the transition to the new reference rates. The EU Benchmark Regulation has set a transition deadline of 1 January 2020 for Euro rates and the UK supervisory authority has stated that it will no longer support LIBOR after 2021. Other jurisdictions have similarly challenging deadlines.

The current situation regarding the ongoing process of transition near risk-free interest rates, is the following:

Currency:	**EURO (EUR)**		**Pound Sterling (GBP)**	**Swiss Franc (CHF)**	**US Dollar (USD)**
Benchmarks in use:	EURIBOR	EONIA	LIBOR	CHF (IBOR)	US LIBOR
Expected replacement:	EURIBOR	€STR	SONIA	SARON	SOFR

EIOPA RFR Curve

From a Solvency II perspective, the main issue which needs to be considered and understood is the impact that the changes will have on the EIOPA RFR curves and consequently the impact on liability valuations.

Changes to the benchmark rates could impact the derivation of the RFR curve in two ways; 1) the choice of swap contracts which are used to construct the EIOPA curve and 2) the derivation of the credit risk adjustment (CRA).

The secretariat's understanding of the current situation for the main European currencies is as follows:

- **For the EUR curve, the secretariat does not expect any significant change to occur in the short term because EURIBOR is expected to continue under a newly-revised hybrid methodology.** (although this has yet to be formally confirmed).
  - As the EURIBOR benchmark will continue as reference rate, it is expected that there will be no change in the swaps underlying the EIOPA EURO RFR Curve.
  - However, as EONIA is being replaced by €STER, there could be a change to the calculation of the CRA (which is calculated as a 50% of the 1-year rolling average of the difference between EURIBOR and EONIA). However, using the ESTER simulated data which has already been published, the secretariat has assessed that this would have not had any impact on the value of the CRA.

- **For the GBP curve, the obsolescence of LIBOR appears to be inevitable. The overall impact on the EIOPA GBP RFR curve of the transition to SONIA has been estimated to be a reduction in the level of the yield curve of between 15-30 basis points (see ECO-SLV-19-055).**
  - The choice of swap contracts underlying the EIOPA GBP RFR curve is expected to change SONIA-based swaps which have lower yields than the current LIBOR-based swaps.
  - However, possible changes to the calculation of CRA may offset this reduction to an extent (because SONIA is considered near risk-free there does not appear to be any prudential or economic reason to make an adjustment for credit risk).

There will likely be similar impacts to GBP curve for other currencies where changes to the reference rates are envisaged, such as US Dollar. This will clearly impact insurers who have liabilities in these currencies.

EIOPA work

The secretariat has previously engaged with EIOPA on an informal basis about the changes to the benchmark interest rates. EIOPA has noted that it is monitoring the situation, but it appears that no firm action has been taken to date on this topic.

The issue has also not been raised either by the Commission in its Call for Advice or by EIOPA in the recent workshop on the 2020 Review.

Potential next steps

Currently, it appears that the changes to the benchmark interest rates will be most acutely felt in the UK market. However, there could potentially be changes to the derivation of the EIOPA RFR curves for other currencies as well as changes to the Credit Risk Adjustment for the Euro curve.

In light of this, members are requested to provide guidance to the secretariat on any next steps it should take beyond continuing to monitor the situation. Examples of potential actions are:

- Request expected timelines from EIOPA to understand when changes to RFRs may occur.
- Re-engage with EIOPA to determine what work, if any, they are currently doing in preparation for the changes and how industry could provide feedback on these proposals.
- Incorporate industry position on the Credit Risk Adjustment into the more general position on RFRs as part of 2020 Review.

Background

In July 2014, the FSB recommended a transition from interbank offer rates (IBOR) to overnight near risk-free rates across all major currencies. The transition from IBOR to near risk-free benchmarks was motivated by a number of reasons, including:

- lack of liquidity in interbank unsecured funding markets

- increasing reliance on expert judgment, with consequences on predictability
- misconduct within the market
- inadequacy due to the presence in the IBOR markets of a bank term risk premium.

In Europe, the current derivation methodologies of both EONIA and EURIBOR do not comply with the required specifications for future benchmarks. The administrator of these benchmarks, EMMI, has indicated it will not pursue an update of the EONIA rate. This will be replaced by €STER which will now be administered by the European Central Bank.

However, EMMI does continue to pursue changes to EURIBOR which would make it compliant. The decision of whether the changes meet the requirements lies with the Belgian Financial Markets and Services Authority. No formal decision has been made but it is expected that the Belgian FSMA will grant the necessary authorisation.

In the UK, the working group tasked with recommending a new risk-free rate to replace LIBOR, recommended the SONIA benchmark as their preferred risk-free rate in April 2017.

In terms of timelines, the €STER rate will first be published on 2 October 2019. The European Benchmark Regulation sets a deadline of 1 January 2020 and rate administrators are expected to stop publishing InterBank Offered Rates (IBORs) by end of 2021.