



Working Group on Euro Risk-Free
Rates
Subgroup 6 reporting

29 August 2019

>>> Agenda

1

Timeline

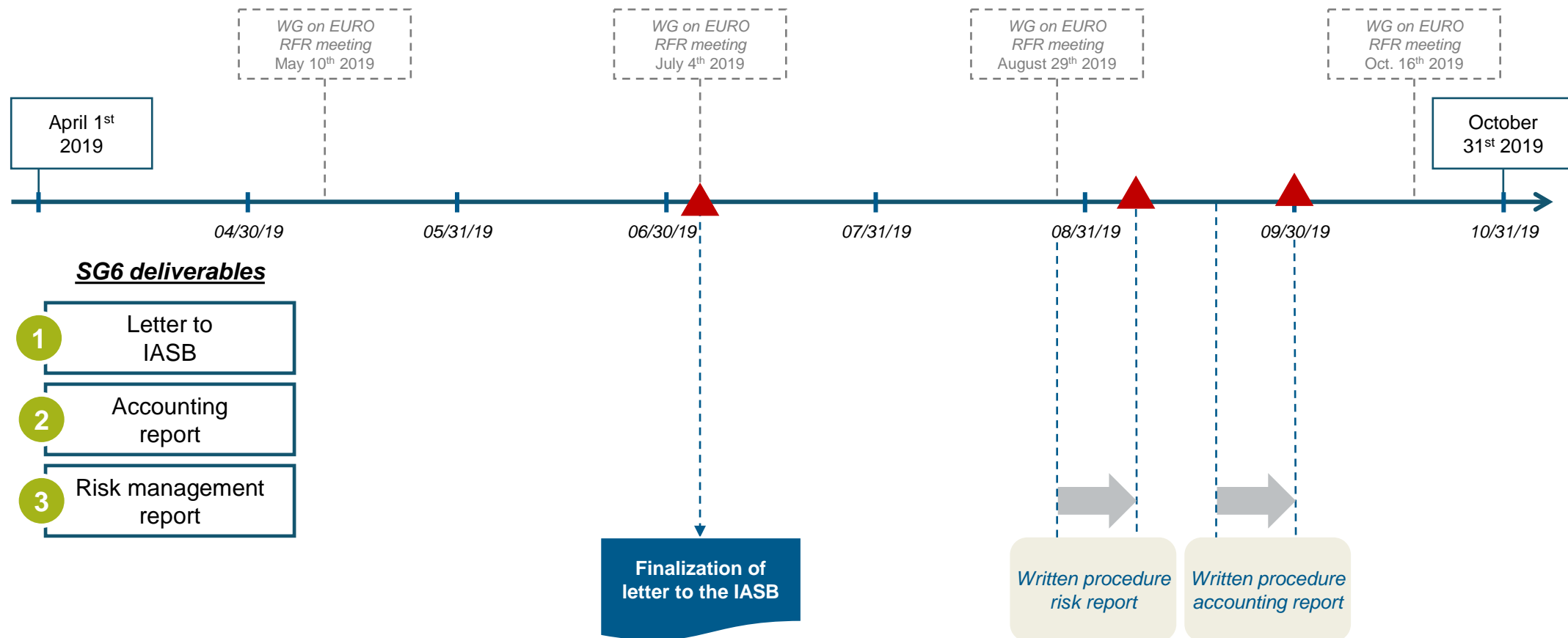
2

Status update: Risk management

3

Status update: Accounting

>>> Intended timeline for subgroup 6





»»» Developments risk management (1/5)

Key messages of the report

- The **transition from EONIA to €STR should not be underestimated** since EONIA is not only used as the floating rate option in financial contracts and instruments. It is also highly relevant for valuation purposes for most financial institutions.
- Given the widespread use of critical interest rate benchmarks the EONIA to €STR transition is **impacting multiple functions along the value chain of many financial institutions** – impacts are expected in the fields of financial instruments and contracts, trading and banking book systems, front-end and back-end systems, valuation and pricing models, financial and risk reporting etc.
- If not already done, each institution should immediately **set up a detailed transition plan** that should be based on assessments of key risks and enable delivery at the latest by end-2021. The plan should consider quantitative and qualitative aspects such as identification of relevant exposures, systems affected and the adaption of contract languages and client communication. It should also entail - amongst others - a detailed **implementation concept for the relevant IT systems, data feeds and new product processes** and specify switch and adjustment dates. Milestones to consider in the transition plan comprise, among others:
 - 2 October 2019: €STR starts to be published.
 - Mid-2020: Time recommended by the WG to central counterparties to switch the PAI and discounting methodology from EONIA to €STR.
 - 3 January 2022: EONIA ceases to exist.

»»» Developments risk management (2/5)

Key messages of the report

1

Market risk & regulatory aspects

- For institutions for which EONIA is a relevant risk factor, **new €STR referencing products** and **€STR risk factors** respectively **€STR scenarios have to be integrated** into the calculations of: VaR, Stressed VaR, sensitivities and stress testing. Also, the P&L calculation as well as the backtesting framework has to be extended.
- To run stress tests and calculate risk measures, **€STR time series** covering ideally a full economic cycle (including stress periods) are required. Given the high correlation between EONIA and pre-€STR and the fixed spread between EONIA and €STR, it seems reasonable to use past EONIA data as a proxy.
- For institutions using internal model approaches for the calculation of own funds requirements, the **quantification of changes in market risk** figures is mandatory.

2

Fallback aspects

- Governance framework is recommended involving front office and risk functions to **monitor the benchmark and contractual fallback exposures**.
- **Avoid inconsistencies** in fallback provisions, especially for hedging relations:
 - Fallback trigger
 - Fallback rate
 - Spread adjustment
- Inconsistencies are a potential source of P&L volatility and (interest rate) basis risk.
- Fallback readiness is an **operational challenge**.
- Therefore, **limit the different possibilities** of fallback methodologies and technical implementation details.

3

Asset management & insurance aspects

- **Solvency II framework:** For **insurance companies** implications on liability valuation and reported capital position will arise if the market in €STR becomes sufficiently liquid, compared to EURIBOR, and the regulatory risk-free curve shifts to €STR.
- However, this would require a decision from EIOPA and a change to the regulations, which is not expected to happen in the near future.
- Given the direct and indirect exposure to various benchmark rates **asset managers** also need **detailed transition plans** (e.g. for contracts, valuation, risk models) and mitigating actions.
- **Asset management specific issues**, such as outsourcing to third parties, investment guidelines and client communication need to be taken into account for both the transition to €STR and the introduction of new fallbacks.

»»» Developments risk management (3/5)

Main implications on market risk management

i Setup of the ability to **value €STR-linked and -collateralized products**

ii Introduction of €STR (index and curve) as **risk factors**, adoption of **pricing models** to calculate corresponding €STR exposures, and establishment of a **time series proxy**

iii Assessment of the materiality of **€STR/EONIA-basis along the curve**

iv Setup of the ability to **transition from EONIA to €STR** in EONIA-linked or EONIA-collateralized **products**, **anticipating possible P&L-jumps** on switch dates

v Catering for potential remaining **EONIA exposure after 2021**

The firm link between EONIA and €STR (fixed spread of 8.5 bp) yields the natural expectation of a negligible €STR/EONIA-basis along the curve.

However, this assessment has to be conducted by each institution individually.

Transition planning should fix switch days in advance. Depending on the compensation mechanisms agreed upon, possible P&L-jumps can then be quantified rather accurately in advance, such that their effect can be isolated and tracked.

Transition planning may exceed the end of 2021, because of potential remaining exposure to EONIA. The plans should include fallback agreements to contracts referencing EONIA (e.g. replace EONIA with €STR+8.5 bp) and enable institutions to price on these fallbacks (e.g. provide an €STR curve +8.5 bp as discount curve).

»»» Developments risk management (4/5)

Main implications on regulatory aspects of market risk

a ICAAP/SREP

- Two pillars of ICAAP: normative (own funds requirements) and economic perspective (economic capital)
→ market risk resulting from changes in the O/N curve is expected to be material for almost all institutions and must therefore be considered.

b Standardised approaches for market risk (CRR, CRR II)

- For the normative perspective, €STR-based products and €STR yield curve must be integrated into capital planning process and scenarios. For economic perspective, refer to (c).

- For the standardized approach, new €STR products have to be integrated into the framework to determine exposures. Thus, there is only limited requirement for amendment expected.

- For the alternative standardized approach, pricing models need to be adapted to calculate €STR sensitivities.

c Internal model approaches for market risk (pillars 1 and 2)

- Market data and pricing needs to be adapted in market risk systems

- Risk factor time series have to be set up (for VaR or expected shortfall calculation): EONIA curve as proxy; potential need to adjust credit spread models (if EONIA is the underlying basis)

- Stress testing, VaR, expected shortfall: risk figures must be extended to cope with EONIA and €STR yield curves; prepare discount switching; integration of €STR risk factors and products into market risk calculations; determine stress period for stressed VaR

- Determination of impact on risk factors and validation of risk metrics: one-off P&L effect after discounting switch date (DSD); impact analysis to quantify change in risk figures

»»» Developments risk management (5/5)

Main implications on regulatory aspects of market risk

d Formal model change criteria for internal models used under pillar 1

- Banks with approved internal model for calculation of regulatory own funds requirements for market risk have to assess materiality of extensions and changes – required by Regulatory Technical Standard (RTS)

e Internal model approaches under FRTB (Outlook)

- Risk factors need to be classified as modellable to pass the risk factor eligibility test (RFET)
 - If either €STR or EONIA were considered non-modellable, this could imply add-on on capital requirements.
 - needs to be assessed by each institution individually
- For expected shortfall under a period of stress, observations must include the year 2007

f Implications for Interest Rate Risk in the Banking Book

- Implications for internal models above also apply to IRRBB
- Scenario generation for IRRBB stress tests as above
- €STR (curves and products) need to be integrated into earnings at risk calculation and modelling of balance sheet evolution
- Impact analysis on risk metrics and validation as above (additionally on earnings at risk and IRRBB stress testing)
- No major impact expected for banking book steering and hedging practice



»»» Developments accounting

Update on IASB matters

15th July: Letter to the IASB

- WG has sent a letter to the IASB with **requests for clarification and certain amendments of standards.**
- Requests for clarification or relief for some issues related to **modification of contracts** and **discontinuation of hedge accounting**:
 - De-recognition of hedged item or hedging instrument
 - Replacement of hedging instrument
 - Documentation of hedging relationship
 - Ineffectiveness of hedging relationship
- Additionally, urgency to start phase 2 was stressed

Action taken by the IASB

- Following the end of the consultation of the exposure draft, **recommended standard amendments** have been published.
- After an additional meeting on 28 August 2019, the IASB balloting process of Interest Rate Benchmark Reform (Amendments to IFRS 9 and IAS 39) will commence in August 2019, with the **final amendments planned to be issued in September 2019.**
- In order to be applicable, a timely **EU endorsement process** would be preferable.
- **Requests by the WG have been taken into account** and are subject to approval by the IASB:
 - **Phase 1** amendments could be applicable to some aspects concerning **uncertainty** during the EONIA/€STR transition period.
 - Additional relief is expected for **retrospective effectiveness test** under IAS 39
 - **Macro hedge accounting**: Separately identifiable risk component is only required at the point in time of the initial hedge designation.
 - This is expected to provide some relief for requests of the WG concerning the hedge documentation (e.g. definition of hedged risk, rollover of hedges).
 - Simplification of **disclosure requirement**
- After finalizing phase 1 of its IBOR project, the IASB is expected to **start with phase 2 issues** (replacement issues). Subsequent IASB meetings are scheduled for:
 - 23-27 September 2019
 - 21-25 October 2019