

CONSULTATION

AFG'S RESPONSE

ISDA consultation -
Fallback rates
for derivatives
referencing IBORs

October 22 2018





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- Informing and supporting its members; the AFG provides members with support on legal, tax, accounting and technical matters,
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ISDA Consultation on Certain Aspects of Fallbacks for Derivatives Referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW

General remarks

The Association Française de la Gestion Financière (AFG) is grateful for the opportunity to comment on ISDA consultation on certain aspects of fallbacks for derivatives referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW.

AFG comments to the questions of the consultation

Q1: The following pairs of adjusted RFR and spread adjustment are possible:

1. Compounded Setting in Arrears Rate with Forward Approach
 2. Compounded Setting in Advance Rate with Forward Approach
 3. Spot Overnight Rate with Historical Mean/Median Approach
 4. Convexity-adjusted Overnight Rate with Historical Mean/Median Approach
 5. Compounded Setting in Arrears Rate with Historical Mean/Median Approach
 6. Compounded Setting in Advance Rate with Historical Mean/Median Approach
 7. Spot Overnight Rate with Spot-Spread Approach
 8. Convexity-adjusted Overnight Rate with Spot-Spread Approach
 9. Compounded Setting in Advance Rate with Spot-Spread Approach
- Preferred Approach**

• Please rank the combinations listed above with 1 as your preferred approach, 2 as your second preferred approach, and so forth.

1. Compounded Setting in Arrears Rate with Forward Approach
2. Compounded Setting in Arrears Rate with Historical Mean/Median Approach

• Please explain your rankings. Please specifically comment on the characteristics of the combinations you ranked the highest that most influenced your decision.

As a general comment we would like to pinpoint that no solution perfectly suits for derivatives and cash instruments at the same time.

That said, the compounded setting in arrears rate with forward approach appears to be the best compromise as it is, in our views, the most reliable measure of the adjusted RFR on the period considered. It gives the most accurate picture of the mechanisms surrounding the determination of interest rates. Besides, it is easy to understand and reduces the risk of cliff effect at the time of trigger.

We also point out the fact that there might be a risk of distortions of the forward curves at the time of discontinuation.

Although not reflecting market conditions upon disruption, the historical approach would allow to avoid such distortions to freeze the spread and to be very simple

For this reason, we would rank it in second position after the forward approach for the calculation of the Adjusted Spread.

- Indicate whether your preferences apply universally to GBP LIBOR/SONIA; JPY LIBOR/TONA; TIBOR/TONA; Euroyen TIBOR/TONA; CHF LIBOR/SARON and BBSW/RBA cash rate. Alternatively, provide a separate ranking for each IBOR that should be handled separately.

Our preference apply universally to GBP LIBOR/SONIA ; JPY LIBOR/TONA ; TIBOR/TONA ; Euroyen TIBOR/TONA ; CHF LIBOR/SARON ; BBSW/RBA cash rate.

- If your preferences apply universally, please indicate whether you would also expect your preferences to apply to USD LIBOR/SOFR, EUR LIBOR/[the identified EUR RFR] and EURIBOR/[the identified EUR RFR].

We would also expect our preferences apply to USD LIBOR/SOFR ; EUR LIBOR/ESTER. For EURIBOR/ESTER, we believe the fallback provision should consider the option under which the FSMA approves the hybrid methodology for EURIBOR.

Q2: Please indicate whether you would not be able to transact using definitions that incorporate fallbacks based on any of the approaches to adjusted RFRs or spread adjustments. If you would not be able to transact, please give specific examples of the types of derivatives for which the fallbacks would be problematic and explain why.

N/A

Q3: Would it be problematic for market participants to use different approaches to calculate adjusted RFRs and spread adjustments in fallbacks across different currencies? Please explain why or why not, commenting specifically on the potential implications of using different approaches across different currencies.

It would be problematic for us to use different approaches depending on the currency. This would lead to operational issues and hinders cross currency swap pricing and hedging.

Q4: Please provide separate comments on the general appropriateness and effectiveness of each of the four approaches to adjusted RFRs and three methodologies for the spread adjustments. Please specifically comment on anticipated operational challenges, economic impacts, implications for hedging, feasibility of implementation and any other complexities. Indicate whether your comments apply to all contracts, new contracts only or legacy contracts only. With respect to any operational challenges, please explain how long it would take to overcome such challenges.

N/A

Q5: Questions about specific methodologies for calculating the spread adjustment:

- **Forward Approach**

- Should the forward approach be based on data from the day prior to the trigger only or a number of days or months prior to the trigger? If the latter, how many days or months? Please specifically consider 5 trading days, 10 trading days, 1 month and 3 months but also indicate whether a different length is most appropriate and explain why.

We think it is appropriate for the forward approach to rely on an average on a short period before the trigger. This period should be comprise between 5 trading days and one month.

- What is the appropriate length of the forward spread curve? Please specifically consider 30 years, 40 years, 50 years and 60 years but also indicate whether a different length is more appropriate and explain why.

Ideally the length of the forward spread curve should be 60 years so as to be aligned with the longest maturity of existing contracts. Now since liquidity generally reduces for longer maturities we think the appropriate length has to be at least 30 years.

- **Would it be acceptable to use data for cleared transactions only when using the forward approach to calculate the spread adjustment? If so, how should the differential between central counterparties (CCPs) be addressed?**

Using only data from cleared transactions would be the ideal solution if a cleared market for the RFR rates had existed today. As it is not the case, we do not support this proposal.

- **Historical Mean/Median Approach**

- **What is the appropriate historical static lookback period? Please specifically consider 5 years and 10 years but also indicate whether a different time period is most appropriate and explain why.**

In order to limit mark to mark swing due to potential differences between historical spreads and market conditions at the time of discontinuation, we recommend to use 5 years historical period to avoid taking into account the 2008 crisis data

- **Should the calculation be based on the mean or the median spot spread between the IBOR and the adjusted RFR? Please explain why.**

N/A

- **Spot-Spread Approach**

- **Should the spot-spread approach be based on data from the day prior to the trigger only or, alternatively, some number of days prior to the trigger? If the latter, how many days prior to the trigger should this be? Please specifically consider 5 trading days, 10 trading days and 1 month, but also indicate whether a different time period is most appropriate and explain why.**

N/A

General

- **How important or unimportant is it for the fallbacks to be approximately present-value neutral at the time of trigger? Please explain why.**

It is of critical importance that the impact of the transition to the fallback be as narrow as possible. Any significant changes in present-value at the time of trigger would generate alert in the monitoring of funds and would create confusion among investors on the reason behind this change. Where this impact could not be avoided, fallback provisions should provide for a compensating lump-sum so as not to infringe one contractor of the derivative.

- **How important or unimportant is it for the fallback rates to be available in advance of the accrual period. Alternative, is setting in arrears acceptable? Please explain why or why not.**

We see no obstacle in setting in arrears with overnight rate compounding as long as a short delay is scheduled to integrate updated data by the back-office.

- **How important or unimportant is it for the fallback rates to be wholly (or mostly) convexity free? Please explain why or why not.**

We think this is an important element for two reasons. First, we would not need to use volatility data to estimate forward rates. Second, adjustment for convexity is much more accurate using the adjustment spread than relying on the compounding effect (which depends on the level of interest rates).

