The Working Group on Sterling Risk-Free Reference Rates

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European Commission
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Removal of pan-European regulatory barriers to transition away from LIBOR and other IBORs

Dear Mr Dombrovskis,

This letter sets out for your attention a number of urgent pan-European issues relating to the conduct and prudential regulation frameworks that impact the ability of market participants to transition from LIBOR ahead of the end of 2021. The UK Financial Conduct Authority (FCA) expects this widely used interest rate benchmark to cease after this date.

The Working Group on Sterling Risk Free Reference Rates (RFR WG) is an industry-led forum convened by the Bank of England and FCA, the participants of which include representatives of major EU-headquartered financial institutions; these are both private sector firms as well as supranational institutions such as the European Investment Bank and the European Bank for Reconstruction and Development. Our mandate is to catalyse a broad-based transition away from LIBOR to SONIA.[1]

As part of executing that mandate, the RFR WG has detailed a number of specific regulatory barriers that, without action, may impede the adoption of alternative risk-free rates (RFRs) in both new transactions and legacy LIBOR linked contracts that mature beyond end 2021.

These barriers are relevant for many European institutions as the widespread use of LIBOR is contained not only within the jurisdictions of the five currencies it is quoted in, but is embedded globally, including across the European financial system. While this is an important issue for UK firms, the implications of LIBOR ceasing will need to be managed across Europe, in particular where there are significant exposures to USD, GBP and CHF LIBOR-linked contracts. In addition, the issues raised relate directly to the regulatory mandates of the EU authorities. We are therefore strongly supportive of efforts to coordinate actions across jurisdictions.

The RFR WG has provided a detailed list of specific cases where regulatory dependencies may act as barriers to the smooth transition to alternative RFRs:

i) Annex 1 refers to prudential regulatory issues for banking;

ii) Annex 2 refers to prudential regulatory issues for insurance; and;

iii) Annex 3 refers to conduct issues applicable across the financial sector which may

[1] The Working Group was established in 2015 to implement the Financial Stability Board's global recommendation to develop alternative risk-free rates for use instead of Libor-style reference rates.

be of relevance in the EU context.

The lists in each annex are preceded by a short executive summary for ease of use. A number of the considerations listed in the annexes are accompanied by recommendations that the RFR WG believes would support a smooth and orderly transition to alternative RFRs.

The RFR WG recognises that the barriers referred to in the annexes emanate from and interlink with different parts of the EU and National Competent Authorities' (NCAs) remits – we would welcome the opportunity to discuss these further with you as part of our ongoing engagement. Please also note that the lists in the annexes are not comprehensive and we will continue to assess if further material dependencies exist.

The RFR WG respectfully asks, as a matter of urgency, that the issues raised in this letter are considered and concrete actions are taken where necessary to ensure a smooth transition. This will help reduce any risks to the safety and soundness of markets from continued reliance on a benchmark that is expected to cease at the end of 2021.

This letter forms part of a wider dialogue with other authorities, including NCAs and the Basel Committee. All impacted jurisdictions must make preparations to remove dependencies on LIBOR and the RFR WG welcomes the support of authorities in addressing regulatory barriers to transition where practicable.

I appreciate the opportunity to share this information and look forward to taking this work forward with you as soon as possible.

Sincerely,

Tushar Morzaria
Chair of the Working Group on Sterling Risk-Free Reference Rates

Copies to:

Olivier Guersent, Director-General, DG FISMA, European Commission

Holger Neuhaus, Head of Division, Money Markets and Liquidity, European Central Bank

Gabriel Bernardino, Chair, European Insurance and Occupational Pensions Authority

Steven Maijoor, Chair, European Securities and Markets Authority

José Manuel Campa, Chair, European Banking Authority

Annex 1: Banking - Issues which could Inhibit Firms implementing the 'transition framework'[2]

Please find below a summary of key issues presented in the table on the following pages.

- Contractual terms

The below items focus on the effect of existing securities (particularly those with maturities beyond 2021) being deemed 'new' as a result of changing their terms so that instead of referencing an IBOR they instead reference a risk free rate.

  - MREL (Minimum Requirement for Own Funds & Eligible Liabilities)

While being deemed 'new' could have broader implications under the internal models-based approaches, it will also create specific problems for MREL-eligible instruments that are already sensitive to changes in contractual terms. The RFR WG therefore requests that supervisory statements (or similar guidance) is provided clarifying that the transition to alternative RFRs in relevant contracts would not lead to those securities being considered 'new' and therefore trigger the requirement to insert relevant contractual terms under regional bank resolution and recovery legislation (e.g. BRRD Article 55). Otherwise, a significant number of MREL-eligible instruments would require costly and operationally intensive "repapering".

  - Securitisations: Grandfathering Protection

Similar to the MREL-eligible instrument issue, existing securitisations that have been "grandfathered" as the applicable regulations have changed over the years could lose this protection if the interest basis is changed and thus the deals are legally considered "new". This could have undesirable consequences - including harsh sanctions for non-compliance under the Securitisation Regulation[3].

- Model Change Assessments

Prudential regulations, and particularly internal model standards, were not designed to accommodate the wholesale shift from existing to alternative interest rate benchmarks across a wide variety of products and currencies over a compressed transition period. This causes a friction between having models calibrated to a rate that is expected to cease and having sufficient historic data to re-calibrate internal models with alternative risk-free rates. In the absence of sufficient data being immediately available relating to alternative RFRs, a period of forbearance may be necessary during where firms are permitted to use current benchmarks as proxies and, where possible, backfill or extrapolate to help mitigate against unnecessary capital.

Once internal models are re-built they may require ex-ante regulatory approvals for model changes and notifications from relevant competent authorities (for example under EBA/RTS/2014/10 or EBA/RTS/2013/06). This could result in a significant bottleneck as the industry pursues model change approvals simultaneously. The RFR WG therefore requests that regulatory authorities to allow ex-poste approvals for model changes resulting from the move to new risk free rates where they are replacing rates that are expect to cease.

For validating the internal models' performance, the standards also require historic transaction data that will not be available for those RFRs which are newly created benchmarks. The RFR WG therefore requests amending the rules to allow use of appropriate proxies for backfilling internal models where appropriate and for as long as is necessary.

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[2] New transactions (Adoption) as well as the replacement of current exposures to Sterling LIBOR with corresponding exposures to SONIA (Replacement) and the adoption of robust contractual fallbacks (Fallbacks). Collectively, Adoption, Replacement and Fallbacks are referred to in this paper as the 'transition framework'.

[3] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2401&from=en

While implementation of the new market risk framework (“FRTB”) will mainly occur after the end of 2021, the historical data on the new RFRs may not be sufficient for all markets and products to pass the new model eligibility requirements. A transitional period or forbearance will be necessary after which market risk models could be revisited and assessed on an ex-post basis. The RFR WG would further like to highlight the lack of clarity on the implementation timelines of the market risk and other regulatory frameworks at a jurisdictional level. This is a concern for global banks with significant exposure to derivative-based instruments as they prepare for the move to risk free rates.

- Client End-user Impact

In addition to the issue pertinent to the model change requirements, the reduction of liquidity for existing IBOR based transactions as a result of the move to using risk-free rates may impact firm’s modelling of counterparty exposure through an increase in the ‘margin period of risk’ (CRR Article 285 3b), which is likely to impact the capital associated with these trades and potentially the cost to corporate end-users as firms look to meet hurdle rates. The same forbearance could be leveraged in the context of these more granular prudential requirements.

Section A: Immediate issues which will impede firms' implementation of the transition framework (Blockers)

Risk Area / Type	Sub Topic / Issue	Description
Model Related Issues	**IMA & IMM Model Approvals**[4]	Implementation of the transition framework could be impeded by the prescriptive nature of model change assessments. Careful planning and management of resources will allow banks to mitigate some of the possible negative impacts but there are other areas where banks will be dependent on regulators to process large volumes of applications simultaneously within very tight timeframes. An important consideration is whether changes made to bank risk models following implementation of the transition framework are considered to be model changes that require ex ante model approvals or whether ex-post approval could be sufficient. Specific areas of potential impact: • Model change notification requirements including requirement to obtain pre-approval from regulators for material changes. (e.g. extended periods of review by regulators may force banks to keep transactions outside of the internal models perimeter) • Model backtesting and stress calibration – potentially impacted by limited data time series • Model limitation monitoring – banks' models for the new benchmarks may evolve in sophistication over time, increasing the complexity of the model limitation monitoring framework including efforts to implement compensating controls, such as through capital add-ons. This may also lead to the need for repeated model change submissions to regulators **Recommendation:** A transitional period or forbearance is necessary after which models could be revisited and assessed on an ex-post basis which will help mitigate time and resource constraints for both banks and supervisors.

[4] https://eba.europa.eu/documents/10180/512948/EBA-RTS-2013-06+%28Materiality+of+model+extensions+and+changes%29.pdf/ca607f06-a5aa-4c5b-9301-9cf800dba74f

[4] https://eba.europa.eu/documents/10180/512948/EBA-RTS-2014-10+%28Final+draft+RTS+on+mkt+risk+model+extensions+and+changes%29.pdf/df84e4ab-3eab-40bf-a608-56f682be36ba

[4] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2017/ss1313update

Model Related Issues	**Counterparty Exposure**	**Margin Period of Risk (CRR Article 285 3b)**[5] The reduction of liquidity in IBORs or collateral (which reference IBORs), could imply an inability to readily replace them, increases the margin period of risk (MPOR) to a minimum of 20 days. For OTC derivatives, this doubles the starting point for MPOR which would impact counterparty risk. This would likely affect a high proportion of firm exposures because most counterparties would have fewer trades than required by the liquidity criterion and would be very likely to have at least one trade which continues to reference the old benchmark as well as trades which reference the new benchmark rate. Furthermore, the potential increase of RWAs and subsequently the capital utilised against could result in increased costs to end users as firms look to meet hurdle rates. It should also be noted that SA-CCR will also use MPOR. As such, the issue will affect the leverage ratio as well as the modelled counterparty exposure. **Recommendation:** A transitional period or forbearance is necessary after which risk models could be revisited and assessed on an ex-post basis
Contractual terms – change into new reference rates could result in securities deemed "new" instead of existing issuance	**MREL (Minimum Requirement for Own Funds & Eligible Liabilities)**	Transition could affect the treatment of MREL-eligible instruments in a number of important ways: I. The change from IBORs to RFRs as reference rates for debt instruments, either through a fallback amendment or a replacement rate amendment, might be treated as newly issuing an instrument rather than amending an existing instrument. II. A firm subject to MREL requirements must obtain regulatory approval of contractual write down and/or conversion triggers present in instruments intended to serve as internal MREL. III. In addition, if firms' balance sheets grow in size because of the Increased Volume Effect, total MREL requirements would increase due to increases in the RWAs and total leverage exposure measures. **Recommendation:** We recommend that the authorities clarify that in light of the potential or actual discontinuation of IBORs and movement to the RFRs such a change to contractual terms for in-scope liabilities is deemed as automatic. This would mitigate one of the significant barriers that would otherwise exist to making such a transition possible.

[5] https://eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/-/interactive-single-rulebook/article-id/3501

Contractual terms – change into new reference rates could result in securities deemed "new" instead of existing issuance	**Securitisations-Grandfathering Protection**	Existing securitisations that have been "grandfathered" (as applicable regulations have changed over the years) could lose this protection if the interest basis is changed. This could have very undesirable consequences - including harsh sanctions for non-compliance under the securitisation Regulation. Under the new Securitisation Framework, existing deals are grandfathered in various ways; if there is a switch from for example Libor to SONIA, there is a risk that that switch makes them "new" deals and therefore they lose the grandfathering. **Recommendation**: We ask that the authorities clarify that in light of the discontinuation of IBORs and movement to the new RFRs such a change to contractual terms is not deemed a "new deal". This would mitigate one of the significant barriers that would otherwise exist to making such a transition possible.

Section B: General effects of implementing the transition framework

Risk Area / Type	Sub Topic / Issue	Description
Throughout banking	**Increased Volume**	During implementation of the transition framework, dealers may hold larger derivatives books than at present because of the need to hold books in both IBORs and risk free rates, including basis swaps and other instruments used to hedge basis risks between IBORs and risk free rates. As a result of this activity, dealers will hold a larger total notional amount of derivatives and hold more derivatives assets and liabilities, as well as trading securities used to hedge this client-driven activity, on their balance sheets.
Throughout banking	**Reduced Liquidity**	Implementation of the transition framework could adversely impact the liquidity of certain instruments in the markets for floating-rate securities and derivatives. For example, RFR-indexed instruments may remain illiquid during the early part of the Transition. In addition, after a shift in volumes to replacement rate amendments and new RFR transactions, certain remaining IBOR-indexed instruments may become illiquid. Due to waning liquidity, such instruments may cease to be considered “liquid and readily-marketable” under applicable capital and liquidity standards.
Throughout banking	**Basis Risks**	Basis risk between IBORs and the RFRs, including secured and unsecured RFRs, will need to be considered and the behaviour of these rates under stressed conditions thoroughly understood. To be able to model the behaviour, the permission to use proxies during a transition period will be required. Furthermore, if methodologies to construct term rates/credit spreads diverge between cash/derivative markets and /or different currencies then increased basis risks will be introduced which will result in additional capital due to ineffective hedges.

Section C: Issues which are a consequence from the introduction of the transition framework (i.e. Adoption, Replacement and Fallbacks) and which, on a forward looking basis, could result in barriers to a smooth implementation by firms and regulators

Risk Area / Type	Sub Topic / Issue	Description
Model Related Issues	**FRTB Modelling Permissions**	There are significant cross-dependencies of these new regulations and the transition framework for firms and regulators. To allow for successful delivery across both FRTB and the transition framework, regulators should allow for a transitional period during which permissions for new market risk models are effectively grandfathered. After this transitional period market risk models could be revisited and assessed, preferably on an ex-post basis and this approach should be consistent across jurisdictions. **Recommendation:** A transitional period or forbearance is necessary after which market risk models could be revisited and assessed on an ex-post basis
Model Related Issues	**FRTB Expected Shortfall (ES)** The relevant text can be found in the FRTB Market Risk Standards BCBS 457 Art 33.5 and 33. 6[6]	The implementation of the transition framework could impact the expected shortfall calculation due to lack of a historical time series and the requirement to calculate the ES measure based on a 12 month stress period. Those RFRs which have been newly created will not have an adequate history going back to 2007. The existing IBOR benchmarks are also likely to suffer from poor historical data quality once trading switches over to the RFRs. Both sets of risk factors may therefore need to be proxied. This could result in the failure of a reduced set of risk factors to explain a minimum 75% of the variation in the full ES - leading to inability to use Internal Models under FRTB. Even where this hurdle is passed, the extent of proxying will result in increasing the ratio of current period ES calculated using the Full Set and Reduced Set of Risk Factors. Further, any basis between these Risk Factors and the proxy will need to be capitalised as a Non-Modellable Risk Factor. These two aspects of the ES calculations will result in a significant capital uplift. **Recommendation:** Allow the use of proxies for meeting the criteria for reduced ES and permit banks to not capitalise the basis between these risk factors and the proxy as NMRF

[6] https://www.bis.org/bcbs/publ/d457.pdf

Model Related Issues	**Model Review**	**Risk Consistency (CRR 288j)** Amendments to legal terms in order to implement the transition framework will require systems to be changed to accommodate the revisions or the requirement for "accurate reflection of legal terms … in exposure value measurements" will be breached. The regulatory drive for consistency across valuation, risk and regulatory frameworks will also be undermined unless regulators permit fast model adoption for prudential purposes. **Recommendation:** A transitional period or forbearance is necessary after which risk models could be revisited and assessed on an ex-post basis
Market Liquidity	**Exceptional Circumstances** The BCBS FRTB Standards provides allowances for banks to continue to use IMA whilst still failing backtesting and PLAT and furthermore allows relief to pass the RFET test under exceptional circumstances.	**Risk Factor Eligibility Test (RFET)** The introduction of the newly created RFRs at around the same time as implementation of FRTB will result in a period where there is likely to be insufficient liquidity in the new benchmarks. There is a concern that the newly created RFRs will not satisfy the modelling conditions set out in the market risk standards and fail the eligibility test. **Treatment for exceptional circumstances** BCBS 457 Art 31.24 and Art 32.45[7] specifically identifies criteria for providing exemptions 'during periods of significant cross-border financial market stress affecting several banks' or when 'financial markets are subjected to a major regime shift'. **Recommendation:** Firms should be allowed to continue to temporarily use the IMA as per the exceptional circumstances provisions in the BCBS market risk standard where failure of PLAT or backtesting can be proven due to the impact of newly created RFRs and 'zombie' IBORs (where the number of panel submitters and tenor points have been reduced resulting in reduced liquidity). Firms should also be provided with an exemption for any failures on RFET due to the newly created RFRs and 'zombie' IBORs. The relief should target the relevant transitioning periods for all key IBOR/RFR rates.
Interest Rate Risk in the Banking Book (IRRBB)		The hedging of interest rate risk in the banking book will usually involve IBOR swaps. Long-dated banking book positions do not necessarily convert to the RFRs, at least at the same time as the market hedges move on to the RFRs and therefore there will likely be higher basis risk between the IRRBB hedges and the BB positions during this period. **Recommendation:** As there is no harmonious global framework for capitalising IRRBB, the Bank of England and other prudential regulators should consider how this basis is captured and capitalised during the transition period, taking into account the multispeed implementation of the transition framework across the main markets and currencies.

[7] https://www.bis.org/bcbs/publ/d457.pdf

Capital Buffers	**GSIB**	Implementation of the transition framework could result in an increase both in a firm's total notional amount of derivatives and in the level 3 assets. The increase in derivative transactions can have a significant impact on the G-SIB surcharge as the OTC notional amounts increase. Further, during the transition, proxies will need to be used in many instances for pricing because of lack of liquidity in new RFR instruments that will lead to sparseness of observations necessary to populate yield and volatility curves. This in turn is likely to cause the reclassification of significant volumes of transactions as level 3. Similarly, other assets that reference IBORs can lose their liquidity and become L3. This increase in firms' level 3 assets impact the calculation of their G-SIB capital buffer. **Recommendation:** Such legacy assets and portfolios should be given temporary regulatory relief in terms of designation to allow for run-off without tying more capital towards existing exposures

Section D: Other Issues which are a consequence of the general effects arising from implementing the transition framework (i.e. Adoption, Replacement and Fallbacks) where no action has been recommended at this stage

Risk Area / Type	Sub Topic / Issue	Description
Stress Testing	**Stress losses**	There is little data on the performance of IBOR-linked instruments during times of stress. It will therefore be difficult to forecast and model the performance of these instruments for purposes of the stress testing. Firms may rely on proxying these rates to historical IBOR data for the purposes of both internally developed and supervisory stress tests. This could result in imprecise stress losses and regulators may impose more severe hurdle rates on firms to pass the stress tests.
Stress Testing	**Financial Projections**	Implementation of the transition framework could affect firms' financial projections under stress scenarios for both supervisory (BOE, EBA, CCAR) and company-run stress tests. Modelled stress scenarios typically assume a flight to quality. RFRs would likely behave differently from IBORs under a flight to quality. For example, a flight to quality could lower the RFR, whereas current models of stress scenarios typically project increased volatility in IBORs, rather than a predictable decline. As a result of the differing behavior of between these rates under stress, firms' projected net interest margins and other projections could be affected by implementation of the transition framework if firm or supervisory stress testing models include RFRs as macroeconomic variables.
Stress Testing	**Stressed RWAs**	Firms forecast stressed balance sheets to assist in forecasting RWAs as part of for both supervisory (BOE, CCAR) and company-run stress tests. The assumption of a dynamic balance sheet and the potential of greater volume of transactions traded through the introduction of the transition framework, will subsequently impact the balance sheet size of organisations and inadvertently affect the outcome of stress tests.
FRTB	**Market Risk Regulatory Capital Impact**	Implementation of the transition framework across various large economies may also result in additional market risk capital under the FRTB standards. The impact to market risk capital has not been thoroughly explored and the unintended consequence of implementing the transition framework is likely to result in an impact in capital requirements through the lack of liquidity and failing the risk factor eligibility test or increased complexity in the profit and loss attribution test. In addition, the lack of historical rates would result in the Expected Shortfall calculation using proxies and any basis between these risk factors and the proxy will need to be capitalised as a Non-Modellable Risk Factor, thus resulting in a further capital uplift. The impact of the RFRs have also not yet have necessarily been accounted for in the Industry QIS exercises due to operational complexities across jurisdictions at this stage.

FRTB	**Timeline**	The lack of clarity on national implementation timelines for FRTB creates additional concern for major institutions with significant exposure to derivative based instruments. Furthermore, some firms could be aiming to deliver FRTB for Q1, 2022, which coincides with the timeframe for implementation of the transition framework. Both programs require extensive work from the same pool of resources (Front Office IT teams, Risk Quants and other specialized staff) to develop, build and test the models and infrastructures to support both programs. It is not expected that timeline for either work stream should be delayed.
FRTB	**Resource Implications**	Many firms will be required to deliver on FRTB for Q1, 2022, which coincides with the timeframe for implementation for the transition framework. Both programs require extensive work from Front Office IT teams, Risk Quants and other specialized staff to develop, build and test the models and infrastructures to support both programs. Therefore, both programs will be competing for the same scarce resources.
Market Risk	**Funding value and risk**	Implementation of the transition framework will encourage banks to change the discounting of uncollateralised swaps from Ibors to RFRs and to capture the cost or benefit of the funding basis as a spread to RFR as a valuation adjustment. The anticipated accounting of the impact of the funding basis as an adjustment will potentially widen the gap between accounting fair value and prudential standards for exposures. For Market Risk RWA, the shift from Ibor to RFR discounting for uncollateralised exposures could increase the materiality of the ambiguity around the inclusion of funding related value adjustments within the Market Risk (MR) capital covered position. Similarly for Leverage Ratio, the replacement cost of uncollateralised asset exposures has the potential to increase due to the change in discounting conventions away from Ibors to RFRs. The change from one overnight rate to another as the RFR will also have an impact. However, assuming that the RFR-OIS basis will be smaller than FRA-OIS, then the effect will be proportionately smaller. Uncollateralised or partially collateralized deals are likely to take place with smaller end-users where the impact of the misalignment between accounting and prudential standards will impact the most.
Ring Fenced Banks	**Business Model**	The impact from implementing the transition framework may have unintended consequences for ‘ring-fenced banks’ where potential compliance with thresholds are breached.
Leverage Ratio	**Increased Volume and Balance Sheet**	If the balance sheet size increases as a result of Increased Volumes, the leverage ratio denominator would similarly increase. More precisely, as firms hold both IBOR- and RFR-linked instruments, firms would have duplicative uncollateralized market positions that would end up as receivables on their balance sheets.

		Consequently, firms would need greater amounts of capital to meet their leverage ratio requirements
Net Stable Funding Ratio (NSFR)	**Increased Volume**	If the amount of gross derivatives liabilities increases as a result of the Increased Volume Effect, then firms could have higher required stable funding amounts. In turn, this would require firms to hold more liquid instruments.
Illiquid Legacy portfolios	**Liquidity Coverage Ratio (LCR)**	If instruments lose "readily marketable" status as a result of the Reduced Liquidity Effect, then firms may have more difficulty meeting their liquidity coverage ratio ("LCR") requirements. The Reduced Liquidity Effect would be most relevant for level 2A and level 2B liquid assets, which feed into the computation of the amount of high-quality liquid assets that forms the numerator of the LCR.
End User Consideration	**Systemic Issues/Costs**	Commercial end users are fundamentally different from most other participants in the over-the-counter derivatives markets in that they generally use derivatives to reduce risks arising from their business operations. For example, to qualify for the exemption from mandatory margining and central clearing for their derivatives transactions, commercial end-users must have entered into their derivative trades to hedge one of their fundamental commercial risks. From an end-user company's point of view, the OTC derivatives market should allow the efficient transmittal of risk from where it is incurred to where it can be matched and offset. Undue regulatory costs along the way, including requirements for higher capital placed on its financial intermediaries, are ultimately borne by the end-user.
Illiquid Legacy Portfolios	**Collateral Recognition Eligibility**	As with the Liquidity Coverage Ratio, if instruments lose "readily marketable" status as a result of the reduced liquidity, then firms may no longer be able to recognize collateral received under the collateral haircut approach (also known as "E minus C" treatment), effectively increasing the capital required to be held against exposures collateralized by less liquid collateral.
Illiquid Legacy Portfolios	**Prudential Valuation (PVA)**	After the transition, legacy instruments/portfolios are likely to become illiquid and unmarketable. This would in turn increase the prudential valuation adjustments for such instruments and also increase the GSIB scores of banks with such assets as they transition to L3 asset category. Valuations impact not only revenue, but also directly bring uncertainty and differences to the leverage exposure, and levels of required stable funding for the same positions. As PVA reduces the capital base the leverage and risk capital ratios are also likely to experience downward pressure across the board. Recommendation: Such legacy assets and portfolios should be given regulatory relief in terms of designation to allow for run-off without tying more capital towards existing exposures.

Annex 2: Insurance - Issues which could Inhibit Firms transitioning

The below table presents a range of issues facing insurers from all jurisdictions as a result of the transition from IBOR to new risk-free rates. The issues presented below are linked to the discount curve insurers use to value their liabilities.

The lack of clarity around the changes to the discount curve has considerable knock on effects on capital management, A/L management and operational planning. Insurers are also exposed to a number of the issues presented in the annexes above, such as liquidity and basis risks, but the main barriers that must be addressed before insurers across the continent can suitably transition away from IBORs relate to the Solvency II discount curve.

Given the cross-border nature of insurance business, insurers face exposure to a range of currencies transitioning away from IBORs, on both the asset and liability side of the balance sheet. In the absence of a European-wide fix to these issues, there is considerable risk of a negative impact on the level playing field, as member states are forced to address the issues unilaterally.

Risk Area / Type	Sub Topic / Issue	Description
Solvency II discount curve	**Level of curve**	EIOPA publishes a discount curve monthly (Art.43 of Solvency II) – the Solvency II risk free rate. It is used to discount insurers' liabilities. A change in liabilities will lead to a corresponding change in capital requirements. Currently the EIOPA Solvency II risk free rate is derived from IBOR rates. New curves are likely to be lower than their current levels, which will cause an increase in insurers' liabilities. This impact alone is likely to be material for some insurers ('material' in Solvency II refers to a change of >5%, in this case of own funds). As the underlying liabilities will have remained unchanged, this should be seen as an artificial inflation. For an industry EIOPA has acknowledged is adequately capitalised, we would encourage the Commission to consider ways in which this artificial inflation could be avoided.
	Long-Term Guarantee Measures	The impact of this will vary between insurers. Those using the Matching Adjustment will be able to mitigate a large proportion of this, however the MA cannot be applied to the Risk Margin, and so the impact on this will be absolute. The Matching Adjustment is also primarily used in the Spanish and UK markets, and as such other member states may be more heavily exposed. To rectify the increase in Risk Margin, TMTP, a transitional measure that can be applied to all liabilities

		written before the launch of Solvency II (1/1/2016), could be used. A TMTP recalculation would allow insurers to take into account the impact of new risk-free rates. However, there is so far no clear indication that insurers will be able to apply a recalculation to dampen the impact of this transition. There is also scope for some member states to allow a recalculation, while others may not, leading to consequences for a level playing field.
	Credit risk adjustment	Following on from the point above, as it stands, EIOPA applies a Credit Risk Adjustment (CRA) to the Solvency II risk free rate, floored at 10bps (Art. 20, 44 & 45 of Solvency II). However, given a risk free rate will be close to risk free, it is not economically correct to still apply the CRA, and will lead to double counting. We would encourage the Commission to endorse, along with the European Parliament, a change to the Delegated Acts of Solvency II to remove the requirement for a CRA to be applied to the discount curve.

Annex 3: Conduct - Issues which could Inhibit Firms transitioning

Please find below a summary of key issues presented in the table in the following pages.

- EMIR clearing and margining obligations

We note the Chair of the EU Risk Free Rate Working Group recently wrote to you on the issue of EMIR margin and clearing obligations in relation to derivatives. The UK RFR WG echo and support the terms of this letter. Market participants are concerned that those margining and clearing obligations could be triggered by amendments to legacy derivative transactions in the context of benchmark reform and IBOR transition. We note, in this respect, that the BCBS/IOSCO published a statement on 5th March 2019[8] and ask that authorities provide further confirmation that these activities would not on their own subject such contracts to the margining or clearing obligations.

- Practical challenges arising from EMIR and MIFIR requirements

The RFR WG has identified a number of other practical challenges related to EMIR requirements where, in the context of LIBOR transition, large volumes of derivative contracts are amended at one time.

In addition, the fact that firms will have updated all transaction reporting to reference RFRs might in turn create an artificial impression that there is sufficient liquidity in certain RFR swap markets to meet the threshold for MIFIR trading obligations.

- Disclosure – Key Investment Documents (KIDs)

The PRIIPs Regulations require manufacturers of PRIIPs to provide a Key Information Document (KID) to retail clients and to update the KID when a change significantly affects the information therein. This may have implications for a LIBOR-based contract that is amended to include a fair replacement rate and / or for legacy contracts that assume LIBOR will continue beyond 2021.

- Market abuse and conflicts of interest

Benchmark reform efforts, including the development of new RFRs and the transition away from some existing IBORs, may lead to specific conflicts for firms as well as giving rise to potential market abuse risks. The RFRWG welcomes the development of best practice guidelines as to how firms should manage these risks.

[8] https://www.iosco.org/news/pdf/IOSCONEWS526.pdf

Risk Area / Type	Sub Topic / Issue	Description
EMIR and MIFIR Requirements in relation to derivatives	**EMIR margining and clearing obligations**	EMIR non-cleared derivatives margining and mandatory clearing rules do not apply to derivatives contracts which were already in existence as at specified points in time[9]. These 'legacy' derivatives may, however, come into scope of those rules in certain circumstances. Market participants are concerned that those margining and clearing obligations could be triggered by amendments to legacy derivative transactions which either: (i) seek to enhance their contractual robustness by including fallbacks for benchmark-related events (such as the International Swaps and Derivatives Association's (ISDA) work on fallbacks for major interbank offered rates (IBORs) or the ISDA Benchmarks Supplement (which provides robust generic fallback provisions for use across interest rate, equity, commodity and FX benchmarks in response to Article 28(2) of the EU Benchmarks Regulation[10]); or (ii) make amendments necessary to replace a benchmark which is perceived by regulators and RFR Working Groups as vulnerable to cessation (such as Sterling LIBOR) with references to a more robust benchmark (such as SONIA). These benchmark reform efforts have been in response to efforts by the Financial Stability Board and other global regulatory and private sector concerns around systemic risks. They rely for their success upon their widespread adoption. Uncertainty as to whether such activities trigger margining and clearing obligations under EMIR will potentially pose a major impediment to those efforts.

[9] 16th August 2012 for margining under Article 11(3) of EMIR. On or after the date on which the clearing obligation takes effect (or for transactions with certain remaining maturities, notification under Article 5(1) has been received) for clearing under Article 4(1)(b) of EMIR.
[10] Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014.

		Recommendation: We ask that authorities provide confirmation that these activities would not on their own subject such contracts to the margining or clearing obligations. We note, in this respect, that the BCBS/IOSCO published a statement on 5th March 2019[11]. We also note that the Chair of the EU Risk Free Rates Working Group recently wrote to the European Commission and ESMA on this issue[12]. We echo and support the terms of that letter which advocates for a broader approach consistent with the policy objectives of Article 28(2) and which would facilitate use of ISDA's Benchmarks Supplement.
	EMIR trade repositories (TR) reporting	Given the importance of TR data to regulators, particularly for systemic risk monitoring, TR data will need to be updated as the industry transitions from IBORs to RFRs. We understand it is important for regulators to have access to TR data that accurately reflects market activity. We note that amendment of an existing derivative transaction so that it ceases to reference an IBOR, such as LIBOR, and instead references an RFR, such as SONIA, will see a large number of EMIR reports needing to be amended, possibly in a very short timeframe. Given the volumes of derivatives transactions already reported to TRs, there will be significant operational and technological work to update existing reports at the TRs. **Recommendation:** We would appreciate a discussion with regulators and infrastructure providers (such as trade repositories and middle-ware platforms) to look into this issue.

[11] https://www.iosco.org/news/pdf/IOSCONEWS526.pdf
[12] Letter from Working Group on Euro Risk-free Rates to European authorities

	EMIR Risk Mitigation Techniques	EMIR also contains provisions relating to risk mitigation techniques for non-cleared derivatives, such as timely confirmation, dispute resolution and portfolio reconciliation. The scale of amendments which will be needed for existing IBOR contracts will present significant challenges to firms' ability to meet these requirements for those existing contracts. **Recommendation:** We therefore request authorities adopt a proportionate approach with respect to firms' compliance with those provisions for existing contracts until the logistical burden has been overcome.
	MIFIR Trading Obligations	MIFIR has mandated that certain interest rate derivatives referencing IBOR benchmarks have to be executed on platforms. While the mandatory trading obligation is related to the EMIR mandatory clearing obligation, we request that regulators consider the trading liquidity and other relevant factors before applying the MIFIR trading mandate to include risk free rate (RFR) referencing derivatives. In particular, in the context of LIBOR transition where there are LIBOR-linked derivatives with fallbacks referencing RFRs, firms will have to report a change in their contracts from LIBOR to the new RFR rate en masse, once that fallback provision is triggered. The fact that firms will have updated all transaction reporting to reference that RFR might in turn create an artificial impression that there is sufficient liquidity in the related swaps market to meet the threshold for MIFIR trading obligations. **Recommendation:** The RFR WG welcomes clarity on the data source used to make the assessment of whether to submit an asset class to the trading obligation under MIFIR and assurance that activity related solely to LIBOR transition will not be counted towards the overall market liquidity to declare the trading obligation. This will inform whether further action is required by authorities to avoid any artificial counting of new RFR liquidity which may result in an inappropriate determination being made. A premature mandate may have unintended and adverse consequences that create further risks to firms' ability to execute such derivatives.

	G20 over-the-counter (OTC) derivatives reforms	**Recommendation:** We request the authorities co-ordinates with the appropriate standard setting bodies to consider the other aspects of G20 derivatives regulatory reforms impacted by IBOR transition, including imposing new regulatory mandates (such as clearing and trading obligations) on new RFR instruments.
Disclosure	**Key Investment Documents (KIDs)**	The PRIIPs Regulations require manufacturers of PRIIPs to provide a Key Information Document (KID) to retail clients and to update the KID when a change significantly affects the information therein. **Recommendation:** The RFR WG seeks clarification as to whether authorities have any guidance on how to interpret existing legal requirements, or have specific expectations beyond those requirements, when a LIBOR-based contract is amended to include a fair replacement rate and / or for legacy contracts that assume LIBOR will continue beyond 2021.

Conduct	**Market conduct and conflicts of interest**	The information regarding transitioning specific clients to new RFR-based products, combined with wider market insight regarding significant positions, may lead to specific conflicts for firms as well as giving rise to potential market abuse risks. In addition, the relative liquidity of new RFR products compared to existing products over the period of transition may provide an opportunity for pricing biases and potentially abusive behaviours to emerge. **Recommendation:** The RFR WG members are aware of current Market Abuse requirements, and that client-facing market participants should not be seeking to profit from the industry transition and benchmark reform initiatives. The RFR WG seeks the development of best practice guidelines as to how firms should handle the conflicts and wider Market Abuse considerations that are potentially inherent in benchmark reform efforts.