Public Consultation regarding a recommendation for a fallback rate for CIBOR

FINANCE DENMARK

Memo

March 31, 2023
Doc: FIDA-1344658213-688423-v1
Contact Morten Frederiksen

1. Introduction and invitation to comment

This report is the second deliverable by the Risk-Free Rate Working Group under Finance Denmark (hereafter the "RFR WG") regarding a recommendation for fallback rates for CIBOR[1].

The Working Group has produced a proposal for a recommendation on how fallback rates for CIBOR can be formulated. The proposal for a recommendation describes in which situations a change of reference interest rate is necessary and what fallback rate is recommended to be used. The recommendation is based on the standards that have been developed internationally in recent years. The recommendation is very generally held to be able to work for all types of markets, instruments, and parties.

The background for the proposed recommendation is that in order to comply with the requirements, set out in Article 28 (2) of the Benchmark Regulation, companies under supervision in contracts must have a description of what happens if a reference rate used in financial contracts ceases permanently (fallback clause).

Stakeholders are hereby invited to comment on all matters in this report and on the questions summarized in Appendix 1.

Comments are most helpful if they:

- Respond to the question stated
- Indicate the specific question to which the comment relates
- Contain a clear rationale
- Describe any alternatives the RFR Working Group should consider

The RFR WG will consider all comments received by latest 28 April 2023 COB. An anonymized summary of the comments and the final recommendation from the Working Group will be published shortly thereafter.

All contributions should be submitted via email to mof@fida.dk.

[1] Terms of Reference for the Working Group on forward-looking term rates based on DESTR and fallback for CIBOR (finansdanmark.dk)

2. Proposal for general recommendations

The RFR WG recommends that financial contracts that refer to CIBOR should regulate:

1. which trigger events in the contract imply that one or more tenors of, or the entire, CIBOR will cease to function permanently as a reference rate,
2. which interest rate replaces CIBOR if a trigger event occurs, which means that a tenor of, or the entire, CIBOR will cease to function permanently as a reference rate,
3. time when the fallback rate begins to apply to the financial contract.

Furthermore, the RFR WG recommends that market participants should seek consistency and use the same trigger events for all asset classes when developing and introducing fallback provisions in different financial instruments and contracts referencing CIBOR, to the extent possible and appropriate.

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Question 1
Do you see other important elements that financial contracts that refer to CIBOR should regulate?

3. Proposal for trigger events

The RFR WG recommends the following trigger events can be used in financial contracts that refer to CIBOR. Trigger events 1–5 can be used in all financial contracts that refer to CIBOR. Trigger events 6–7 can be used in financial contracts that refer to CIBOR if the contracting parties deem it necessary.

Furthermore, the RFR WG finds that a statement by a public authority other than the parties referred to below that the CIBOR rate will be discontinued will not have any impact and will therefore, not constitute a trigger event.

Proposal for recommended trigger events:

1. The supervisory authority for CIBOR's administrator makes a public statement or publishes information stating that one or more CIBOR rates will no longer be provided.
2. The administrator of CIBOR makes a public statement or publishes information stating that one or more CIBOR rates will no longer be provided.
3. The bankruptcy administrator of CIBOR's administrator or the administrator, according to the resolution regulations, of CIBOR's administrator makes a public statement or publishes information stating that one or more CIBOR rates will no longer be provided.
4. The supervisory authority for CIBOR's administrator makes a public statement or publishes information stating that:

a) One or more CIBOR rates are no longer, or will no longer be, representative of the underlying market that the CIBOR rate or CIBOR rates are intended to represent, and

b) The representativeness of the CIBOR rate or the CIBOR rates will not be restored.

5. The supervisory authority for CIBOR's administrator makes a public statement or publishes information stating that it is, or will be, illegal to use one or more CIBOR rates as a reference rate in financial contracts.

6. One or more CIBOR rates cease to be provided without a statement or publication of information in accordance with items 1–3 above. Contracting parties must agree on what is considered a permanent cessation if this trigger is to be included in the contract.

7. CIBOR's administrator or the supervisory authority for CIBOR's administrator makes a public statement or publishes information stating that one or more CIBOR rates should or may no longer be used, without reference to regulations.

Question 2

Do you agree with the proposed trigger events and/or do you see other important events that should be included in the list of trigger events?

4. Proposal for recommendations regarding fallback rate(s) for CIBOR

The RFR WG proposes that the general fallback interest rate that replaces the CIBOR rate if a trigger event occurs and one or more tenors, or the entire CIBOR, permanently cease to function as a reference rate, is recommended to be the adjusted (compounded) DESTR for the same term as CIBOR plus a spread adjustment.

This division of the fallback rate into two parts conforms to the way fallback rates have been specified internationally. The adjusted DESTR is used to create a term, while the spread adjustment is used to even out the differences between CIBOR and the adjusted DESTR. This is to reduce the risk of value transfers between the parties resulting from the change of reference rate.

The adjusted DESTR must be calculated in a conventional manner in line with international standards. In Denmark, this calculation will be made according to the principles established by ISDA. The spread adjustment will also be calculated in the way specified by ISDA. This means calculating the median daily difference between CIBOR and the adjusted DESTR over the previous five years. A full description of the ISDA principles for calculating the DESTR based fallback interest rate for CIBOR can be found here[2].

Question 3
Do you agree with the proposal that the general fallback interest rate for CIBOR rate should follow the ISDA principles for calculating the DESTR based fallback interest rate for CIBOR?

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The RFR WG have also analyzed possible fallback rates for the Danish mortgage loans (in Danish "realkreditlån" and "bankboliglån") and mortgage bonds.

Danish mortgage institutions are subject to legislation and the balance-principle, which implies a close link between the mortgage loan and the bond. The mortgage borrowers receive payment advice well in advance prior to an interest payment date, typically 45 days before a quarter-end. This means that the Lookback method (eq. the ISDA principles for calculating the DESTR based fallback interest rate for CIBOR) will not be workable for Danish mortgage loans. The mortgage borrower would need know the rate in advance. Forward-looking rates are therefore superior in terms of interest calculations and settlement on Danish mortgage loans and their underlying bonds. There may also be a consideration to know the interest rate in advance for certain banking loans, banking deposits and other banking product types for instance due to consumer protection rules in article 57 and 58 in the Benchmark Regulation EU 2016/1011.

On that background the RFR WG proposes for CIBOR based mortgage loans, mortgage bonds and certain banking products etc. that the fallback interest rate that replaces the CIBOR rate if a trigger event occurs and one or more tenors, or the entire CIBOR, permanently cease to function as a reference rate, is recommended to be the CITA rate[3] for the same term as CIBOR plus a spread adjustment. CITA is a benchmark for risk-free interest rates for DKK over the relevant forward-looking tenors as implied by Overnight Index Swap contracts that reference DESTR.

The RFR WG recommends that spread adjustment for each tenor will be calculated as the means calculating the median daily difference between CIBOR and

[2] ISDA-2021-Fallbacks-Protocol_November-2022-Benchmark-Module.pdf
[3] CITA & SWAP - DFBF

CITA over the previous five years. Because of the CITA benchmark reformation process the RFR WG recommends that prior to 1 January 2026 the median daily difference is calculated between CIBOR and CITA deducted 19bps. From 1 January 2026 and ongoing it is recommended the median daily difference is calculated between CIBOR and CITA.

Question 4
Do you agree with the proposal that the fallback interest rate for CIBOR based mortgage loans, mortgage bonds and certain banking products etc. should be CITA?

The RFR WG have also analyzed possible fallback rates for financial products that contains two product categories with different recommended fallback rates. An example of such a product could be a CIBOR based mortgage loan or bond combined with a derivative. Another example could be multi-currency products or prospectus' referring/using different reference rates and fallback provisions. For these types of products, the RFR WG recommends that the financial institutions (and their counterpart) select the fallback rate and language that adapts to the product and risk profile in the best manner.

5. Proposal for recommendation regarding when the fallback rate takes effect

When a trigger event occurs, which means that the CIBOR rate ceases, the RFR WG proposes that the change to the fallback rate is recommended to take place in connection with an interest rate determination opportunity. It is suggested that the change must take place at the latest in connection with the first interest rate determination opportunity after CIBOR has ceased. The parties to the contract are recommended to agree on this time in advance.

Question 5
Do you agree with the proposal regarding when the fallback rate takes effect?

6. Executive summary

The purpose of this report by the Risk-Free Rate Working Group under Finance Denmark has been to produce a proposal for a recommendation on how fallback clauses for CIBOR can be formulated.

The proposal for a recommendation describes in which situations a change of reference interest rate is necessary and what fallback rate is recommended be used. The recommendation is based on the standards that have been developed internationally in recent years. The recommendation is very generally held to be able to work for all types of markets, instruments, and parties.

To summarize, the RFR WG recommends the following fallback rates for CIBOR:

- The general fallback interest rate that replaces the CIBOR rate if a trigger event occurs and one or more tenors, or the entire CIBOR, permanently cease to function as a reference rate, is recommended to be the adjusted (compounded) DESTR for the same term as CIBOR plus a spread adjustment.

- For CIBOR based mortgage loans, mortgage bonds and certain banking products etc. the fallback interest rate that replaces the CIBOR rate if a trigger event occurs and one or more tenors, or the entire CIBOR, permanently cease to function as a reference rate, is recommended to be the CITA rate for the same term as CIBOR plus a spread adjustment.

Appendix

Overview of questions for the consultation.

Question 1

Do you see other important elements that financial contracts that refer to CIBOR should regulate?

Question 2

Do you agree with the proposed trigger events and/or do you see other important events that should be included in the list of trigger events?

Question 3

Do you agree with the proposal that the general fallback interest rate for CIBOR rate should follow the ISDA principles for calculating the DESTR based fallback interest rate for CIBOR?

Question 4

Do you agree with the proposal that the fallback interest rate for CIBOR based mortgage loans, mortgage bonds and certain banking products etc. should be CITA?

Question 5

Do you agree with the proposal regarding when the fallback rate takes effect?