Response of market participants to report on alternative reference rates

ARR secretariat, 30 January 2019

The working group on alternative reference rates (ARR) published a consultation report in autumn 2018. The report was presented at an open meeting arranged by the working group and held at Norges Bank on 20 November 2018. Market participants and other interested parties were invited to offer their views on the report. The working group has received comments from five market participants. Norges Bank has as secretariat written the following anonymised summary of the respondents' views:

1. To what extent would your firm be affected by the introduction of a new reference rate?

The respondents all answer that they would be affected, to some extent considerably. Respondents' answers to this question are fairly similar.

2. What do you regard as the three most important criteria for an alternative reference rate?

All the respondents offer views on alternative reference rate criteria, emphasising the following:

2.1 Same type of reference rate in Norway as in other countries

Respondents all make the point here that market standards and alternative reference rates established in other countries must also be made applicable in Norway. When overnight rates are established as reference rates internationally, an alternative NOK reference rate should also be an overnight rate. Repondents point out that this is particularly important in derivative contracts.

2.2 Based on actual transactions, robust and verifiable

All the respondents emphasise that the reference rate should be transaction-based, as this increases confidence in the rate and reduces the possibility of manipulation. They are all also agreed that reference rate quoting must be verifiable and that calculation of the rate must be transparent.

2.3 Transition to new reference rate

Several respondents mention the importance of good transitional solutions and fallback methodologies in existing contracts. The respondents note that the current lack of contractual provisions for fallback methodologies for Nibor-related contracts generates financial and legal risk and they place considerable emphasis on the importance of finding a satisfactory solution to this problem. A couple of respondents make reference to international work focusing on this issue, such as the work to establish methods for calculating premiums that can be added to the risk-free reference rate in a transitional phase.

3. How important is it for a reference rate used in banks' loan and debt contracts to reflect risk premiums?

Some respondents answer that this could be important, while others say it is not important. No respondents view the issue as so important that it precludes the introduction of overnight rates as alternative reference rates. The following answers were submitted by four respondents:

- *The credit/liquidity element in IBOR represents a safety valve for variations in banks' own refinancing costs and is thus a natural hedge in a business model where banks' borrowing is at shorter maturities than their lending. A short reference rate does not take account of the uncertainty related to long-term lending. We expect that new margin models with higher credit premiums for customers will have to be established in a transitional phase. Over time, we expect rates to converge and clear to a new market equilibrium. When the transition is made to a new, close to risk-free reference rate, banks and credit institutions will to a greater extent assume the responsibility and risk associated with the calculation of credit risk through market cycles.*
- *It is not particularly important, but I believe that replacing Nibor with an OIS rate will result in increased volatility in the credit spread over the reference rate. This may be difficult for market participants to get used to, and they might demand extra compensation. Today, USD Libor volatility is largely absorbed by Nibor, and market participants operate with a relatively stable credit spread over Nibor. With a stable OIS rate as the reference rate, credit spreads will have to compensate for US money market volatility.*
- *The reference rate does not have to reflect risk premiums. There will be a premium between the lending rate/bonds and the reference rate anyway. There are two risk premiums today: 1) between Nibor and the risk-free rate: 2) the credit spread over Nibor. It is not necessary to have both. We assume that the size of the second credit premium could increase if the first is removed, since banks' costs related to foreign funding will not change (but will probably be reflected in basis swap spreads instead). Today's Nibor premium is not transparent and is actually a function of the US money market. As well as various demand-side factors in the US, conditions that for example affect the volume of US Treasury bills that can be issued (such as the US debt ceiling) have considerable influence on Nibor. As well as a lack of transparency in the calculation of the rate, the Nibor rate is thus subject to considerable volatility. This could potentially affect liquidity in the Norwegian money market as many participants (including foreign participants) will choose to avoid this market.*
- *When new business transactions are entered into, parties will probably observe that forward credit spreads over the new reference rate are more volatile than previously*

since the reference rate may now be virtually risk-free. Both professional investors and the average mortgage customer will have to take account of these conditions.

4. How important is it for a reference rate used in derivative contracts to reflect risk premiums?

The general consensus is that this is not important.

5. If Libor is discontinued, should Nibor be retained as a reference rate?

All the respondents answer that it would not be appropriate/desirable to retain Nibor if Libor is discontinued. One respondent writes:

- *As mentioned above, keeping two benchmarks will reduce liquidity. Nibor should be discontinued when bonds and derivatives have migrated to the new benchmark. Converting contracts with long residual maturity based on Nibor will likely be problematical, but this will not only be the case in Norway. We should follow the same practice as other countries for converting remaining contracts when the time comes.*

6. Nowa/expanded Nowa/reformed Nowa as reference rate

The report raises the question of using Nowa/expanded Nowa/reformed Nowa as a reference rate. In general, respondents point to the current Nowa rate's weaknesses, particularly low transaction volumes at some quarter-ends. The respondents all agree that Nowa, or a variant of this rate, should be an alternative reference rate. The respondents also emphasise that the method of calculation must comply with international standards.

7. What is your view of the possibility of creating an OIS market based on Nowa or expanded Nowa as the underlying rate?

Some of the respondents answer that an OIS market could be based on Nowa or expanded Nowa, while others do not respond to this question. There were no negative responses.

Three respondents write:

- *It should be very possible to create an OIS market based on Nowa or expanded Nowa as the underlying rate.*
- *Well-functioning derivatives markets are important, [and they will not become] more or less complex with Nowa as the reference rate compared with Nibor. To estimate a 3-month rate, the 3-month OIS swap rate could be quoted (instead of 3-month Nibor).*
- *Our perception is that the Norwegian market is limited and that it can be challenging to generate enough liquidity in new derivatives that would be based on a new reference rate. But at the same time, there is an advantage in that Norwegian market participants make up a small and homogeneous group, who with their common interests and understanding could facilitate a derivatives market. The most natural choice for the basis of an OIS swap market would be 'Expanded Nowa'.*