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RFR transition beyond G5

The road ahead for alternative reference rates

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The road ahead for ARRs

After preparing ground for the transition of Group of 5 (G5) currencies — the US dollar, pound, euro, Swiss franc and yen — from interbank offer rates (IBOR) to their respective alternative reference rate (ARR), focus has shifted to the migration of Asia-Pacific (APAC) and Latin American (LATAM) currencies to ARR.

Even though the lessons learned from the transition of G5 currencies can be leveraged, the adoption of ARR by other economies in APAC and LATAM would not be easy.

The G5 currency portfolio has a material impact worldwide and represents a significant transaction volume across major global banks. The transition to their respective risk-free rate (RFR) has led to the creation of systems and methodologies and standard processes.

However, the exposure of the currencies of emerging economies is not as significant and other key hurdles to the transition are availability of liquidity, unorganised market structure and lack of clear regulatory mandates.

In this paper, we explore the intricacies and challenges related to ARR adoption in 2024 for a few key currencies.

JPY TIBOR cessation

Published by Japanese Banking Association TIBOR Administration (JBATA), Tokyo Interbank Offered Rate (TIBOR) is a interest rate benchmark for Japanese yen and mainly used in loans and derivative transactions and comprises Japanese yen TIBOR and Euroyen TIBOR.

In May 2019, JBATA published its first consultation paper on retaining Japanese yen TIBOR and discontinuing Euroyen TIBOR. After further discussions, JBATA announced that it expects Euroyen TIBOR to be discontinued by the end of December 2024 and the cessation date for booking new trades based on the benchmark has been set six months prior to the deadline i.e., June 2024. However, further discussions are needed to resolve uncertainty over the following key issues:

- Lack of clarity on the methodology to calculate fallback rates and issues with existing contracts caused by replacement of the benchmark
- Limited window for banks to implement changes in their existing systems to ensure a smooth transition
- Hedge accounting and interest rate swap clearing issues

JBATA plans to publish a consultation paper in March 2024, seek comments from market participants on permanently discontinuing the Euroyen TIBOR and determine the cessation date. The agency also plans to simultaneously focus on development of the fallback methodology.

KOFR adoption

Amid RFR adoption across the globe, South Korea is working on the Korea Overnight Financing Repo Rate (KOFR) and the Korea Securities Depository will handle development and publication of KOFR. The depository has already begun to officially publish KOFR from November 26, 2021. Unlike certificate of deposit (CD) rates, KOFR will be directly computed by the Korea Securities Depository based on real transaction data.

Though there is no official timeline, market participants expect the transition to gather pace once the regulator opens the USD/Korean won (KRW) spot market to offshore investors. The demand for KOFR could boom once the domestic regulator includes Korean government bonds in the World Government Bond Index (WGBI) and enables CD/KOFR transition.

RFR transition of MXN TIIE

Market participants are preparing for the transition of the Mexican interbank equilibrium interest rate (MXN TIIE) index which has a swap market size of $4.9 trillion in terms of central clearing counterparty (CCP) volumes. TIIE will move to a new overnight funding rate called TIIE de Fondeo on January 1, 2025.

From January 1, 2024, TIIE rates with maturities longer than one business day started transitioning to the new overnight rate i.e., the 91-day and 182-day tenor TIIEs. The 28-day TIIE will transition to the new overnight benchmark a year later, on January 1, 2025. However, the use of 28-day TIIE for new agreements would be prohibited from January 1, 2025, onwards.

The MXN RFR transition is quite different from the transition of other currencies as the 28-day TIIE would not cease to exist, only the method to compute it would change.

- The major challenge for banks is to transition their existing systems and infrastructure to the new Fondoe TIIE index rate and the fallback spread
  - The new overnight Fondeo TIIE index rate is calculated based on real transaction data and the benchmark is determined based on wholesale repo transactions. The index rate is a volume weighted median of interest rate paid on repo transactions
  - The other challenge for banks is the divergence in the methodology for computing fallback spread based on Banxico and CME exchange. The fallback spread for legacy trades is 24 basis points (bps) as per Banxico methodology and 23 bps as per CME proposed International Swaps and Derivatives Association (ISDA) methodology
- Another major challenge for market participants is transitioning all existing contracts to new standards within stringent timelines

Note: As per our recent industry interactions, CME has confirmed that it will also comply with Banxico methodology which LCH has already adopted.

Market participants and the regulator need to collaborate closely to implement a common methodology for determining the fallback spread.

Though the market for F-TIIE is almost negligible, its liquidity is expected to quickly scale up amid planned CPP adoption in September 2024.

SGD SORA adoption

The Association of Banks in Singapore and the Singapore Foreign Exchange Market Committee (ABS-SFEMC) recommended Singapore Overnight Rate Average (SORA) as the most suitable and robust benchmark to replace the SGD Swap Offer Rate (SOR) for interest rate derivatives. The Steering Committee for SOR Transition to SORA (SC-STS) was tasked to provide strategic direction and oversee the transition from SOR to SORA.

The Singapore Interbank Offered Rate (SIBOR) will be discontinued after December 31, 2024. Hence, outstanding SOR-based business loans and derivatives that mature after that date will require a new fallback rate. Separately, the SC-STS will also provide supplementary guidance on adjustment spreads to apply for interest rate periods before end-2024 to support the industry's ongoing transition of wholesale SOR contracts.

- **Methodology:** SORA is a volume-weighted average rate of borrowing transactions in the unsecured overnight interbank SGD cash market in Singapore
- **Publication:** Along with SORA index, one-month, three-month and six-month compounded SORA and other relevant details are published every day on the Monetary Authority of Singapore (MAS) website and through third-party redistribution services
- **Contingency SORA:** If data is insufficient, SORA will not be computed using the normal methodology and a contingency process will be triggered i.e., contingency SORA
- **Fallback spread:** Adjustment spreads within the MAS recommended rate should be derived from the historical median spread between SOR and SORA. Together with the linear interpolation outlined in the supplementary guidance, the historical median approach will reduce inequity or unintended value transfer among different participants to the same contract that may arise due to conversion from SOR to SORA

THB

As Thai Baht interest rate fixing (THBFIX) is linked to the USD London Interbank Offered Rate (USD LIBOR), the Bank of Thailand decided to cease the THBFIX rate from June 2023, along with USD LIBOR. However, the central bank introduced a fallback THBFIX rate calculated using the USD SOFR index + spread. This rate will be published only until the end of 2025 and can be adopted only on legacy contracts.

Any contracts with maturity beyond 2025 need to switch from the THBFIX fallback rate to a new ARR known as THOR. It was first published in April 2020, together with the THOR average, which is the compounding-in-arrears rate for one, three and six months. The Bank of Thailand supports the adoption of THOR as an ARR for all new contracts to improve its liquidity. Also, banks need to ensure that all contracts based on THBFIX contain fallback provisions.

CRISIL’s expertise and experience with RFR migration

With its in-depth regulatory know-how and experience of implementing RFR transition across jurisdictions, CRISIL can support financial institutions in their efforts to transition from IBOR to ARR.

CRISIL is currently helping its clients on the following RFR activities:

- RFR curve construction and testing
- Technology and pricing library for RFR adoption
- Thorough quantitative testing of various milestones of RFR adoption for trading desk and other functions such as finance and market risk
- Assist with gap analysis and contract remediation

Parting thoughts

The transition from IBOR to ARR is a dynamic process and market participants need to continuously monitor regulatory developments and be prepared to adapt to changes. They also have to adopt industry best practices, track regulatory updates, and monitor market dynamics to make informed decisions throughout the transition process.

To conclude, ARR adoption marks a significant shift in the financial landscape. Market participants, regulatory bodies, and industry stakeholders have to collaborate closely to successfully navigate this transition. By focusing on global standardisation, addressing challenges in implementation, effectively managing risks, upgrading technology and infrastructure and fostering open communication with clients and regulators, the financial industry could effectively resolve challenges associated with ARR adoption.

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