Pills

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TOPICS:
MARKET RISK, ELIGIBILITY CAPITAL INSTRUMENTS, PRUDENT VALUATION, FINANCIAL STATEMENTS

SOURCE:
European Banking Authority

Benchmark Rate Transition Risks – Analysis of the EU/EEA Banking Sector's Exposures Linked to Benchmark Rates and Transition Risks Relating to Interbank Offered Rates

Benchmark Rate Reforms

- **The reforms of two major benchmark (interest) rates are nearing their completion. These are the London Interbank Offered Rates (LIBOR) for different currencies and for varying tenors, and the Euro Overnight Index Average (EONIA).** The reforms of other (national) benchmark rates are in various degrees of completion. **Benchmark rates play a major role in banks' daily business, including in valuation and risk management.** Transitioning away from ceasing benchmark rates to new risk-free rates (RFRs) poses a potential key risk for financial markets in general and for banks in particular. There are also links to prudential requirements and accounting, as benchmark rate transitions may affect banks' internal market risk models, prudent valuations and the eligibility assessment of capital instruments. This may have a non-negligible impact on banks' financial statements.

Benchmark Rate Transition Risk

- **Even though the largest share of benchmark-referenced assets and liabilities of EU/EEA banks is linked to EURIBOR and national benchmark rates, significant exposures are linked to LIBOR and EONIA, both of which will cease to exist.** LIBOR-linked derivative volumes are particularly high (reaching nearly EUR 50 trillion - notional amount), mostly USD-denominated exposures. LIBOR-referenced loans and advances are a particular focal point, as their transition risk might be higher than for other LIBOR-linked exposures.
- **Banks and Competent Authorities (CAs) consider legal challenges accompanying the transition of existing business on the assets side as well as changes in bank-internal operations and systems as key areas of concern. Despite these major challenges, CAs tend to agree that the ongoing work and general awareness of the banks under their supervision should adequately address and mitigate risks relating to benchmark rate reforms.** However, they also point to challenges relating to the renegotiation of existing contracts, as litigation and conduct risks presumably do not dissipate even if transitions are well managed. They also stress that legal uncertainties would remain anyway even if transitions are well managed and show certain concerns relating to the updating and validation of internal risk models.