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Fallback rate in the event of a cessation of Nowa

Background

At the end of September 2019, the working group for alternative reference rates (ARR) published its report, which recommended a reformed version of Nowa as an alternative reference rate for financial contracts denominated in NOK. Since that time, the group's work has concentrated on how Nowa can be utilised as an alternative reference rate.

A well-functioning market for interest rate derivatives is important for market participants who wish to hedge against interest rate risk. Interest rate derivatives are also widely used by market participants who wish to speculate in changes in market interest rates. Derivatives linked to overnight rates are likely to play an increasing role in global derivatives markets in the years ahead. In December 2019, ARR created a subgroup to report on the possibility of establishing a Nowa-linked OIS market in Norway.

The subgroup has issued a public report[1] and is now working on how a Nowa-linked derivatives market can be established. The report outlines a timeline where the plan is for Nowa-linked trading to start in 2021 Q3. A necessary prerequisite is to put in place a Floating Rate Option (FRO) for Nowa in the ISDA framework (ISDA 2006 Definitions). In such an FRO for Nowa, it is necessary to include a fallback covering a scenario where Nowa is no longer published. Such a fallback will also be included in a fallback waterfall for Nibor fallbacks, once they are included in the ISDA framework.

The methodology that has been used for a number of the major currencies, such as eg the euro short-term rate (€STR), is based on a two-step structure, where the first step is a fallback rate recommended by the administrator of the rate in question. If the administrator has not recommended a fallback rate, the reference rate will be replaced by another defined rate, typically a central bank rate.

As an example, the ECB has published a document that describes the procedure for the possible cessation of the €STR.[2] The procedure contains an option for the ECB to recommend a fallback rate for the €STR. If the €STR ceases to be produced, and the ECB has published such a recommendation, all derivative contracts with the €STR as the underlying where the ISDA framework is used will convert to the rate recommended by the ECB. However, if the ECB refrains from recommending a fallback ate, the contracts will be converted to the ECB's deposit facility rate (EDFR) plus a spread.[3] It

[1] https://www.norges-bank.no/contentassets/81885ab218dd4eeb9129f5cdb6c293fc/establishing-an-ois-market-in-nok---final-report.pdf
[2] https://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/euro_short-term_rate/shared/pdf/ECB_policy_and_procedure_for_cessation_of_the_euro_short_term_rate_(%E2%82%ACSTR).pdf
[3] It is necessary to add a spread to adjust for the difference between the EDFR and €STR.

is worth noting that even if the first fallback rate for the €STR is a rate recommended by the ECB, the ECB is not required to make such a recommendation.

Request to Norges Bank

ARR proposes that the fallback rate for Nowa be based on the methodology adopted for the €STR. This will require Norges Bank to formulate a procedure for the cessation of Nowa that includes a clause giving the Bank the option of recommending a fallback rate. Should Norges Bank refrain from making a recommendation, Nowa will be replaced by Norges Bank's sight deposit rate.

We would like speedy clarification of this request so that ISDA can begin preparing an FRO for Nowa and kindly ask for a response to our request by 5 February.

Sincerely,

Vidar Knudsen
on behalf of the working group on alternative reference rates

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