

Market conventions and fallback solutions

Mandate

Background

Reference rates play a critical role in the financial system. The value of various financial products and loan agreements linked to these rates is very high. In early 2018, a working group on alternative Norwegian krone reference rates (hereinafter referred to as the ARR working group) was established by Norges Bank, in consultation with the financial industry. The main objective of the group's work is to establish a reference rate for the Norwegian krone as an alternative to Nibor. In September 2019, the ARR working group recommended Nowa (Norwegian Overnight Weighted Average) as an alternative Norwegian krone reference rate. The work on alternative reference rates is now moving into a new phase and will focus on how to transition to using Nowa as a reference rate.

Use of reference rates

The Benchmark Regulation (EU 2016/1011) requires users of reference rates to nominate an alternative reference rate in their contracts.¹ The rate shall be used as a benchmark if the contract's original benchmark is substantially changed or no longer available. The current reference rate Nibor and the alternative reference rate Nowa have different maturities. In addition, Nibor may contain considerably larger risk premiums in the form of credit and liquidity risk than the nearly risk-free rate Nowa. For Nowa to replace Nibor in financial contracts, solutions will be needed for dealing with the differences between the two rates.

Nowa is currently little used as a benchmark in financial products, but is likely to be increasingly used as a reference rate. To avoid fragmentation of liquidity across markets and minimise unnecessary differences between products, it will be appropriate to establish common conventions for the use of Nowa as a benchmark in new contracts. Common conventions will also enable the necessary changes in IT systems and accounting to be implemented across markets and products.

Sub-group for fallback solutions and market conventions

In order to solve problems associated with fallback solutions and market conventions for Nowa products, the ARR working group has decided to establish a sub-group for fallback solutions and market conventions.

¹ EU Regulation 2016/1011 provides rules for setting financial benchmarks (see https://ec.europa.eu/info/law/benchmarksregulation-eu-2016-1011_en).

Objectives

The sub-group is to

- prepare an official report with recommendations for fallbacks with Nibor as a benchmark and market conventions for different financial products with Nowa as a benchmark.
- specify what would trigger the use of fallbacks and how the difference between Nowa and Nibor (premium) should be dealt with. ISDA shall be consulted with regard to fallback solutions for derivative contracts in NOK.
- aim to recommend the same conventions for the use of Nowa across markets and products to the extent possible.

Administration and work structure

- The sub-group comprises market participants from various parts of the private and public sectors.
- The chair of the sub-group is to be one of the voting members of the working group. The chair is selected by the ARR working group.
- Each member of the sub-group represents his or her own institution.
- Each institution has one vote. Norges Bank and Finance Norway will have observer status without voting rights.
- Finance Norway will perform the secretariat function. This will be a coordinating role. The secretariat will, in collaboration with the chair or other members, convene meetings, draw up the agendas, write minutes and coordinate the writing of reports.
- The mandate, participants, agendas, minutes and reports will be published on the ARR working group's web page on Norges Bank's website.
- Non-members may be invited to make presentations or participate in some of the work of the sub-group. The sub-group can also establish sub-groups to examine more closely certain themes if deemed appropriate. Establishment of new groups must be cleared with the ARR working group in advance.
- The sub-group shall draw on relevant parties for input into the group's work. In particular, the groups should seek to establish a consultation group comprising international market participants with experience in the work of transitioning to alternative reference rates abroad.
- In collaboration with the ARR working group, the sub-group may assume tasks associated with communicating the group's work to users of reference rates.
- The sub-group must coordinate its work with the sub-group exploring the OIS market in NOK.
- The sub-group shall regularly update the ARR working group on its work. The ARR working group shall be presented with consultation report(s) and final report(s) prior to publication and shall give its endorsement to what is published.

Indicative timetable

The sub-group aims to publish at least one official report by the end of 2020. The report(s) will contain recommendations for both fallback solutions for all types of contracts with Nibor as the reference rate and market conventions for financial products using Nowa as a benchmark. During the year, the sub-group will aim to publish one or more consultation reports to obtain input on its preliminary work from outside parties.

Confidentiality

All information provided, discussions and statements during the meetings of the sub-group are subject to a duty of confidentiality, if the sub-group has not approved public disclosure of such information. However, this does not prevent participants from conducting internal consultations in the institutions they represent.