Consultation by European Commission on CHF Libor
[Targeted consultation on the designation of a statutory replacement rate for CHF LIBOR | European Commission (europa.eu)](https://ec.europa.eu).

CONSULTATION QUESTION N.1

1. ON THE EFFECTIVE NEED FOR A REPLACEMENT FOR CHF LIBOR
Pursuant to article 23a of the EU BMR, the Commission may only designate replacement rates for third-country benchmarks "*if their cessation or wind-down would significantly disrupt the functioning of financial markets in the Union or pose a systemic risk to the financial system in the Union*.".
Question 1. Do market participants agree that the situation as described above, requires that the Commission exercises the statutory replacement powers for the CHF LIBOR? Please explain and provide data if available.
a) Yes
b) No
c) No opinion

UniCredit Answer
a) Yes

We believe that a statutory replacement for main CHF LIBOR (1M, 3M, 6M, 12M) is needed in particular for a group of financial products which share similar characteristics such as retail mortgages, consumer loans and SME loans.

An addition to proposed 3-month setting, we also suggest including the 1-month (1M), 6-month (6M) and 12-month (12M) settings in the framework of statutory replacement rates.

As stated in the public consultation on €STR-based EURIBOR fallback rates[1] launched by the working group on euro risk-free rates, borrowers of these products are usually unsophisticated parties for which the corresponding interest payments form an important part of their overall finances. These contracts have a long-dated maturity, are difficult and expensive-to-amend bilaterally and are regulated by consumer protection legislation. Consequently, they could be considered as tough legacy contracts for which a statutory replacement rate is welcomed.

Unicredit, which is a pan-European group, is especially exposed to several rules and legislations in different European countries. Therefore, we consider a statutory replacement rate for main CHF LIBOR essential to have a smooth transition to the new SARON-based risk-free rates across Europe, and even more so for contracts involving consumer and SME borrowers.

The Austrian retail mortgages, where UniCredit has a significant exposure, sees a widespread use of contracts indexed to 1-month CHF LIBOR, while the other settings are also used in the other European countries. Most of these contracts do not include a fallback clause as they were signed prior to the BMR approval. Besides national consumer protection laws often set very high transparency standards. Consequently, we believe that the 1-month, 6-month and 12-month tenor have the same relevance as the 3-month one.

As UniCredit group, we recommend that the statutory replacement framework shall specifies in detail the methodologies, including spread adjustment, floor and conforming changes, to be used as a fallback for cash products, avoiding any interpretative doubts.

[1] https://www.ecb.europa.eu/pub/pdf/other/ecb.pubcon_ESTRbasedEURIBORfallbackrates.202011~d7b62f129e.en.pdf

Replacement rates for CHF LIBOR 1M and 3M

With reference to CHF LIBOR 1M and 3M, we suggest to use the compounded SARON under a last reset methodology (1M for CHF LIBOR 1M and 3M for CHF LIBOR 3M) plus the corresponding ISDA spread adjustment (1M spread adjustment for the 1M CHF LIBOR and the 3M spread adjustment for the 3M CHF LIBOR calculated as a historical median approach over a five-year lookback period[2]).

This will allow all the market operators to adopt rates and spreads provided by external administrators (like the SIX Group[3] and Bloomberg), increasing transparency to protect consumers.

Moreover, the ISDA's spread adjustments published by Bloomberg are already available and set to the value calculated on March 5, 2021 ("Spread Adjustment Fixing Date"), coinciding with the announcement by the UK Financial Conduct Authority (FCA) on the future cessation and loss of representativeness of the LIBOR benchmarks[4].

Below it is reported a table with the SIX compounded SARON and the Bloomberg tickers[5] corresponding to the 1M and 3M spread adjustments.

LIBOR	TENOR	Compounded Rate	Spread Adjustment Value	Spread Adjustment Bloomberg Ticker
CHF	1M	SARON 1 month Compound Rate (SAR1MC) ISIN CH0477123886	-0.0571	SSF0001M Index
CHF	3M	SARON 3 months Compound Rate (SAR3MC) ISIN CH0477123902	0.0031	SSF0003M Index

Replacement rates for CHF LIBOR 6M and 12M

We have the opinion that it is fair to bring to the attention of the European Commission that there are a number of contracts indexed to 6M CHF LIBOR and 12M CHF LIBOR on the consumer market. In the UniCredit group, for example, we have a significant exposure to 12M CHF LIBOR in Slovenia and minor exposure to 6M CHF LIBOR in Italy. Accordingly, we believe that also these tenors need to be addressed.

We suggest to use the compounded 3M SARON under a last reset methodology for CHF LIBOR 6M and 12M plus the corresponding ISDA spread adjustment (6M spread adjustment for the 6M CHF LIBOR and the 12M spread adjustment for the 12M CHF LIBOR calculated as a historical median approach over a five-year lookback period).

As noted by the working group on euro risk-free rates in the Public consultation on €STR-based EURIBOR fallback rates, the last reset methodology has the clear disadvantage of inconsistency between the observation period and the interest period. The usage of the compounded 6M/12M SARON under a last reset methodology for CHF LIBOR 6M /12M would provide a material mismatch and flawed reflection of the actual interest rate environment.

Besides, the compounded 6M/12M SARON under a last reset methodology creates additional complexity for legacy transactions where the bank hedged the interest rate / fx risk using cross currency interest rate swaps

2 https://www.isda.org/2020/05/11/benchmark-reform-and-transition-from-libor/
3 https://www.six-group.com/exchanges/indices/data_centre/swiss_reference_rates/compound_rates_en.html
4 https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf
5 https://assets.bbhub.io/professional/sites/10/IBOR-Fallbacks-LIBOR-Cessation_Announcement_20210305.pdf

having as fallback the backward-looking lookback methodology. Some additional concerns are on the proper representation of time value of money when performing an IFRS 9 Solely Payment of Principal and Interest (SPPI) test at the initial recognition of a financial asset in the event of a benchmark cessation or a benchmark replacement measure. These mismatches are reduced using the last reset methodology up to three months.

For the sake of linearity, simplicity and transparency toward the customers, it would be desirable to apply the spread adjustment of the corresponding tenor. Moreover CHF retail mortgages and SME loans are usually hedged with derivatives (cross currency interest rate swaps) to which the fallback methodology established by ISDA is applied. For example, a 6M CHF LIBOR indexed mortgage is usually hedged with a cross currency swap for which the CHF floating leg rate is 6M CHF LIBOR. Consequently, once the CHF LIBOR discontinuation occurs, the 6M/12M CHF LIBOR in the hedging derivative will be replaced by the sum of compounded 6M/12M SARON under the lookback methodology and 6M/12M spread adjustment. Accordingly, with the aim to minimize value transfer between the lender and the borrower and to maintain the maximum degree of consistency between mortgages and hedging derivatives, it is advisable to apply the 6M/12M spread adjustment on these contracts.

The example just made is schematically described below:

- As is
  - Loans→6M/12M CHF LIBOR
  - Hedging IRS → 6M/12M CHF LIBOR vs Euribor
- To be
  - Loans→3M SARON (last reset) + 6M/12M Spread adjustment
  - Hedging IRS → 6M/12M SARON (lookback) + 6M/12M Spread adjustment vs Euribor

This methodology will also help to reduce the economic impact under IFRS9 or IAS39 of the imperfect hedging relationship between cash products and derivatives coming from last reset methodology on the loans and lookback methodology on the derivatives.

Therefore, we can sum up the statutory replacement rates by tenor in the following way:

LIBOR	TENOR	Compounded Rate	Spread Adjustment Value	Spread Adjustment Bloomberg Ticker
CHF	1M	SARON 1 month Compound Rate (SAR1MC) ISIN CH0477123886	-0.0571	SSF0001M Index
CHF	3M	SARON 3 months Compound Rate (SAR3MC) ISIN CH0477123902	0.0031	SSF0003M Index
CHF	6M	SARON 3 months Compound Rate (SAR3MC) ISIN CH0477123902	0.0741	SSF0006M Index
CHF	12M	SARON 3 months Compound Rate (SAR3MC) ISIN CH0477123902	0.2048	SSF0012M Index

Conforming changes for some specific use cases

It is important to note that in contracts having a CHF LIBOR tenor higher than 3M, a conforming change has to be applied to both the payment frequency and the fixing frequency.

For example, in a 6M CHF LIBOR indexed loan with semiannual payment frequency and fixing frequency, the suggested statutory replacement rate will be compounded 3M SARON. In order to maintain the financial uniformity in the contract structure as much as possible, the fixing frequency and the payment frequency should quarterly set, as showed in the following table:

ASIS				Statutory Replacement				
Tenor	Fixing Frequency	Payment Frequency		Tenor	New Index Description	Fixing Frequency	Payment Frequency	Spread adjustment (ISDA)
CHF LIBOR 6M	6M	6M	→	LAST RESET 3M	3M SARON	3M (Conforming Change)	3M (Conforming Change)	6M
CHF LIBOR 12M	12M	12M	→	LAST RESET 3M	3M SARON	3M (Conforming Change)	3M (Conforming Change)	12M

Non-standard loans having a de-synchronicity between fixing frequency, and the instalments payment frequency must also be considered in this analysis. In particular, we consider loans with a monthly payment frequency and tenor from 3M to 12M. A monthly payment is usually set for the borrowers' needs, especially in mortgages.

Assuming that a statutory replacement aims to keep the features of the original contracts to the extent possible, we suggest to use the 3M SARON plus the spread adjustment corresponding to the tenor of the original loan index. As a result, it should be applied a conforming change to the fixing frequency, which will become quarterly, but the payment frequency will remain monthly in line with the original contract (see the grid reported as follows).

ASIS				Statutory Replacement				
Tenor	Fixing Frequency	Payment Frequency		Tenor	New Index Description	Fixing Frequency	Payment Frequency	Spread adjustment (ISDA)
CHF LIBOR 3M	3M	1M	→	LAST RESET 3M	3M SARON	3M	1M	3M
CHF LIBOR 6M	6M	1M	→	LAST RESET 3M	3M SARON	3M (Conforming Change)	1M	6M
CHF LIBOR 12M	12M	1M	→	LAST RESET 3M	3M SARON	3M (Conforming Change)	1M	12M

Up to this point we have only dealt with legacy contracts with a single value fixing in advance, i.e. the floating rate is set at the beginning of the interest period and is equal to a specific value. However, another important case is when the rates set in advance as the average of the index values over a given time range. For example, in a loan with a monthly interest payment the floating rate is calculated as the average of 1M CHF LIBOR in the month preceding the interest period. This methodology has been used to reduce the refixing risks for the consumers, smoothing the contract rate fixings along a period of time. Since the compounded SARON with the last reset methodology is already computed as an average rate, we suggest to apply the same methodology both for single value and average fixing and both for standard and non-standard contracts.

<u>Floor Option</u>

Another aspect that we suggest including in designating a statutory replacement rate for CHF LIBOR is the way in which floor options are applied, since floor options are widely used on the index (zero floor on the index) or on the sum of the index plus commercial margin (negative floor on the index) . In fact, the floor application is extremely relevant in fallback clauses for legacy contracts to avoid the rise of legal disputes, which could create instability on the market. Based on this, we propose to apply the floor to the sum of the compound SARON plus the spread adjustment, as also recommended by the working group on euro risk-free rates.

<u>Definition of Legacy Stock</u>

Finally, we believe that the application of the statutory replacement must not be limited only to the contracts concluded prior to the entry into application of the EU Benchmark Regulation (EU BMR) on 1 January 2018 but should be extended at least until March 5, 2021, i.e. the date of the announcement of LIBOR discontinuation by the FCA. It might be that some contract concluded after the 1 January 2018 do not include a robust fallback clause due to the uncertainty of a viable fallback rate before the recommendations of national working group on risk-free rates.
In conclusion, the UniCredit proposal for different cases can be summarized as in the following page.

UniCredit Final Proposal

	ASIS					Statutory Replacement								
	Tenor	Rate Type	Fixing Frequency	Payment Frequency		Tenor	New Index Description	Compounded Rate	Fixing Frequency	Payment Frequency	Spread Adjustment (ISDA)	Spread Adjustment Bloomberg Ticker	Spread Adjustment Value	Zero Floor Option
Standard Cases	CHF LIBOR 1M	Single Value / Average	1M	1M	→	LAST RESET 1M	1M SARON	SARON 1 month Compound Rate (SAR1MC) ISIN CH0477123886	1M	1M	1M	SSF0001M Index	-0.0571	Index + Spread Adj
Standard Cases	CHF LIBOR 3M	Single Value / Average	3M	3M	→	LAST RESET 3M	3M SARON	SARON 3 months Compound Rate (SAR3MC) ISIN CH0477123902	3M	3M	3M	SSF0003M Index	0.0031	Index + Spread Adj
Standard Cases	CHF LIBOR 6M	Single Value / Average	6M	6M	→	LAST RESET 3M	3M SARON	SARON 3 months Compound Rate (SAR3MC) ISIN CH0477123902	3M (Conforming Change)	3M (Conforming Change)	6M	SSF0006M Index	0.0741	Index + Spread Adj
Standard Cases	CHF LIBOR 12M	Single Value / Average	12M	12M	→	LAST RESET 3M	3M SARON	SARON 3 months Compound Rate (SAR3MC) ISIN CH0477123902	3M (Conforming Change)	3M (Conforming Change)	12M	SSF0012M Index	0.2048	Index + Spread Adj
Non Standard Cases	CHF LIBOR 3M	Single Value / Average	3M	1M	→	LAST RESET 3M	3M SARON	SARON 3 months Compound Rate (SAR3MC) ISIN CH0477123902	3M	1M	3M	SSF0003M Index	0.0031	Index + Spread Adj
Non Standard Cases	CHF LIBOR 6M	Single Value / Average	6M	1M	→	LAST RESET 3M	3M SARON	SARON 3 months Compound Rate (SAR3MC) ISIN CH0477123902	3M (Conforming Change)	1M	6M	SSF0006M Index	0.0741	Index + Spread Adj
Non Standard Cases	CHF LIBOR 12M	Single Value / Average	12M	1M	→	LAST RESET 3M	3M SARON	SARON 3 months Compound Rate (SAR3MC) ISIN CH0477123902	3M (Conforming Change)	1M	12M	SSF0012M Index	0.2048	Index + Spread Adj