

Fallbacks for BBSW Securities

Duke Cole and Lara Pendle^[*]



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Abstract

The bank bill swap rate (BBSW) is an important short-term benchmark interest rate for Australian financial markets across various maturities. It is a robust benchmark based on a liquid market. However, it is possible that, at some point in the future, BBSW might no longer be robust. Market participants need to be prepared for the possibility that BBSW, or at least some BBSW tenors, cease to be published. To do so, participants should include a ‘robust, reasonable and fair’ fallback to another interest rate in their financial contracts. To promote appropriate use of fallbacks, the Reserve Bank will only accept securities referencing BBSW issued after 1 December 2022 as collateral in its domestic market operations if those securities include such a fallback. The article explains this change and how participants can prepare for the contingency of BBSW ceasing to exist.

Introduction: The importance of BBSW

The bank bill swap rate (BBSW) is the key credit-based benchmark for the Australian dollar. It measures the rates at which banks in Australia can borrow funds in wholesale money markets. Specifically, it refers to a set of benchmarks for each monthly tenor between one and six months, based on the traded price of short-term bank bills and negotiable certificates of deposit (bank paper) issued by highly rated banks (Graph 1). It is administered by the Australian Securities Exchange (ASX).

The BBSW benchmarks are widely referenced in Australian financial contracts. By far the largest market is the derivatives market, where approximately \$20 trillion by notional value reference BBSW; these contracts are used by market participants to manage interest rate risk. BBSW is also used as a referenced rate in: floating-rate AUD-denominated corporate bonds; almost all asset-backed securities issued by Australian securitisation trusts; and some securities issued by the state and territory governments. BBSW is widely referenced in syndicated loans and corporate loan contracts. In addition, much of banks’ other wholesale debt

(including in foreign currencies) and deposits are linked to BBSW either directly or as part of their interest rate hedging practices (Black and Titkov 2019). In turn, this means that movements in BBSW can influence lending rates on household and business loans.

Historically, key global equivalents to BBSW rates are the London Interbank Offered Rates (LIBOR). However, unlike BBSW, the various LIBOR benchmarks were not considered robust, as they were not supported by a sufficient volume of transactions in wholesale short-term funding markets. As a result, LIBOR jurisdictions have transitioned (or are in the process of transitioning) to referencing overnight (near) risk-free rates. Most LIBOR benchmarks ceased at the end of 2021, with the notable exception of certain key USD LIBOR benchmarks, which will continue to 30 June 2023 to support legacy contracts. By contrast, BBSW has remained robust, in part because its methodology was strengthened in 2018, including by: widening the set of transactions that are eligible to be included in the calculation; and adding a robust waterfall, setting out alternative methods of determining the rate when transactions on a given day may be insufficient.^[1] Not all BBSW tenors are as liquid as others. In particular, the one-month BBSW is largely a buy-back market and so it is less liquid than other tenors. Accordingly, the Reserve Bank has suggested that users of one-month BBSW should consider alternative benchmarks given the lower liquidity in this market (Kent 2020).

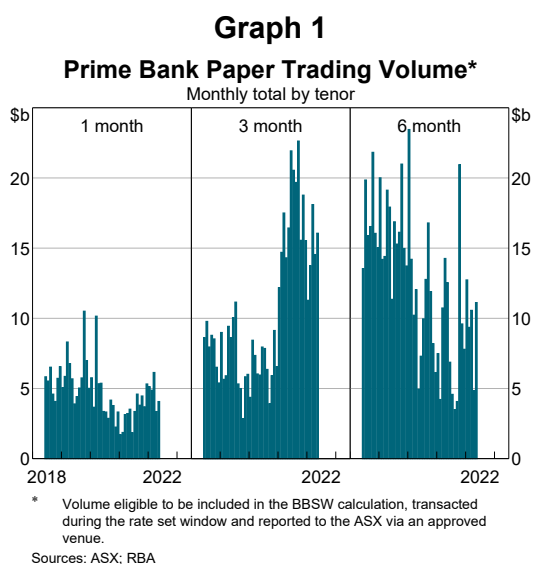
A feature of the Australian benchmark landscape is that it is a 'multiple-rate' jurisdiction, reflecting the fact that there is both a robust credit-based benchmark (BBSW) and a robust (near) risk-free rate (the cash rate, also known as the Australian Overnight Index Average Rate (AONIA)). In some LIBOR currencies (like the US dollar, British pound and Swiss franc), there are no sufficiently robust alternative credit-based benchmarks, so LIBOR cessation has resulted in a wholesale shift to risk-free rates for all contracts and securities that would otherwise reference LIBOR. By contrast, in Australia the multi-rate approach allows market participants to choose the reference rate that best suits each of their products and situations, taking into account their own and their clients' needs or hedging strategies.

However, while BBSW is currently robust, LIBOR has shown that existing benchmarks should not be taken for granted. If BBSW was to follow a similar path to LIBOR and cease to exist, then users of BBSW could face considerable disruption, with broader ramifications for financial markets given the importance of BBSW in Australia. Regardless of the reference rate used in a contract, it is prudent to include robust fallbacks. As part of global reforms to strengthen financial benchmarks, this is why the Reserve Bank is introducing a new eligibility requirement for 'robust, reasonable and fair' fallbacks for securities to be accepted as collateral in the Bank's market operations (as published on the Bank's website and provided below).

The Bank will not accept floating-rate bonds that reference BBSW as collateral under repo if they do not have effective fallbacks, where those bonds are issued after 1 December 2022. Therefore for bonds that reference BBSW that are issued after this date, issuers will need to include a fallback in their transaction documents that meets the Bank's criteria.^[2]

Why fallbacks matter

A fallback outlines how a given interest rate based on a benchmark such as BBSW would be calculated if it stopped being published. For floating-rate bonds, this is the coupon payment. Fallbacks are a key element in Australia's multiple-rate approach, by



preparing for the risk that BBSW ceases to exist at some point in the future (Kent 2021).

Fallbacks make it clear how issuers, investors and other market participants should proceed in the event that a benchmark such as BBSW ceases to exist or is unavailable. In many cases to date, the fallbacks in transaction documents for floating-rate bonds have fallen short. For example, they often call on the calculation agent to choose another 'suitable rate' in the event that BBSW is not available. This is not robust.

Effective fallbacks are necessary for robust risk management, and are a matter of good practice. They reduce the legal risks for both sides of the contract, including the possibility for disputes and litigation. More broadly, fallbacks support market resilience (FSB 2021), helping market participants plan for the potential cessation of a benchmark.

Fallbacks should be 'robust, reasonable and fair'

For repo eligibility, the Reserve Bank has not prescribed the specific interest rates that are to be used as fallback rates for BBSW-referencing securities, nor the legal text to incorporate those rates into transaction documents. This provides flexibility for market participants, allowing them to stipulate fallbacks that meet the needs of their specific markets. Instead, the Bank has set principles to ensure the fallbacks are effective (see below). Only BBSW-referencing securities with fallbacks that meet these principles will be eligible for repo in the Bank's domestic market operations. Fallbacks must be 'robust, reasonable and fair'. This ensures that fallbacks will be effective in a wide range of plausible contingencies, and will provide legal certainty and economic clarity for all parties.^[3]

A **robust** fallback is one that remains effective in many scenarios. It should facilitate the calculation of coupon payments under a wide range of contingencies, and be clear and easy to understand for all participants. It should include:

- how the fallback will be triggered
- the interest rate and calculation method for coupons.

The fallback rate itself should also be robust. This is more likely where the fallback rate is deemed to be a significant benchmark by the Australian Securities and Investments Commission (ASIC).^[4] This allows participants to plan – including to hedge exposures – and make decisions based on certain future outcomes. Discretion (such as over the successor rate) should be avoided as it does not provide clarity to both parties, and may be open to manipulation (FSB 2017). There is also the risk that, even if an independent third party is responsible for exercising discretion, this leads to a dispute over their decision, which could be disruptive.

A **reasonable and fair** fallback minimises the risk that value will be transferred between the issuer and the noteholder. This might occur if the fallback rate is fundamentally different to the original interest rate, so fallbacks should have similar economic and credit characteristics to the original interest rate. For example, fixing the rate at the last rate published when BBSW ceases is neither reasonable nor fair. This would effectively transform a floating-rate security into a fixed-rate security. Depending on the future path of interest rates, the cash flows might be markedly different.^[5]

Eligible securities – The Reserve Bank's fallback criteria^[6]

All floating rate notes (FRNs) and marketed asset-backed securities issued on or after 1 December 2022, where BBSW is the relevant interest rate for the purposes of calculating coupons, must meet the following criteria in order to be eligible for purchase by the Reserve Bank under repo:

- Include at least one 'robust' and 'reasonable and fair' fallback for BBSW in the event that it permanently ceases to exist.
- A 'robust' fallback is one that clearly specifies the method for the calculation of interest that would apply for the purposes of calculating coupon payments. The fallback must also specify a clear and unambiguous trigger event after which the fallback would apply. Acceptable fallbacks would include those that reference AONIA (including AONIA plus or minus a fixed spread). Fallbacks that reference another benchmark interest rate may also be

accepted at the Reserve Bank's discretion. A fallback waterfall may additionally include a fallback to a reference rate that might exist in the future, for example forward-looking term AONIA, subject to it being declared a significant financial benchmark by ASIC at the time the fallback is triggered.

- A 'reasonable and fair' fallback is one that reasonably mitigates the impact on the economic value of the security in the event the fallback is invoked. A fixed-rate fallback would not be considered reasonable nor fair for the purposes of these criteria.
- The robust and reasonable and fair fallback(s) must sit above any other fallbacks that rely on collecting dealer quotes, or on discretion – whether by the issuer, the calculation agent, or any other related or third party – in the fallback waterfall.
- Include a fallback to apply in the case that BBSW is not available, but where it has not permanently ceased. This fallback must: clearly specify the method for determining the interest that would apply for the purposes of calculating coupon payments; and specify a clear and unambiguous trigger event after which the fallback would apply. An example of an acceptable fallback structure is that provided for the 'No Index Cessation Effective Date with respect to BBSW' circumstance in the 2020 ISDA Interbank Offered Rates (IBOR) Fallbacks Supplement. A fallback relying on collecting dealer quotes, or on discretion by the issuer, the calculation agent, or any other party related to the security must not sit at the top of the fallback waterfall.

All self-securitisations, regardless of the date of issue, will also be required to include at least one robust and reasonable and fair fallback in order to be eligible. The Reserve Bank will engage with self-securitisation issuers and give at least 12 months' notice before enforcing this requirement.

FRNs and marketed asset-backed securities issued before 1 December 2022 will not be subject to this requirement for eligibility. Nevertheless, the inclusion of robust and reasonable and fair fallbacks

for such securities, depending on their length of time to maturity, is recommended as a matter of prudent risk management.

Fallbacks in practice

The Reserve Bank is adopting a principles-based approach to requiring fallbacks for repo eligibility. However, it is practical and more efficient for market participants to work together to develop market conventions that specify the specific fallback rates and language to be used in prospectuses and other legal documents. Industry groups –including the Australian Financial Markets Association and the Australian Securitisation Forum – are developing template fallback language for use in BBSW-linked securities (AFMA 2021; ASF 2021).

Indications are that this template language will apply a similar approach to ISDA's IBOR Fallbacks Supplement and Protocol, which sets out the equivalent fallbacks for derivatives, and is just one example of a 'robust, reasonable and fair' fallback that the Reserve Bank would accept under its eligibility criteria. However, issuers may use any fallback that meets the principles set out above. The choice of fallback may depend on a number of factors, including how it aligns with fallbacks for other instruments, such as derivatives or other exposures on their balance sheet. Participants might also consider having multiple fallback rates in their 'fallback waterfall'. The Reserve Bank expects the first fallback to be 'robust, reasonable and fair'.

Fallbacks have two key components:

1. the triggers for the fallback rate being used
2. the fallback rate itself.

Triggers

In fallback documentation, a trigger is an event that would activate the fallback provision. The trigger is defined as a public statement from either the administrator (ASX) or the administrator's supervisor (ASIC) stating that BBSW will permanently no longer be published. If this occurs, BBSW is deemed to permanently cease.^[7]

Fallback rate: AONIA compounded in arrears plus a spread

If the fallback is triggered, then the fallback rate would apply for the calculation of interest payments instead of the original reference rate (BBSW). In ISDA's IBOR Fallbacks Supplement and Protocol, the fallback rate is defined as AONIA – also known as the overnight cash rate – compounded in arrears plus a spread. As mentioned above, because BBSW is an unsecured term rate and AONIA is an overnight risk-free rate, AONIA must be adjusted to be sufficiently equivalent to BBSW. In particular, the fallback based on AONIA needs to be:

- **Adjusted for tenor** – by compounding interest in arrears. This takes a series of overnight rates and combines them so they represent a rate that matches the tenor (one, three or six months) of the equivalent BBSW. Although the tenor will match, BBSW is a forward-looking rate that captures interest rate expectations, while AONIA is calculated based on historical interest rates.
- **Adjusted for credit risk** – by adding a spread. BBSW reflects the borrowing costs for banks in the unsecured short-term money market. This is slightly riskier than borrowing cash overnight, so typically (although not always) BBSW has been slightly higher than AONIA to account for this risk. This spread is calculated as the median difference between AONIA and the relevant BBSW rate over a five-year period. The spread will be fixed on the date that BBSW ceases to exist.

To prepare for every contingency, the ISDA's IBOR Fallbacks Supplement and Protocol language also allows for a rate recommended by the Reserve Bank to replace the cash rate in the scenario that the cash rate itself ceases to exist.

These adjustments ensure that the fallback is reasonable and fair for both issuers and noteholders by minimising the economic impact of the fallback being triggered. Similar approaches have been

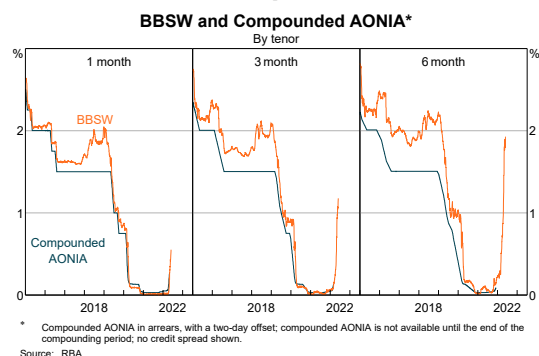
taken for fallbacks globally.^[8] AONIA compounded in arrears plus a spread is the primary fallback for derivatives. It is an example of one rate that would meet the Bank's principles for 'robust, reasonable and fair' fallbacks. The eligibility criteria also allow for the fallback waterfall to include other interest rates, including ones that might exist in the future – such as forward-looking term AONIA. However, such rates cannot be activated in the waterfall unless they meet the eligibility criteria and are declared a significant financial benchmark by ASIC.

Conclusion: Getting ready for 1 December 2022

Issuers of securities that reference BBSW and include fallbacks must ensure they are operationally ready to deploy those fallbacks in the event they are triggered. This includes updating systems to calculate the relevant interest rate, and to switch over if necessary. All market participants should understand how the fallbacks would work in practice.

The Reserve Bank's criteria were announced well in advance of them coming into effect to give market participants enough time to make the relevant system and documentation changes. However, issuers need not wait until 1 December 2022 to incorporate fallbacks for new issuance. It would be prudent to include 'robust, reasonable and fair' fallbacks as soon as practical, especially for longer-dated securities. ✎

Graph 2



Endnotes

- [*] The authors are from Risk and Compliance Department and Domestic Markets Department. This article draws on work completed with Andrea Brischetto, Sasha Kofanova, Jin Lim and Andrew Sewell. The authors would like to thank the Australian Financial Markets Association, the Australian Securitisation Forum and a number of market participants for their feedback on the fallback criteria for BBSW-linked securities.
- [1] See ASX, 'Benchmark Conventions and Calculation Methodologies'. Available at <<https://www2.asx.com.au/connectivity-and-data/information-services/benchmarks/benchmark-data/conventions-and-calculation-methodologies>>.
- [2] By contrast, over-the-counter derivatives fallbacks for BBSW (and other inter-bank rates) have been incorporated via the ISDA IBOR Fallbacks Supplement and Protocol (available at <<https://www.isda.org/protocol/isda-2020-ibor-fallbacks-protocol/>>). When both parties to a derivative contract adhere to the Protocol, the fallbacks are automatically incorporated into all over-the-counter derivative transactions between two counterparties that have both adhered to the Protocol. Although this is a very effective way to amend derivatives to allow for fallbacks, the Protocol mechanism is not available for floating-rate bonds.
- [3] IOSCO (2018) elaborates on a number of these issues.
- [4] ASIC may deem a benchmark to be significant if it is systematically important to the Australian financial system, or there is material risk of financial contagion or impact on investors if the availability of the benchmark were disrupted (ASIC 2018).
- [5] For example, if a BBSW-linked bond switched to a fixed rate based on the last rate published and interest rates were expected to increase in the future, then the coupons would be much lower than expected. This could substantially reduce the income noteholders might have expected to earn over the life of the bond to the benefit of the issuer.
- [6] As published at RBA (2021), 'Eligible Securities', 16 November.
- [7] If BBSW is temporarily unavailable, then either the ASX or ASIC will determine the rate that applies. The fallbacks described here would only apply if BBSW *permanently* ceases.
- [8] See, for example, ARRC (2021).

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