

12th Meeting of the Working Group on Alternative Reference Rates in Mexico (GTTR)

April 9th, 2024

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Uso Público

Información de acceso público.

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Introduction



Last February 1st, the eleventh session of the Working Group on Alternative Reference Rates in Mexico (GTTR) was held. The main topic of that session was the actions that Banco de México will take to address the problem of **mismatch (basis) that some market participants will face** once the swaps conversion is carried out in the clearing houses.^{1/} The adjustments to the regulation were submitted to public consultation and as a result of the comments received, some clarifications will be made to limit the use of basis swaps to the exchange of Funding TIE for TIE 28 (in the original project it was open to any rate).



Additionally, at that meeting the results of the survey to determine the commitments regarding the **Funding TIE First** initiative were announced.^{2/} In general terms, the majority of institutions are willing to adopt the initiative.



On the other hand, during said meeting, several doubts arose regarding the publication of a prospective reference rate (forward looking) based on Funding TIE derivative operations (Term TIE).



This presentation will address the current operating conditions of the markets linked to Funding TIE, some considerations regarding the possible determination and publication of a Term TIE rate, as well as the implications of this action.

1/ If a participant has a bilateral 28-day TIE IRS contract with a client that does not settle through a clearing house, and the risk of said contract is covered with a swap that settles through a clearing house, a basis will be generated with the conversion of 28-day TIE IRS contracts to Funding TIE OIS contracts in the clearing houses.

2/ TIE de Fondeo Primero is a voluntary initiative with the objective of promoting the use of this reference rate in different markets.

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Debt market

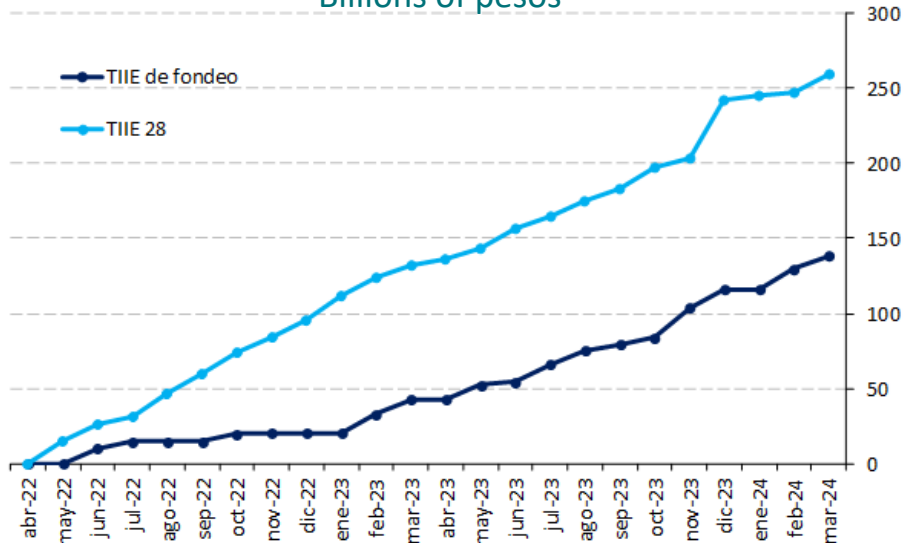


Since the announcement of the first issuance of debt linked to the Funding TIEE by the Ministry of Finance and Public Credit in August 2021, several financial institutions have joined the efforts to issue debt securities linked to this reference.



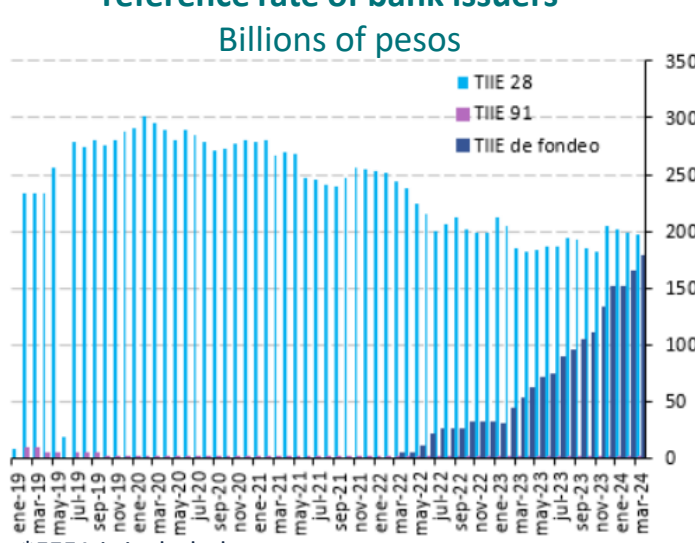
Since March 2022, the date on which the first issuance of non-governmental debt linked to the Funding TIEE was recorded, around 35% of the issuances that have been observed are linked to the Funding TIEE.

Cumulative amount of non-governmental debt issuances with original term greater than one year
Billions of pesos



Source: Banco de México.

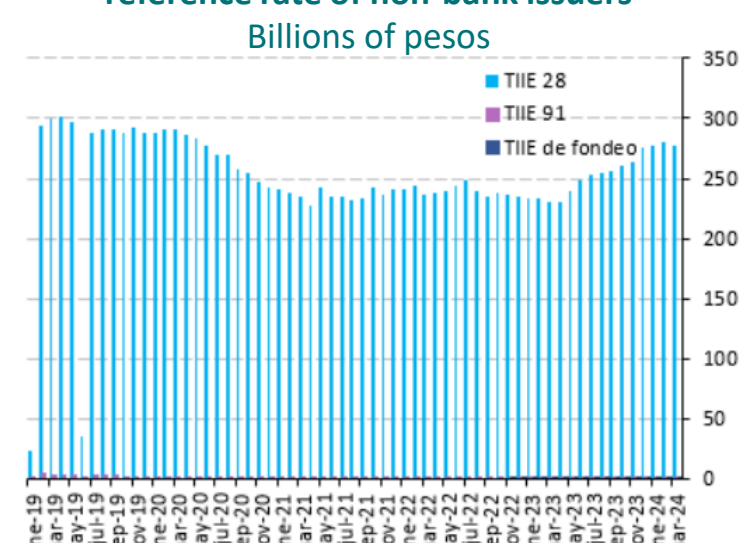
Monthly outstanding amount of non-governmental debt with original term greater than one year, by reference rate of bank issuers*
Billions of pesos



* FEFA is included.

Source: Banco de México.

Monthly outstanding amount of non-governmental debt with original term greater than one year, by reference rate of non-bank issuers
Billions of pesos



Source: Banco de México.

Derivatives market

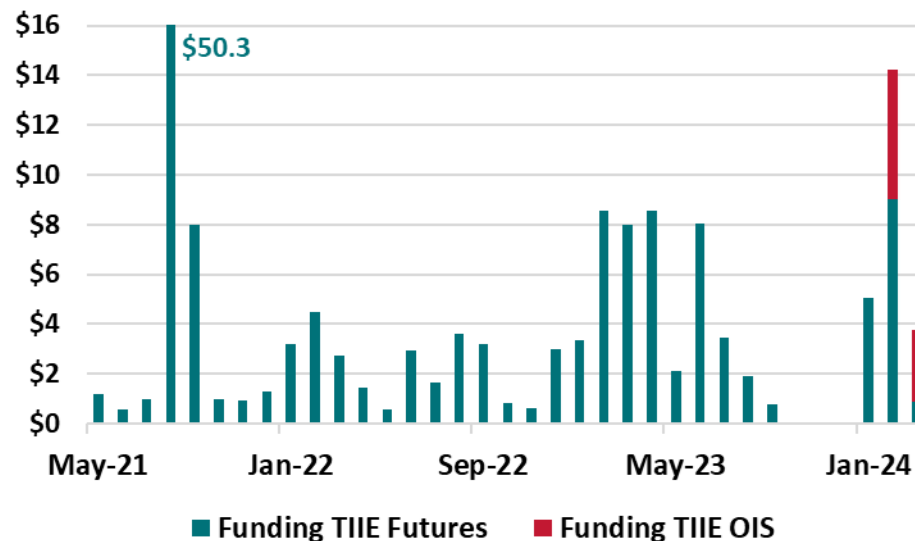


In the derivatives market, despite the fact that the operation of futures contracts linked to the Funding TIIE began in the first quarter of 2021, traded volume remains limited.



On the other hand, the newly created OIS referenced to Funding TIIE do not yet show a deep and stable operating volume.

Total monthly volume operated in derivatives linked to the Funding TIIE
Billions of pesos



Source: Banco de México with data from CME and MexDer as of March 11, 2024.

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International experience in the use of forward looking rates^{1/}



At the international level there are a series of forward looking rates that have been developed as an additional tool in the transition from IBOR rates to RFR rates. In the United States, a backward looking rate known as SOFR Average is published, which was published one year before the forward looking rate.

	Term SONIA	Term SOFR	Term CORRA
Jurisdiction			
Start of publication	July 8, 2020 (ICE) and July 21, 2020 (Refinitiv)	July 26, 2021	September 5, 2023
Underlying market	SONIA OIS Operations	One- and three-month SOFR futures operations	One- and three-month CORRA futures operations
Rate provider	ICE Benchmark Administration and Refinitiv (two different rates with similar methodologies)	CME	CanDeal Benchmark Solutions and TMX Datalinx (same rate, two distributors)
Additional rates and indices	August 3, 2020, publication of the SONIA Compounded Index (BoE)	March 2, 2020, release of SOFR Average and SOFR Index (New York Federal Reserve)	April 6, 2021, publication of the CORRA Compounded Index (Bank of Canada)

^{1/} See Annex 1 for references to the information in the table.

International experience in the use of forward looking rates^{1/}



Although the use of forward looking rates is accepted in different jurisdictions, their use has been restricted mainly to the granting of certain loans.



In general, the use of the major term rates is limited because the aim is to avoid a use that is not proportional to the depth and liquidity of the underlying derivatives market (OIS or futures), and to prevent the use of term rates from reducing the volume of the derivative operations that give rise to the term rates.^{2/}


	<i>Term SONIA</i>	<i>Term SOFR</i>	<i>Term CORRA</i>
Recommended use	<p>Banking products:</p> <ul style="list-style-type: none"> a) Export finance. b) Emerging markets loans. c) Smaller corporates. d) Retail mortgages. e) Wealth/Private bank. f) Trade and working capital products. <p>Derivatives:</p> <ul style="list-style-type: none"> a) Hedge of cash products. b) Hedge of legacy products. 	<p>Banking products:</p> <ul style="list-style-type: none"> a) As a fallback rate for legacy LIBOR cash products. b) Loans for business or commercial purposes. c) Securitizations that hold assets linked to Term SOFR. <p>Derivatives:</p> <ul style="list-style-type: none"> a) Hedge of cash products. b) Hedge of legacy products. 	<p>Banking products:</p> <ul style="list-style-type: none"> a) Corporate loans. b) Commercial loans. c) Small business loans. d) Commercial related products. <p>Derivatives:</p> <ul style="list-style-type: none"> a) Hedge of cash products.


1/ See Annex 1 for references to the information in the table.


2/ Consult the “Final Reflections on the LIBOR Transition” of the FSB (<https://www.fsb.org/2023/07/final-reflections-on-the-libor-transition/>) and the “Term SOFR Scope of Use ARRC Best Practice Recommendations” (<https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2023/ARRC-Term-SOFR-Scope-of-Use-Best-Practice-Recommendations.pdf>)

Financial Stability Board's Considerations on Term rates

 The FSB carried out an analysis of Term rates from which it obtained the following conclusions:^{1/}

 Liquidity in the derivatives market referenced to the new RFRs is not as deep and stable as in the overnight funding market, which is the most liquid market in many jurisdictions.

 Given the numerous examples of successful use of overnight RFR on a wide range of cash products, in many cases a Term rate will not be necessary for new cash products. The FSB encourages market participants to try to use overnight RFR directly on these products.

 “Therefore, because the FSB does not expect such RFR-derived term rates to be as robust as the overnight RFRs themselves, they should be used only where necessary” (FSB, 2021).

1/ For more information see: <https://www.fsb.org/wp-content/uploads/P020621-2.pdf>

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Operating volume of the derivatives market linked to the Funding TIE

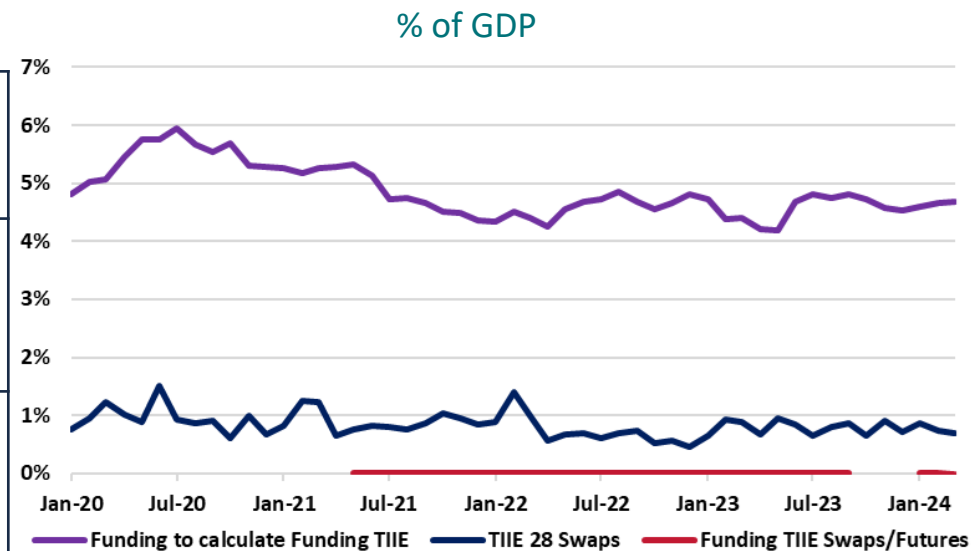
To obtain the TIE Term, information from the derivatives market with specific characteristics is required. However, operation in this market is still limited, so at the moment it is not possible to calculate a Term TIE that is robust and complies with international standards.

Additionally, as indicated by the FSB, the overnight funding market is the most liquid and deep market, so the Funding TIE with any type of composition should be the most preferred rate to structure financial products.

General specifications of the operations that would be necessary for the calculation of a possible Term TIE

Underlying Market	Funding TIE Futures	Funding TIE OIS
Recommended methodology	Methodology proposed by the Federal Reserve based primarily on futures and secondly on swaps (similar to Term SOFR)	Sampling of traded prices in the OIS market (similar to Term Sonia)
Input operations	Operations of monthly contracts with expiration less than the next 7 months	Operations with contracts 1x1 for the period of 28 days, 4x1 for the period of 91 days and 7x1 for the period of 182 days

Average daily volume per month of the TIE 28 swap operation in DTCC and of the operations that count for the calculation of the Funding TIE



Source: DTCC and Banxico.

Advantages and disadvantages of using a Term TIE



There are a number of advantages and disadvantages that have to be analyzed with respect to the use of a possible Term TIE.

Advantages

- It is a forward looking rate.
- Considers the most recent market conditions.
- Incorporates monetary policy expectations.
- It is known at the beginning of the interest period.

Disadvantages

- Currently there is a low trading volume in the derivatives market linked to the Funding TIE.
- The standard that has been adopted for Funding TIE OIS and futures contracts would not generate perfect coverage for cash products that use a Term TIE.
- Its use would have to be restricted to certain products (e.g. corporate and commercial loans), in line with international experience.
- The banking products market could be segmented.

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- At the moment the necessary conditions for the publication of a robust Term TIE do not exist.
- However, at the time that the market begins to actively operate Funding TIE derivatives, Banco de México could publish a Term TIE whose use would be limited to the granting of corporate/commercial credits and the hedging of rate risk of those same credits.
- Therefore, we ask you to answer the following questions:
 - Do you agree that Banco de México, when the necessary operating conditions exist, publish a Term TIE?
 - In addition to corporate/commercial loans, do you think there should be another product that can use a potential Term TIE?
 - What is your institution doing to develop the derivatives market linked to the Funding TIE so that a Term TIE can exist?
 - Why hasn't your institution started actively trading Funding TIE derivatives?
- Banco de México continues its rigorous exhortation to all market participants to make the necessary modifications to stop using TIE 28 and use in new contracts the reference rates authorized for derivative, passive and active operations.^{1/}

1/ For more information see Circulars 3/2012, 4/2012 and 14/2007.



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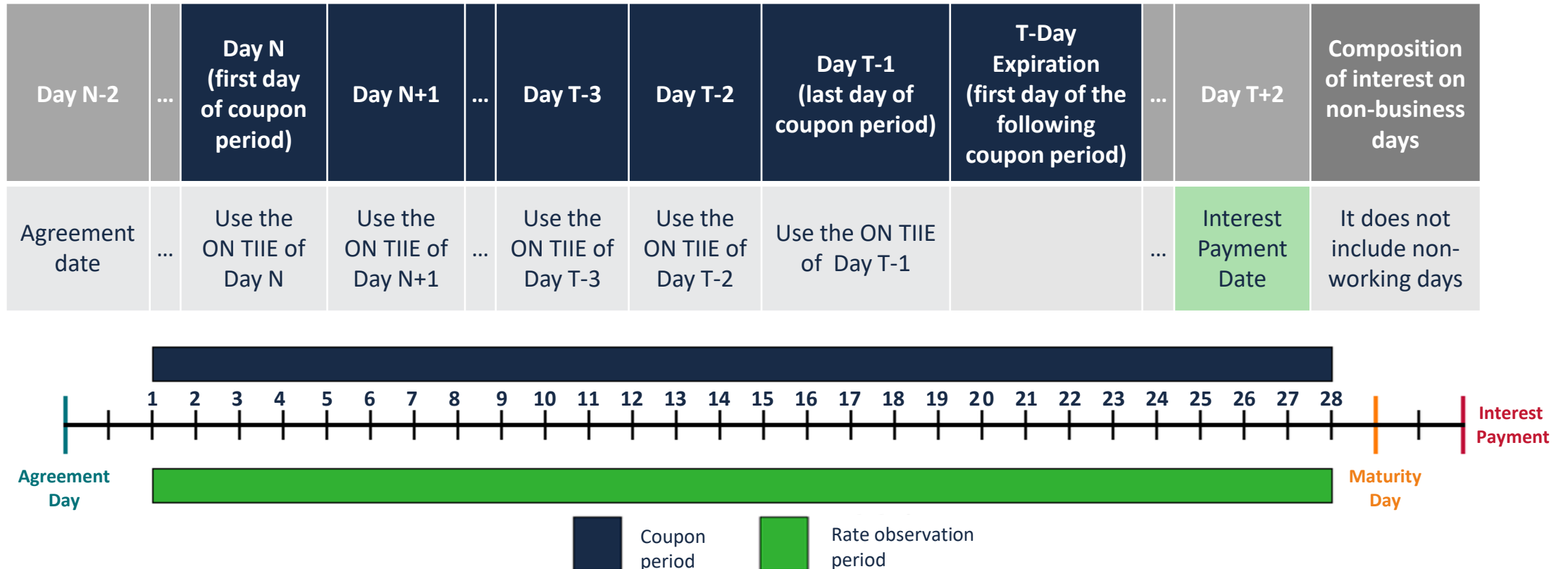
Annex 1: International experience references

- For more information about the transition in the United Kingdom, consult:
 - [SONIA Key features and policies | Bank of England](#)
 - [Term SONIA reference rate publication summary \(bankofengland.co.uk\)](#)
 - [FTSE Term Sonia Methodology Guide \(lseg.com\)](#)
 - [Use cases of Benchmark Rates: Compounded in Arrears, Term Rate, and Further Alternatives \(bankofengland.co.uk\)](#)
 - [Standard-on-use-of-Term-SONIA-reference-rates FINAL.pdf \(fmsb.com\)](#)
- For more information about the transition in the United States, consult:
 - [ARRC Press Release Term SOFR.pdf \(newyorkfed.org\)](#)
 - [Statement Introducing the SOFR Averages and Index - FEDERAL RESERVE BANK of NEW YORK \(newyorkfed.org\)](#)
 - [cme-term-sofr-reference-rates-benchmark-methodology.pdf \(cmegroup.com\)](#)
 - [ARRC-Term-SOFR-Scope-of-Use-Best-Practice-Recommendations.pdf \(newyorkfed.org\)](#)
- For more information about the transition in Canada, consult:
 - [Term CORRA to be launched on September 5, 2023 - Bank of Canada](#)
 - [Methodology for calculating the Canadian Overnight Repo Rate Average \(CORRA\) - Bank of Canada](#)
 - [Term CORRA Methodology - CARR Recommended Approach \(bankofcanada.ca\)](#)
 - [CARR's approved use cases for Term CORRA \(bankofcanada.ca\)](#)

Annex 2: Conventions in OIS contracts linked to the Funding TIE

After the derivatives subgroup meeting of this GTTR in April 2023, the following convention was reached:

OIS international convention: The interest for the period is calculated using an “in Arrears” methodology without capitalizing non-business days. Under this convention, accrued interest is paid 2 days after the coupon expiration date. Additionally, it was agreed that the coupon periods would be 28 days.

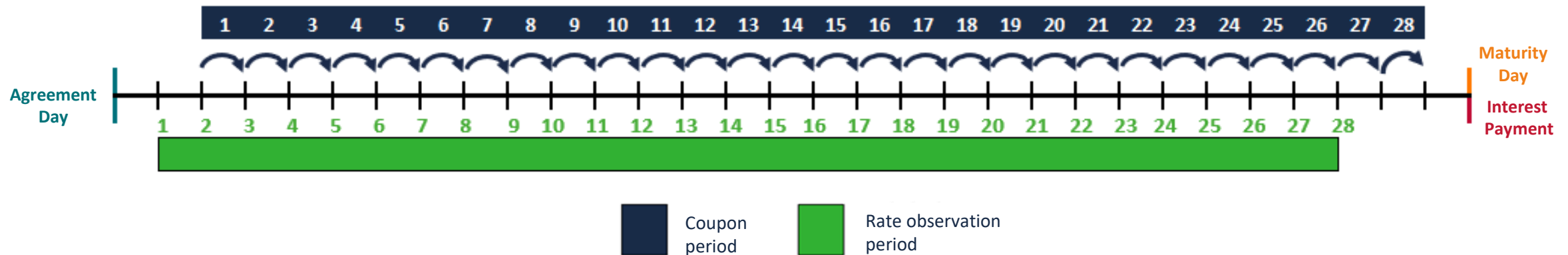


Annex 3: Conventions for debt issuances linked to Funding TIE



Within the GTTR, the following convention was reached for debt issuances linked to the Funding TIE:

- Said methodology is calculated with composition in arrears of 28-day coupons. Where for each day of the coupon period, the Funding TIE published the previous day is used (Lookback of one day in the Funding TIE). Finally, coupons are settled on the business day following the last day of the coupon period.



This convention is also known as “FIRA Bond Type”, as this institution was the first to use it for its debt issuances linked to Funding TIE.

Annex 4: Timeline

- Below is an example of a timeline with the most important dates for the Conversion of Swaps in clearing houses:

