



Status: Final
Department: DGOBC
Last Update: March 6th, 2023

7th Meeting of the Working Group on Alternative Reference Rates in Mexico (GTTR)

March 2023



Publicada-Usu General

Información que ha sido publicada por el Banco de México

Introduction

- **The proposed timeline and methodologies regarding the transition of TIE rates with tenors greater than one business day (Term TIE) were discussed** at the previous meeting of the Working Group on Alternative Reference Rates in Mexico (GTTR) on October 6th.
- Afterwards, Banco de México received additional comments by several attendants from diverse institutions. After a thorough internal analysis by this Central Bank, a final proposal for the transition of Term TIE was presented to the Board of Governors of Banco de México.
- **The Board of Governors approved** the proposal and two actions have been taken:
 1. Release of the official statement with the next steps for the transition of TIE rates with tenors greater than one business day.^{1/}
 2. Begin the public consultation process for the draft provisions to modify Circulars 3/2012 and 14/2007.^{2/}

1/ The official press release in Spanish is available at: <https://www.banxico.org.mx/publicaciones-y-prensa/miscelaneos/%7B82FBF3BA-B398-F999-B9CF-C3C521598D5D%7D.pdf>, an informative English version is available at: <https://www.banxico.org.mx/markets/mexican-alternative-reference-rates-working-group/d/%7B2D6F5896-CF86-3F28-0C02-98D17B7542B9%7D.pdf>

2/ Available at: <https://www.banxico.org.mx/ConsultaRegulacionWeb/>

Topics


1 Statement on the transition of the Term TIE

2 Relevant comments on the public consultation process


3 Next steps on the transition of the Term TIE

Press release

- On December 20, 2022; Banco de México published a press release about the transition of the Term TIEE.^{1/} This document is focused on four actions Banco de México will carry out in the near future:

 **The use of Term TIEE in new contracts will be prohibited after the established dates** (from January 2024 and January 2025, depending on the tenor).

 **The methodology used for the calculation of Term TIEE will be modified.** These rates will only be used on legacy contracts, once the use of Term TIEE is prohibited in new contracts.^{2/}

 **Begin the public consultation process** of the draft provisions to modify Circulars 3/2012 and 14/2007.^{3/}

 **Strong encouragement to all market participants to use the Overnight TIEE Funding Rate (ON TIEE Funding rate) as a reference in new contracts** as soon as the press release is published.

1/ The official press release in Spanish is available at: <https://www.banxico.org.mx/publicaciones-y-prensa/miscelaneos/%7B82FBF3BA-B398-F999-B9CF-C3C521598D5D%7D.pdf>, an informative English version is available at: <https://www.banxico.org.mx/markets/mexican-alternative-reference-rates-working-group/d/%7B2D6F5896-CF86-3F28-0C02-98D17B7542B9%7D.pdf>

2/ For more information refer to Annexes 1 and 2.

3/ Circular 4/2012 (about derivative operations) should be modified before December 2024 to restrict the use of Term TIEE on standardized swaps contracts (TIEE 28). To do this, the market should be monitored to identify the new standardized contracts linked to the ON Funding TIEE rate. Regardless of this, the current regulation allows the use of the ON Funding TIEE rate in derivative operations.

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Relevant comments on the public consultation process

Public consultation comment	Banxico response
<i>Dates of the transition (Possible extension)</i>	<p>The announced dates are confirmed:</p> <ol style="list-style-type: none">1. The use of the 91 and 182-day TIIEs as reference rates for new contracts will be prohibited as of <u>January 1, 2024</u>. From this date and onwards, only the methodology for the Term TIIE with tenors of 91 and 182 days will be modified. These reference rates will only be available for use on legacy contracts.2. The use of the 28-day TIIE as reference for new contracts will be prohibited as of <u>January 1, 2025</u>. From this date and onwards, the methodology for the Term TIIE with tenor of 28 days will be modified. This reference rate will only be available for use on legacy contracts.
<i>Date and hour of the Term TIIE publication</i>	<p>The publication of the Term TIIE under the new methodology <u>will continue to be at 12:30 hours</u> of the same business day in which Banco de México estimates it (using the ON TIIE Funding Rate of the previous business day). The next business day, these rates will be published in the Official Federal Gazzete (<i>Diario Oficial de la Federación</i>), as usual.</p>
<i>Responsible of the estimation of the Term TIIE</i>	<p><u>Banco de México will be the sole responsible of the estimation and publication</u> of the Term TIIE. The institutions will not need to estimate these rates.</p>
<i>Legacy operations as a result of the current Term TIIE methodology</i>	<p>The operations made with Banco de México, as a result of the current Term TIIE methodology, that remain still active after the deadlines, <u>will be carried out until maturity and settled under the original terms.</u></p>

Relevant comments on the public consultation process

Public consultation comment	Banxico response
<i>Contracts without a defined term and modification to the contracts</i>	The contracts without a defined term will be able to keep using Term TIE after the established deadlines. Any restructure to said contracts, could be done without changing the reference rate.
<i>Communication with the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores or CNBV)</i>	Banco de México will coordinate with the CNBV, <u>to analyze the feasibility of launching regulations</u> to allow methodological changes or the substitution to Overnight TIE Funding Rate, without updating contract restructuring assumptions, as well as without issues related to accounting in the credit portfolios of banking institutions.
<i>Nature of the modification of the Term TIE methodology</i>	Banco de México does not deem necessary to specify that the modification of the methodology to estimate Term TIE does not alter the transactions carried out. Because <u>the modifications on the methodology do not mean a change of the reference rate</u> and such specification has not been made on previous modifications.

Relevant comments on the public consultation process

Public consultation comment	Banxico Response
Interest estimation for derivative operations	After the deadlines, Banco de México will publish the Term TIE with the new methodology indefinitely.
<i>Amendments to Circular 4/2012 “Reglas para operar derivados”</i>	<p><u>The current Circular 4/2012 already allows derivative operations linked to the ON TIE Funding rate.</u></p> <p>However, soon this Circular will be modified to specify that after the established deadlines, derivative operations should not be linked to the Term TIE.</p>
<i>Similar initiative to “SOFR First”</i>	During 2023, Banco de México will launch the “TIE de Fondeo Primero” strategy to promote the development of the derivatives market and other contracts. This, to prioritize the transition to the ON TIE Funding Rate (see Annexes 3, 4 and 5).
<i>Publication of Term ON TIE Funding Rate (similar to Term SOFR)</i>	Once the derivatives market linked to the ON TIE Funding rate is developed, Banco de México will evaluate the feasibility of publishing reference rates based on the ON Funding TIE Rate derivatives (similar to Term SOFR).

Topics

1

Statement on the transition of the Term TIE

2

Relevant comments on the public consultation process

3

Next steps on the transition of the Term TIE

Next steps: timeline

Preliminary transition timeline

2023

First quarter

- Publicconsultation analysis.
- Meeting with the Board of Governors to analyze the final amendments to the Circulars.
- Circulars publication in the Official Federal Gazzete (*Diario Oficial de la Federación*).
- Support clearing houses with their initiatives to incentivize the use of Future contracts linked to the ON TIIE Funding Rate (CME and MexDer) – Market Makers.
- Analyze the possibility to develop brokers screens with ON TIIE Funding rate operations.

Second semester

- Start operations in the OIS market with contracts referenced to the ON TIIE Funding rate (Clearing houses contracts).
- Along with the GTTR, develop the “*TIIE de Fondo Primero*” strategy to prioritize new operations referenced to the ON TIIE Funding rate.

December 31

Last day to use TIIE with tenors of 91 y 182 days in new contracts. Change in the methodology of those tenors, the next business day.

2024

Second semester

Carry out the conversion of the standardized IRS contracts referenced to the Term TIIE to OIS contracts referenced to the ON TIIE Funding rate.

December 31

Last day to use the Term TIIE with tenor of 28 days in new contracts. Change in the methodology of this tenors, the next business day.

Discussion Issues

- Are there any additional comments about the actions taken regarding the Term TIE transition?
- Are there anything that the authorities could do to incentivize the “*TIE de Fondo Primero*” strategy?
- Are there any additional actions that the authorities should be taking?
- Are there any issues spotted on the LIBOR transition, that should be taken into consideration for the local financial market transition?



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Annex 1: Term TIIE new methodology


 The new methodology will be based on the **ON TIIE Funding Rate compounded by the number of days in the corresponding term, plus a historical spread adjustment.**^{1/}

 The proposed methodology is regarded as the best option because of the following advantages:

- ✓ It would be known at the beginning of the interest calculation period.
- ✓ It replicates the stepped adjustments of the monetary policy decisions.
- ✓ It is consistent with the international standards and practices as it is based on a near Risk Free Reference Rate(RFR).
- ✓ It incentivizes the usage of the ON TIIE Funding rate.
- ✓ Derivatives clearing houses mentioned the possibility to transform the current interest rate swaps contracts (IRS) to OIS contracts linked to the ON Funding TIIE rate.

 It is important to mention that the ON TIIE Funding Rate is currently being published at 5:00 p.m., while the Term TIIE is published at 12:30 p.m. Therefore, there is a risk in delaying the publication, and therefore the relevant processes of the financial institutions, if the new methodology is based on the ON TIIE Funding Rate published the same day.

 To eliminate this risk, **the new methodology to estimate the Term TIIE rates will be based on the previous business day ON TIIE Funding rate. As consequence, the reference rate will be published at 12:30 p.m.**

 To ensure that the Term TIIE with the new methodology reflects the monetary policy changes in a timely manner, **the ON TIIE Funding rate of the previous business day will be adjusted by the number of basis points that the target rate has been modified.**

^{1/} The historical spread adjustment will remain fixed during the time in which TIIE rates with tenors greater than one business day are published. The definition of this spread adjustment was based on international experience (i.e. ISDA's methodology for fallback rates). This value is defined as the historical median of the last five years (November 2017 - October 2022) of the daily spreads between TIIE with tenors greater than one business day and the ON TIIE Funding rate compounded by the number of days of the corresponding term (28, 91 or 182 days, which would imply a 24 bps adjustment, in all tenors).

Annex 2: New methodology of the Term TIE

🔍 The new methodology will be based on the ON TIE Funding rate of the business day prior to the reference day, compounded by the number of days in the corresponding term, plus a historical spread adjustment. In other words:

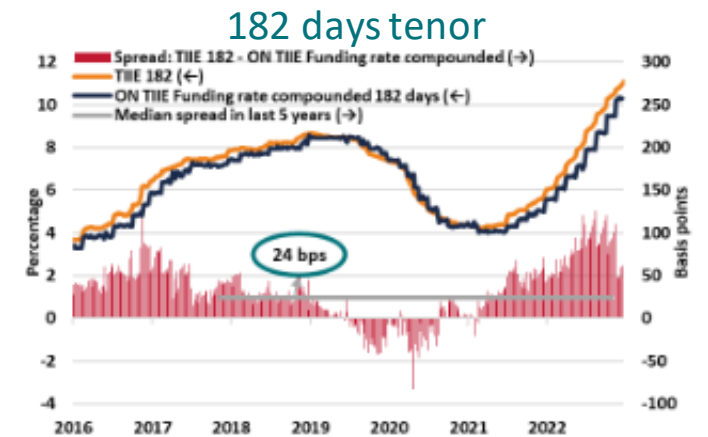
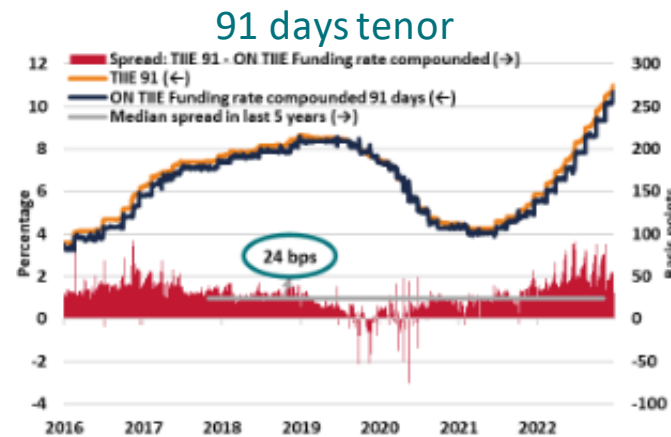
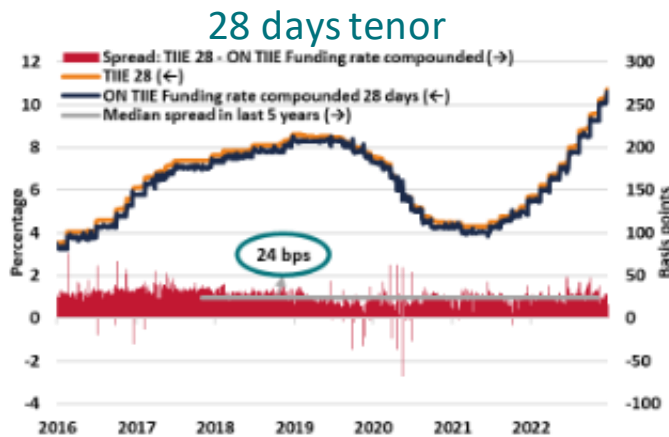
$$\text{Term TIE } n_t = \left[\left(1 + \frac{TF_{t-1} + A}{36000} \right)^n - 1 \right] \times \frac{36000}{n} + \text{Adjustment}$$

Where:

TF_{t-1} = The **ON TIE Funding rate from the previous business day** expressed in percentage points.


A = If there is a change in the target rate of Banco de México applicable in t , to the ON TIE Funding rate will be added an adjustment **A**, in the same amount of basis points (bp) that the target rate has changed. This should only be observed on the first applicable day of the new target rate determined by the board of Governors.


Spread adjustment = The historical spread adjustment will remain fixed during the time in which TIE rates with tenors greater than one business day are published. The definition of this spread adjustment was based on international experience (i.e. ISDA's methodology for fallback rates). This value is defined as the historical median of the last five years (November 2017 - October 2022) of the daily spreads between TIE with tenors greater than one business day and the ON TIE Funding rate compounded by the number of days of the corresponding term (28, 91 or 182 days, which would imply a **24 bps adjustment**, in all tenors). The historical spread adjustment defined as the median of the last five years, considers both restrictive and accommodative monetary policy cycles.




Source: Banco de México.

Annex 3: TIE de Fondo Primero Initiative

 Internationally, several jurisdictions have promoted initiatives of **best practices for derivatives markets, to help the participants in reducing their dependency on LIBOR and increase liquidity on RFRs**, which has facilitated the LIBOR transition process.

 These initiatives, among which *SONIA First* (in the United Kingdom) and *SOFR First* (in the United States) stand out, are based on a sequence of steps to **change the conventions of interdealer agents in diverse sectors of the derivatives market**, to use the local RFR (SONIA or SOFR) instead of the corresponding LIBOR. In general, there are four actions that have been taken with these initiatives:^{1/}

- ✓ Promote, in the interdealer financial market, the use of RFR instead of LIBOR in linear swaps.
- ✓ Promote, in the interdealer financial market, the use of RFR instead of LIBOR in non linear swaps.
- ✓ Promote, in the interdealer financial market, the use of RFR instead of LIBOR in currency swaps.
- ✓ Promote conventions in the derivatives standardized markets to operate with RFR.

 Taking into account the international experience, Banco de México will promote a similar initiative, called **TIE de Fondo Primero, to increase the liquidity in the ON TIE Funding rate derivatives market, and to reduce the use of Term TIE rates**. This initiative will also encourage other financial products to migrate to the ON TIE Funding rate.

^{1/} For more information refer to Annex 4 and Annex 5.

Annex 4: SONIA First Initiative

 In England, the *Financial Conduct Authority* and the Bank of England, worked since the last quarter of 2020 in several initiatives (called **SONIA First**) to migrate derivative products linked to Sterling LIBOR to SONIA:

- On October 27, 2020^{1/} the authorities started promoting that the **interdealer market of sterling interest rate swaps should adopt new quoting conventions based on SONIA instead of Sterling LIBOR.**
- On May 11, 2021^{2/}, they started promoting that the **interdealer market of sterling non-linear derivatives should use new quoting conventions based on SONIA instead of Sterling LIBOR.**
- On June 17, 2021^{3/}, they incentivized that the **sterling exchange traded derivatives should change to instruments linked to SONIA instead of Sterling LIBOR, as the default products.**
- Lastly, on September 21, 2021^{4/}, they advised that the interdealer market of LIBOR cross-currency swaps should adopt new quoting conventions based on RFR.

1/ Refer to: <https://www.bankofengland.co.uk/news/2020/september/fca-and-boe-joint-statement-on-sonia-interest-rate-swap>

2/ Refer to: <https://www.fca.org.uk/news/statements/fca-and-bank-england-encourage-market-participants-switch-sonia-sterling-non-linear-derivatives>

3/ Refer to: <https://www.bankofengland.co.uk/news/2021/may/fca-and-boe-encourage-market-participants-in-a-switch-to-sonia-17-june>

4/ Refer to: <https://www.bankofengland.co.uk/news/2021/july/fca-boe-encourage-market-participants-in-a-switch-to-rfrs-in-the-libor-cross-currency-swaps-market>

Annex 5: SOFR First Initiative



On July 13, 2021 the Commodity Futures Trading Commission in the United States (CFTC) adopted a best practice initiative called **SOFR First**, to change the conventions of the interdealer agents of the market, from LIBOR to SOFR. *SOFR First* was split into four stages to tackle different groups of derivative instruments:

- ✓ The first stage^{1/} happened on July 26, 2021, where the interdealer agents replaced trading of **LIBOR linear swaps with trading of SOFR linear swaps**. Additionally, interdealer agents' screens for LIBOR linear swaps would only be available for informational purposes and then completely turn off on October 22, 2021.
- ✓ The second stage was split in two parts, the first on September 21^{2/} and the second on December 13,^{3/} 2021 respectively. In this stage, **the interdealer agents of the cross currency swaps market first substituted LIBOR transactions with RFR transactions** (initiative called *RFR First*), **then** adopted SOFR instead of USD LIBOR in all new cross currency swaps with a USD LIBOR leg.
- ✓ The third stage^{4/} was done on November 8, 2021, in which the interdealer agents **changed the conventions in the non-linear swaps markets to use SOFR instead of USD LIBOR**.
- ✓ Lastly, the fourth stage^{5/} was announced on December 16, 2021, date in which the CFTC published a **user guide for the transition of newly-executed exchange-traded derivatives from LIBOR to SOFR**.

1/ Refer to: <https://www.cftc.gov/PressRoom/PressReleases/8409-21>

2/ Refer to: https://www.cftc.gov/media/6176/MRAC_SOFRFirstSubcommitteeRecommendation071321/download

3/ Refer to: <https://www.cftc.gov/PressRoom/PressReleases/8466-21>

4/ Refer to: <https://www.cftc.gov/PressRoom/PressReleases/8449-21>

5/ Refer to: <https://www.cftc.gov/PressRoom/PressReleases/8469-21>