March 1st, 2019

Recent developments relating to the Harmonised Index of Consumer Prices all items excluding tobacco (HICPxT)

The International Swaps and Derivatives Association, Inc. ("**ISDA**") announces the following guidance for parties to over-the-counter derivative transactions that reference the Harmonised Index of Consumer Prices all items excluding tobacco (HICPxT).

ISDA is issuing this guidance in the interest of mitigating market risk and the promotion of orderly and efficient valuation and settlement of positions by market participants. This guidance is not legal, accounting or financial advice and market participants should consult their legal or other professional advisors as appropriate. ISDA does not assume any responsibility for this guidance and it is not intended to set a precedent. Parties and Calculation Agents are not obliged to follow this guidance and may choose alternate means of addressing the matters discussed.

Guidance

On 22 February 2019, Eurostat, in its capacity as index sponsor, published an announcement in respect of certain revisions to the Harmonised Index of Consumer Prices (HICP) (the "**Eurostat Announcement**").[1] The Eurostat Announcement sets out the reasons for the revisions to the HICP. The final paragraph of page 2 of the Eurostat Announcement contains a link to an Excel spreadsheet, which sets out, amongst other things, a list of "back data linking factors" (the "**Back Data Linking Factors**") in respect of certain ancillary indexes, including the Harmonised Index of Consumer Prices all items excluding tobacco (HICPxT).

(1) Rebasing of the Index under Section 2.3 of the 2008 ISDA Inflation Derivatives Definitions

(a) Who determines whether a "rebasing" has occurred?

Whether the HICPxT has been "rebased" for the purposes of Section 2.3 is to be determined by the Calculation Agent (who will be identified in the documentation of the relevant inflation derivative transaction).

The term "Calculation Agent" is not defined in the 2008 ISDA Inflation Derivatives Definitions but is defined in the 2006 ISDA Definitions. The Preamble to the 2008 ISDA Inflation Derivatives Definitions states that "Any capitalized term not herein defined, shall have the meaning given to that term in the 2006 ISDA Definitions or other relevant ISDA publication as the context requires".

(b) Does an event have to be described as a "rebase" in order for it to be a "rebase" for the purposes of Section 2.3?

The term "rebase" is not defined in the 2008 ISDA Inflation Derivatives Definitions. When assessing whether an event constitutes a "rebasing", a Calculation Agent will have to consider relevant factual evidence.

Factual evidence may include, among other things, the following (which may or may not be considered individually or collectively determinative of whether a "rebasing" has occurred):

(i) whether the index sponsor has described it as a "rebase". In this instance the initial version of the Eurostat Announcement did not describe the event as constituting a

[1] https://ec.europa.eu/eurostat/documents/272892/272974/Improved_calculations_and_methods_change.pdf

”rebase” but the Back Data Linking Factors were described as “implicit rebasing keys”. This was changed when the Eurostat Announcement was amended on 27 February 2019 and the “implicit rebasing keys” were relabelled as “back data linking factors”;

(ii) the extent to which the events in connection with the Index accord with any common understanding of the term “rebase” in the inflation derivatives market. To the extent that this has a commonly understood meaning, it may preclude something outside of that terminology from being a “rebasing”. For example, a “rebasing” may commonly be understood to include changing the year (the “base year”) in which the average level of inflation is set to = 100 by the index sponsor. In this instance, the base year before the Eurostat Announcement was 2015 and this did not change after the Eurostat Announcement;

(iii) the fact that the Back Data Linking Factors are expressed to apply to the HICPxT and that a rescaling is applied; and

(iv) whether the calculation agent of any Related Bond (see paragraph (1)(d) below for information on what a Related Bond is) has determined that a “rebasing” has occurred. It is important to note that, where the terms of the Related Bond have a different definition or concept of “rebasing” than that set out in Section 2.3, any such determination may not be determinative.

The above is provided for illustrative purposes only.

(c) What adjustments, if any, is the Calculation Agent required to make in the event that it determines a “rebasing” has occurred?

Section 2.3 states that, if the Calculation Agent has determined that an index has been “rebased”:

> *“the Index so rebased (the “Rebased Index”) will be used to determine the level of an Index from the date of such rebasing; provided, however, that the Calculation Agent shall make such adjustments as are made by the calculation agent pursuant to the terms and conditions of the Related Bond, if any, to the levels of the Rebased Index so that the Rebased Index levels reflect the same rate of inflation as the Index before it was rebased”.*

ISDA considers that, if the Calculation Agent determines that an index has been “rebased”, the adjustments (if any) made to the inflation derivative transaction must replicate the adjustments made in the Related Bond insofar as they relate to the “rebasing”.

Consequently for transactions which have a Related Bond, if no adjustments are made to the Related Bond, the determination of whether a “rebasing” has occurred is likely to be academic, because no adjustments will be made to the inflation derivative transaction in any event.

(d) What is the Related Bond?

The parties to an inflation derivative transaction may specify a Related Bond. If no bond is specified, the Related Bond will be the Fallback Bond unless the parties have expressly stated that there shall be no Fallback Bond.

The Fallback Bond will be selected by the Calculation Agent in accordance with a set of criteria specified in definition of “Fallback Bond” in the 2008 ISDA Inflation Derivatives

Definitions. If more than one bond satisfies the relevant criteria, the Calculation Agent will choose one eligible bond to be the Fallback Bond.

Given the nature of the HICPxT, the Fallback Bond for inflation derivative transactions referencing the HICPxT will be limited to bonds issued by the governments of France, Italy Germany or Spain which pay a coupon or redemption amount which is calculated by reference to the level of inflation in the European Monetary Union.

(e) *What adjustments are being made to the possible pool of Fallback Bonds?*

The debt management office (a "**DMO**") of each such sovereign has confirmed that no amendments will be made to the terms of their debt instruments which reference the level of inflation in the European Monetary Union as a result of the Eurostat Announcement.

(f) *What if there is no Related Bond?*

If, for an inflation derivative transaction, no Related Bond was specified and the Fallback Bond was specified to be not applicable, the penultimate sentence of Section 2.3 applies. It states that:

> *"the Calculation Agent shall make adjustments to the levels of the Rebased Index so that the Rebased Index levels reflect the same rate of inflation as the Index before it was rebased".*

The Calculation Agent has discretion how to amend the inflation derivative transaction and it is not obliged to replicate the adjustments, if any, made by any DMO in respect of its bonds.

(2) ***Material change to the Index under Section 2.4 of the 2008 ISDA Inflation Derivatives Definitions***

(a) *What are the conditions to Section 2.4 applying?*

First, the Index Sponsor must make an announcement. Eurostat has made an announcement in its capacity as index sponsor of the HICP, a link to which is available in footnote 1 (referred to in this guidance as the Eurostat Announcement). The Eurostat Announcement indirectly refers to the HICPxT.

Second, the announcement must set out a material change to the relevant index.

Whether that change is material is a question of fact. Section 2.4 does not require the Index Sponsor to describe the change as material.

(b) *What adjustments, if any, is the Calculation Agent required to make?*

If a material change to an Index has been announced by the Index Sponsor, then the Calculation Agent is obliged to make:

> *"any such adjustments to the Index consistent with adjustments made to the Related Bond, or, if there is no Related Bond, only those adjustments necessary for the modified Index to continues as the Index".*

Any adjustments made to the inflation derivative transaction must be consistent with the adjustments (if any) made in the Related Bond. The Calculation Agent is under an obligation to effect the adjustments and to ensure a consistent approach with the Related Bond.

Consequently for transactions which have a Related Bond, if no adjustments are made to the Related Bond, the determination of whether a material change has occurred is likely to be academic, because no adjustments will be made to the inflation derivative transaction in any event.

(c) *What is the Related Bond?*

The definition of Related Bond applies in the same manner to Sections 2.3 and 2.4. Consequently, similar analysis to that in paragraph 1(d) above applies.

(d) *What adjustments are being made to the possible pool of Fallback Bonds?*

Please see the summary in paragraph 1(e) above.

(e) *What if there is no Related Bond?*

Similar analysis to that in paragraph 1(f) above applies. The Calculation Agent has discretion how to amend the inflation derivative transaction, although Section 2.4 states that those adjustments must be "necessary for the modified Index to continue as the Index".