Euro risk-free rate reform

By David Hiscock

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From EONIA to €STR

On 14 March 2019, the private sector Working Group on Euro Risk-Free Rates endorsed recommendations to market participants regarding the transition from the euro overnight index average (EONIA) to the euro short-term rate (€STR), which was previously adopted by the working group as the preferred new near-risk free rate for the euro area.

Among other things, the working group recommended that market participants gradually replace EONIA with €STR for all products and contracts, making €STR their standard reference rate and making certain adjustments to their IT systems. In order to give market participants sufficient time to transition to €STR, the working group recommended that EONIA's administrator, the European Money Market Institute (EMMI), modify the current EONIA methodology to become €STR plus a fixed spread – for a limited period of time – based upon a recommended spread calculation methodology. EMMI was also requested to engage with the relevant authorities to ensure that EONIA, under its evolved methodology, complies with the EU Benchmarks Regulation (the BMR).

Finally, the working group recommended a methodology for calculating a forward-looking term structure based on €STR derivatives markets, that could be used as a fallback in EURIBOR-linked contracts. The working group is analysing further both backward and forward-looking approaches as potential fallbacks for EURIBOR, acknowledging work being done in other currency areas as well as by ISDA, which has announced its intention – following the start of the publication of the €STR – to consult on determining a fallback for EURIBOR-linked derivatives contracts.

EMMI consulted on these working group recommendations for EONIA, with the results of that consultation being released on 31 May. EMMI confirmed that the EONIA methodology would change to €STR plus a spread as from 2 October 2019 and that EONIA was intended to be discontinued on 3 January 2022.

Concurrently, the ECB announced that it had calculated the spread between €STR and EONIA, based on the methodology as recommended by the working group and adopted by EMMI, for the recalibration of the EONIA methodology as of 2 October and until its discontinuation by EMMI. On the basis of daily EONIA and pre-€STR data, from 17 April 2018 to 16 April 2019, the ECB has calculated this spread as 0.085% (ie 8.5 basis points).

Subsequently, on 16 July, the private sector Working Group on Euro Risk-Free Rates published a set of *Recommendations on the Legal Action Plan* for the transition from EONIA to €STR.

Among other things, the working group recommended €STR plus a fixed spread of 8.5 basis points as the EONIA fallback rate for all products and purposes. Market participants, whenever feasible and appropriate, should consider avoiding entering into new contracts referencing EONIA, in particular new contracts maturing after 31 December 2021 – as EONIA will cease to exist directly after that date. For existing contracts referencing EONIA and maturing after December 2021, market participants should consider replacing EONIA as a primary rate as soon as possible or embed robust fallback clauses. In those cases where new contracts still reference EONIA and mature after December 2021, or fall within the scope of the BMR, market participants should include robust fallback provisions.

Additionally, for the purpose of enhancing transparency, new contracts signed before October should ideally include clarification that the EONIA methodology would change as of 2 October and that, unless otherwise agreed by the parties, references in contracts to EONIA shall be understood to be references to EONIA as changed. Following public consultation on the legal action plan and the feedback received from the market, the working group also provided two templates for EONIA discontinuation fallback language for new cash products – market participants may use the wording and tailor it to take into account the terms and conditions for each particular asset class and the legal requirements of each governing law and relevant European jurisdiction.

When considering these recommendations, it is important to keep in mind that many provisions of the BMR have been in application since 1 January 2018. These provisions include Article 28(2), which states that supervised entities that use a benchmark "shall produce and maintain robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided. Where feasible and appropriate, such plans shall nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives. The supervised entities shall, upon request, provide the relevant competent authority with those plans and any updates and shall reflect them in the contractual relationship with clients." Where the "use" of a benchmark falls within scope of this provision of the BMR, supervised entities therefore need to be satisfied that they do indeed have such robust written plans in place.

As a next step, on 19 August, the private sector Working Group on Euro Risk-Free Rates published a report containing a set of *Recommendations Addressing the Impact of the Transition from EONIA to €STR*. These recommendations take an operational and valuation perspective, taking into account EONIA's wide use as a reference rate and as a collateral remuneration and cash flow discounting rate. The report analyses the various financial products and processes affected by the transition, covering secured (eg repos) and unsecured (eg current accounts) cash products, securities (eg CP and CDs), investment funds, derivatives and models referencing EONIA.

The report urged market participants to prepare for two key phases of transition: first, the change in EONIA's publication time from 19:00 CET on day T to 09:15 CET on the next business day, T+1, which stemmed from the change in EONIA's methodology as of 2 October (representing transactions executed on 1 October 2019) – as determined by EMMI and alongside the instigation of €STR; and second, the discontinuation of EONIA on 3 January 2022.

Regarding the change in EONIA's publication time, the working group encourages market participants, among other things:

- to screen their inventory of affected transactions and system environments to assess the modifications needed;
- to design a communication strategy geared towards internal and external stakeholders; and
- in certain cases, to consider adjusting the default settlement time.

Regarding the transition period until EONIA is discontinued, the working group recommended, among other things:

- that, before the end of 2021, market participants actively transition floating rate options referencing EONIA to €STR floating rate options;
- that CCPs align their discounting switch dates as much as possible to transition from an EONIA discounting regime to a €STR discounting regime, and set the discounting switch date as early as possible – preferably towards the end of the second quarter of 2020; and
- that market participants introduce all necessary modifications in order to be able to issue, buy, trade and manage new securities indexed to the €STR and avoid issuing new securities indexed to EONIA with maturities going beyond the transition period.

The full report provides the detailed set of recommendations and underlying analyses, which include some market best practices agreed by ICMA's European Repo and Collateral Council in relation to the practicalities of the EONIA to €STR transition for non-cleared repo markets. The working group's recommendations are not legally binding but do provide guidance to market participants preparing for the transition from EONIA to the €STR. A further report focused on risk management implications of the transition from EONIA to €STR, and of the inclusion of fallbacks for EURIBOR based on a €STR-based term structure methodology, is being prepared for publication by the working group.

Following on from a first event in November 2018, the second roundtable on euro risk-free rates was hosted by the ECB, in Frankfurt, on 25 September 2019. It focused on providing information to market participants on how to transition from EONIA to the €STR; and included panel sessions and speeches by various speakers.

EURIBOR

Finally, turning to the topic of EURIBOR, on 6 May 2019, EMMI announced that it had applied to the Belgian Financial Services and Markets Authority (FSMA) for authorisation under the BMR. As a subsequent step, EMMI started transitioning panel banks from the current EURIBOR methodology to the new hybrid methodology on which it had earlier consulted the market, with a view of finishing the process before the end of 2019. In support of all this, EMMI has adopted a governance framework establishing the requirements and principles related to the provision of the EURIBOR benchmark under the hybrid methodology.

Subsequently, on 3 July, it was announced that EMMI had been duly granted authorisation for the administration of EURIBOR by the FSMA. With this recognition under the BMR confirmed and the EURIBOR methodology reformed, EU authorities anticipate that the use of EURIBOR will persist for the foreseeable future.

Contact: David Hiscock
david.hiscock@icmagroup.org