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The transition to risk-free rates in the euro area

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RFR

Background

The most widely used interest rate benchmarks for financial contracts denominated in euro are EONIA and EURIBOR, both of which are administered by EMMI, the European Money Markets Institute. These benchmarks are based on the unsecured interbank market and, in the context of the EU's Benchmarks Regulation (the BMR), have both been designated as "critical benchmarks".

In September 2017, the Working Group on Euro RFRs was launched. It was tasked with the identification and adoption of a "risk-free overnight rate" (RFR) able to serve as a basis for an alternative to current benchmarks used in a variety of financial instruments and contracts in the euro area.

Having developed key selection criteria for a robust alternative rate, the working group identified three rates with characteristics that could potentially qualify them to become the euro RFR. Based on further discussion and the feedback received from a public consultation, on 13 September 2018, the working group announced its recommendation that the euro short-term rate (ESTER) be used as the RFR for the euro area; and as the replacement for EONIA. ESTER is a new wholesale unsecured overnight bank borrowing rate, which the ECB has committed to produce on a daily basis, by October 2019, based entirely on money markets' statistical data reported to it daily by banks.

On 9 November, at the ECB in Frankfurt, the working group hosted a roundtable, which is now available as a webcast, together with the supporting slides. The purpose of this roundtable was to explain to market participants the reasons behind the recommendation of ESTER as the preferred euro RFR; make the features of ESTER better known to future users; and discuss the next steps in the transition. During the roundtable, drawing from the *IBOR Global Benchmark Transition Report* published in June 2018 by ICMA together with AFME, ISDA, SIFMA and SIFMA AMG, ICMA delivered a short address regarding how to prepare for the transition.

Complementary to this identification and recommendation of an alternative RFR, the working group has established three sub-group workstreams which are focused on (i) identifying and recommending a term structure on the RFR; (ii) contractual robustness for legacy and new contracts; and (iii) transition from EONIA to ESTER.

Transition from EONIA to ESTER

There is particular urgency relating to the transition from EONIA to ESTER, as EMMI has made public its conclusion that, under current market conditions, EONIA's compliance with the BMR "cannot be warranted". This stems from the fact that in 2018, underlying volumes for EONIA have averaged just below 5 billion euros per day and have fallen below 1 billion euros on a handful of occasions, owing to local business holidays. These factors reflect prolonged structural change in the underlying interbank lending market. In light of its non-compliance with the BMR, the usage of EONIA will, as the law currently stands, be restricted as from 1 January 2020.

But transition will be challenging, including because of the fact that ESTER is only currently assured to be available on a daily basis by October 2019. It is possible that this timeline will be changed, as the European Commission, together with the co-legislators, the European Parliament and Council, are debating potential legislative amendments which would allow for the extension of the transition period in the BMR, potentially for a further two years – taking it to a new end date of 31 December 2021. But, for now, there is no certainty that such extension will be agreed, and the market needs to continue to plan on the assumption that the BMR transition period will end on 31 December 2019.

The restriction imposed by the BMR means that supervised entities must not use EONIA in securities or derivatives traded on a venue or via a systematic internaliser, nor in certain consumer loans or investment funds. Continued use in legacy, as opposed to new, contracts is likely to be possible, subject to approval by the FSMA. This, however, clearly depends upon a value for EONIA continuing to be available on a daily basis.

On 20 December, the working group called on market participants and all other interested parties to comment on its technical analysis of the paths available for transitioning from EONIA to ESTER, as well as on its recommendation of the preferred transition option. This working group recommendation is that EMMI, as the administrator of EONIA, should take the following steps before 1 January 2020:

(a) Modify the current EONIA methodology to become ESTER plus a spread for a limited period, in accordance with Financial Stability Board (FSB) recommendations and IOSCO Principles for Financial Benchmarks to further anchor EONIA's methodology in transactions.

(b) Engage with the relevant authorities to ensure the compliance of EONIA, under its evolved methodology, with the EU Benchmarks Regulation.

(c) Consider and consult market participants on discontinuing the publication of EONIA under its evolved methodology, after a transition period that ensures firms can achieve transition to ESTER in a smooth manner and that pays due regard of the existing EONIA legacy book. This transition period should last until the end of 2021, which is consistent with benchmark transitions in other jurisdictions.

The working group also invites EMMI to take the following considerations into account:

(a) that an EONIA-ESTER spread methodology is considered which is based on a simple average with an observation period of at least 12 months, combined with a 15% trimming mechanism;

(b) that the recalibration methodology and the effective determination of the spread are announced at the same time and before ESTER's first day of publication;

(c) that the recalibration date is on the first day of ESTER's publication for simplicity reasons.

The working group recommends that market participants gradually replace EONIA with ESTER as a reference rate for all products and contracts and make all adjustments necessary for using ESTER as their standard benchmark after the transition period (including making the appropriate changes to their systems to enable a T+1 publication). The working group also encourages market participants to make all reasonable efforts to replace EONIA with ESTER as a basis for collateral interest for both legacy and new trades with each of its counterparties.

The situation relating to EURIBOR

Meanwhile, EURIBOR is presently a quote-based interest rate benchmark available for eight tenors; and is currently undergoing reforms, led by EMMI. Given the low levels of activity in the underlying markets which the two-week, two-month and nine-month EURIBOR tenors intend to represent, EMMI announced the cessation of these three tenors, as of 3 December 2018.

Considering the remaining five tenors – one week, as well as one, three, six and twelve months – as the current, quote-based methodology is not compliant with the BMR, on 17 October, EMMI announced the publication of its second stakeholder consultation, for comment by 30 November, on a hybrid methodology for EURIBOR – which leverages market transactions whenever available and is composed of a three-level waterfall model.

This second consultation paper presents a summary of EMMI's findings during the hybrid EURIBOR testing phase and provides details on EMMI's proposals for the different methodological parameters. By early 2019, EMMI will publish a summary of the feedback received and a thorough view of the final methodological blueprint, including a concrete timeline and next steps. EMMI expects to file for authorisation to the Belgian FSMA (the relevant national competent authority under the BMR) by Q2 2019 and, subsequently, will transition panel banks from the current EURIBOR methodology to the hybrid methodology – with a view of finishing the process before the end of 2019.

It seems reasonably clear that this ongoing reform work will allow that EURIBOR can become a BMR compliant benchmark – as is already the case for LIBOR. For EURIBOR this will solve the immediate challenge of the BMR but does not solve longer-term concerns – that there are relatively few actual transactions in each tenor on a daily basis and that panel banks could prove reluctant to have to continue submitting rates. Hence, as with LIBOR, pressure to transition away from EURIBOR use should be expected.

ESTER-based term structure methodology

The situation relating to EURIBOR described above adds to the importance of ensuring that there are robust fallback rates identified, in case EURIBOR should at some point cease to be available, and to ensure that documentation suitably references such fallback rates. Accordingly, with

ESTER established as the euro RFR, the working group is also seeking market feedback, through a consultation launched on 20 December (for comment by 1 February) on its assessment of alternative ESTER-based term structure methodologies that can serve as a fallback for EURIBOR-linked contracts, as well as on their specific use cases.

The working group has considered a variety of potential term rate methodologies which are discussed in the consultation. Term rates can be backward-looking or forward-looking. Backward-looking term rates are based on simple mathematical calculations on the past realised daily fixings of the overnight risk-free rate (ie ESTER) over a given period in time, whereas forward-looking term rates are based on derivatives markets of the underlying RFR. A backward-looking methodology is easy to understand and to construct. However, the working group recognises the potential need for a forward-looking methodology for cash flow forecasting and for managing interest rate risk, especially in the mortgage, loan and debt securities markets, so the working group will ultimately consider both approaches.

The focus of the public consultation is to seek feedback on the need for term rates in different products, and on the analysis of forward-looking methodologies to obtain term rates which could serve as appropriately robust fallbacks. The working group developed key selection criteria rooted in IOSCO principles and identified four forward-looking approaches building on, as yet non-existent, ESTER-based derivatives markets (overnight index swap (OIS) and futures markets) for deriving a euro risk-free term rate.

It is acknowledged that any assessment of such risk-free term rates would necessitate a successful transition from EONIA to ESTER with a significant transfer of liquidity to ESTER OIS markets; a transparent and regulated underlying derivatives market such as trading on multilateral trading facilities; and sufficient sources of data to capture the majority of market activity. Against this background and making these assumptions, the working group assessed three approaches for deriving term RFRs by building on OIS markets and one based on futures markets. Under the defined main assumptions, a majority of its members expressed a preference for the OIS quotes-based methodology as the methodology that is most likely to be viable at the present time.

The working group also expects the feedback from this consultation to help in assessing the suitability of a one-size-fits all, versus a product-specific, approach for a fallback rate. As part of the subsequent evaluation, the working group will assess various factors impinging on a broad-based market adoption of the recommended term RFR, including hedging and accounting issues, and will address the issue of the credit spread difference between EURIBOR and ESTER-based curves.

Contract robustness

ICMA is closely monitoring this continuing work of the sub-group workstreams of the Euro RFR Working Group and is actively participating in the sub-group on contract robustness. This sub-group's key deliverables (as described in the sub-group's terms of reference) are: (i) to analyse the legal risks and impact of embedding fallback provisions referencing newly defined RFRs, or, where appropriate, a replacement of references to EONIA and EURIBOR with references to newly defined RFRs (and term/credit spreads where appropriate) in legacy contracts; (ii) to define solutions to embed fallbacks, and replacements where appropriate, for EONIA and EURIBOR; and (iii) to suggest measures to enhance the legal soundness of references to newly defined RFRs (and term/credit spreads where appropriate) in new contracts, taking into account consumer protection interests.

A key area of focus for this sub-group recently has been to provide legal input into the sub-group on EONIA transition. Going forward, it is expected that the sub-group will publish some information relating to the current legal frameworks and market practices in relation to EONIA and EURIBOR references in contracts for cash products and guiding principles for more robust fallback clauses in cash products in early 2019.

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