Note drafted by the Eurofi Secretariat

BENCHMARK REGULATION: IMPLEMENTATION CHALLENGES

Benchmark interest rates are used across a large range of financial market instruments. Consequently, benchmark rates are also important for the assessment of monetary policies given their interconnectedness with the financial system but also because benchmark interest rates underpin a substantial part of retail borrowing in the euro area.

Yet attempted market manipulation and the false reporting of global reference rates, together with the post-crisis decline in liquidity in interbank unsecured funding markets have led to a significant drop in underlying transaction volumes as well as the stronger role of non-banks in managing liquidity, and have undermined confidence in the reliability and robustness of existing interbank benchmark interest rates.

To address these issues international supervisory and standard setting bodies undertook a fundamental review and reform of major interest notably regarding benchmark designs and their governance. Eventually, the FSB endorsed the IOSCO Principles for Financial Benchmarks. Furthermore, a Market Participant Group recommended the strengthening of existing IBORs by underpinning them to the greatest extent possible with transaction data and finally to developing alternative, nearly risk-free reference (RFR) rates that better suit certain financial transactions, including many derivatives transactions. In the EU, these efforts have resulted in the adoption of the EU Benchmark Regulation.

In this context, EONIA and EURIBOR which have both been designated as "critical benchmarks", do not currently comply with these requirements, and may be prohibited use, at least in new contracts. It is also uncertain whether their use in legacy contracts will be permissible. The volume of legacy contracts with maturities beyond 2019 is substantial. Notably a quarter of outstanding interest rate derivatives using EONIA and more than half using EURIBOR have maturities in 2020 or later. 80% of floating-rate debt securities using EURIBOR – worth almost €1.5 trillion – also extend beyond 2019[1].

Therefore, in September 2017, the ECB, the Belgian Financial Services and Markets Authority (as lead supervisor of both EONIA and EURIBOR), the European Securities and Markets Authority and the European Commission launched a new private sector working group. The group was entrusted with the identification and adoption of risk-free rates to serve as a basis for an alternative to the current benchmarks. This group recommended ESTER -to be produced by the ECB - reflecting euro area banks' borrowing costs in the wholesale unsecured overnight market - as the euro risk-free rate to replace EONIA.

However, progress towards the development of alternatives for longer tenures is expected. As far as EURIBOR is concerned, the European Money Markets Institute (EMMI) is working out the features of a new compliant benchmark, based on a hybrid methodology using actual transactions whenever available, and relying on other related market prices when required, which should still entail expert judgement in order to sustain daily benchmark publications on longer tenures. However, ECB would not be well placed to produce term rates (as opposed to overnight rates), as the central bank may not have the same overview of the prevailing market conditions and funding costs as banks.

Even producing ESTER which requires building the infrastructure, defining processes and governance, and testing operations, has proved challenging notably due to a very tight timeframe. An early release of the new rate should allow market participants to be better prepared for and understand the properties of ESTER. But too fast a publication which reduces the testing period, might entail operational risk. Robust business continuity and contingency plans must also be developed. Consequently, the ECB should be in a position to publish ESTER by October 2019, although the usage of EONIA will, should be restricted as from 1 January 2020. However, a pre-ESTER will be provided for market participants.

Finally, an extension of the transition period in the European Benchmark Regulation (BMR), is expected, potentially for a further two years – taking it to a new end date of 31 December 2021.

The ICMA together with AFME, ISDA, SIFMA and SIFMA AMG published in June 2018 the IBOR Global Benchmark Transition Report.

Three workstreams have been respectively 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.

On 20 December, the working group called on 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. These recommendations advise that EMMI, as the admi-

[1] Benoît Coeuré 25 Septembre 2018 https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180925.en.html

nistrator of EONIA, should modify the current EONIA methodology (EONIA-ESTER spread approach) and define a transition period which should last until the end of 2021, before discontinuing the publication of EONIA that ensures firms can achieve transition to ESTER in a smooth manner. The working group also recommends that market participants should gradually replace EONIA with ESTER as a reference rate for all products and contracts. Finally, the working group 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.

Regarding the EURIBOR, a hybrid methodology has been designed. By Q2 2019 panel banks will move from the current EURIBOR methodology to the hybrid methodology – with a view to finishing the process before the end of 2019. This will allow EURIBOR to become a BMR compliant benchmark but does not solve longer-term concerns – that there are relatively few actual transactions in each tenure on a daily basis and that panel banks could prove reluctant to have to continue submitting rates. Pressure to transition away from EURIBOR use should be expected. Mid-February, EMMI stressed the fact that its hybrid methodology to calculate EURIBOR, received broad support in the consultation it undertook, and consequently announced its intention to file for an authorization to the Belgian Financial Service and Market Authority by Q2 2019.

Ensuring that there are robust fall-back rates identified and that documentation references to such fall-back rates are indispensable. A consultation ended 1 February on alternative ESTER-based term structure methodologies (probably both backward-looking and forward-looking to address cash flow forecasting needs and for managing interest rate risk) that can serve as a fall-back for EURIBOR- linked contracts. Assessing such risk-free term rates necessitates a successful transition from EONIA to ESTER with a significant transfer of liquidity to ESTER OIS markets as well as a transparent and regulated underlying derivatives market and sufficient sources of data to capture the majority of market activity. However, the working group expressed beforehand a preference for the OIS quote-based methodology. An assessment of the success factors of a broad market adoption of the recommended term RFR (Risk Free Reference) is also necessary.

Finally, key points of attention are the legal risks and impact of embedding fallback provisions referencing newly defined RFRs, the replacement of references to EONIA and EURIBOR with references to newly defined RFRs in legacy contracts, and to define solutions to embed fallback replacements where appropriate, for EONIA and EURIBOR, as well as measures to enhance the legal soundness of references to newly defined RFRs.

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 fall-back clause is expected. ■