

Working group on euro risk-free rates - Next steps

Executive summary

- The EU Benchmark Regulation (BMR) transitional provision requires EU firms to only use registered or authorised benchmarks that comply with the BMR in new contracts as of 1 January 2020. In addition, the BMR requires supervised users to have robust written plans setting out the actions they will take in the event a benchmark ceases to exist, including the inclusion of fallbacks in their contracts.
- The European Money Markets Institute (EMMI), the administrator of two of the most critical benchmarks in the euro area, EONIA and EURIBOR, has conducted reforms for both benchmarks. Based on the outcome, EMMI announced that EONIA in its current form will not become BMR compliant, hence EONIA in its current form cannot longer be used in new contracts as of 1 January 2020. EURIBOR could become BMR compliant once the reform towards the EURIBOR hybrid methodology, by strengthening EURIBOR to the greatest extent possible with transaction data, is finalised in 2H 2019.
- Based on the outcome of the EONIA reform, in February 2018 the European Central Bank (ECB), the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission set up a working group with the task to identify and recommend alternative euro risk-free rates. In addition, this group needs to work on a market adoption plan to ensure a smooth transition to these alternative euro risk-free rates by all market participants.
- Over the last year, during the preparation phase, the working group on euro risk-free rates has worked hard on finding and recommending (1) the replacement of EONIA with €STR; (2) the transition path to move from EONIA to €STR; and (3) an €STR-based term structure that can function as a robust and resilient fallback to EURIBOR.
- Next phase for the working group is to ensure that these recommendations will be adopted by all market participants. For a smooth market adoption in order to minimise market disruption, market participants must be made aware of this upcoming change that will significantly impact a large part of their activities across the full value chain. During the market adoption phase, the working group will focus on the implications for contracts, cash products & derivatives and financial accounting & risk management and the communication towards & education of all market participants.
- The current organisation of the working group on euro risk-free rates does not factor in these requirements for market adoption. The working group therefore introduces new subgroups to work on the steps required to ensure that alternative benchmarks will be adopted by all market participants, while some of the initial subgroups will be phased out progressively. **Market participants are welcome to join these new subgroups, in order to broaden the range of market participants to cover the full industry, including end-users.**
- The organisational change will take effect once the working group has made recommendations on the transition path to move from EONIA to €STR and on the €STR-based term structure methodology (targeted end of March 2019).

Background

Benchmark regulations

In 2014, the Financial Stability Board (FSB) made the following recommendations on 'Reforming major interest rate benchmarks':

- To strengthen existing benchmarks by underpinning them to the greatest extent possible with transaction data; and
- To develop alternative, nearly risk-free reference rates.

Following the FSB recommendations, reforms are underway in all jurisdictions. The FSB recommendations have been incorporated in the EU Benchmarks Regulation (BMR) that entered into force in June 2016. The BMR transitional provision requires EU firms to only use registered or authorised benchmarks that comply with the BMR in new contracts as of 1 January 2020. In addition, the BMR requires supervised users (including regulated sell and buy side institutions such as banks, pension and insurance entities, UCITS, AIFMs and investment funds) to have robust written plans setting out the actions they will take in the event a benchmark ceases to exist, including the inclusion of fallbacks in their contracts.

Status of the reform of critical euro-denominated benchmarks

The most important euro-denominated interest rate benchmarks are EONIA and EURIBOR. Based on the FSB recommendations and the implementation of the BMR, the administrator European Money Markets Institute (EMMI) conducted reforms for both EONIA and EURIBOR. Based on the outcome, EMMI concluded that:

- **EONIA** in its current form will not become BMR compliant, given the lack of underlying transactions and high concentration of volumes by only a few contributors. As a consequence, unless its methodology is improved, EONIA cannot longer be used in new contracts as of 1 January 2020.
- **EURIBOR** could become BMR compliant once the reform towards the EURIBOR hybrid methodology, by strengthening EURIBOR to the greatest extent possible with transaction data, is finalised in 2H 2019. The Financial Services and Markets Authority (FSMA, supervisor of EURIBOR) concluded that the new methodology represents a significant step towards a BMR-compliant benchmark. FSMA will therefore make an effort to expedite the authorisation process, once EMMI will file for authorisation, provided that the 19 panel banks have given (1) their commitment to be operationally ready to contribute according to the new hybrid methodology and (2) their intention to continue their contribution to EURIBOR.

Working group on euro risk-free rates

Based on the outcome of the EONIA reform, in February 2018, the European Central Bank (ECB), the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission set up a working group with the task to identify and recommend alternative euro risk-free rates. Such rates could serve as a

basis for an alternative to current benchmarks used in a variety of financial instruments and contracts in the euro area. In addition, this group needs to work on a market adoption plan to ensure a smooth transition to these alternative euro risk-free rates by all market participants. A careful market adoption plan could minimise disruption to markets and consumers and could safeguard the continuity of contracts to the greatest extent possible, including contracts that currently reference a term rate rather than an overnight rate. The above-listed tasks require the involvement of public authorities and a concerted effort by all market participants to facilitate a gradual reduction in the current reliance on interbank offered rates.

Important deliverables of the working group on euro risk-free rates

As a consequence of the BMR and outcome of the EONIA and EURIBOR reforms, the base case scenario for the working group is to provide recommendations for:

- A transition from EONIA to the euro risk-free rate; and
- Fallbacks for the euro risk-free rate and EURIBOR.

Type	Current Euro rates	Replacement	Fallback (BMR art 28.2)
O/N	EONIA	 RFR	Alternative RFR
Term	EURIBOR		RFR + term structure

This base case scenario forms the basis for the key deliverables of the working group:

1. Identify and recommend (alternative) euro risk-free rates;
2. Identify and make recommendations for term structures based on risk-free rate(s);
3. Identify and make recommendations on legal implications for legacy and new contracts; and
4. Promote market adoption of the recommendations to ensure a smooth transition.

Status update and next steps for the working group on euro risk-free rates

Usage of EONIA and EURIBOR

Both EONIA and EURIBOR are widely used in both cash and derivative products representing underlying gross notional volumes exceeding EUR 150 trillion. EONIA is widely used in derivatives, with maturity dates that can go beyond 30 years, and to a lesser extent also in cash products and instruments. Its usage is largely concentrated in the professional market. Besides EONIA's usage as an index in overnight index swaps (OIS), it is also used for the valuation of EONIA and EURIBOR derivatives for margin and collateral calculations, for risk management purposes and for financial accounting and hedge accounting purposes. Replacing EONIA with €STR will therefore not only require changes to outstanding and new contracts, it will also have consequences for the valuation of derivatives and require operational changes within the user community. EURIBOR is widely used in both derivatives and cash products. Its usage is not limited to the professional world but also widely spread to corporates and individuals.

Status update and next steps

A smooth market adoption of risk-free rates requires thorough preparation in order to avoid market disruption to the greatest extent possible, by ensuring a fair solution that is implemented across all market participants, mitigating legal and operational risks and allowing for market participants to adapt in time. Several sequential steps are required to ensure a smooth transition and implementation. In this plan, the working group distinguishes two phases:

1. Ensuring that alternative benchmarks based on a risk-free rate, that could serve as a replacement to EONIA and as a fallback to EURIBOR, are readily available; and
2. Ensuring that these alternative benchmarks are adopted by market participants.

In this section, the working group will provide a status update per implementation phase and indicate the next steps for the working group to ensure a smooth market adoption by all market participants. In addition, the working group will detail the organisational consequences of entering into the second phase.

1. Ensuring that alternative benchmarks to EONIA and EURIBOR based on a risk-free rate are readily available

The main purpose of this phase is to make recommendations for a robust replacement euro risk-free rate for EONIA and for appropriate fallbacks for the euro risk-free rate and EURIBOR, ready for use across the whole market place. The following main steps have been identified for this preparation phase (please refer to the appendix of this document for a more granular reflection of the required actions and an indication of the required timelines):

EONIA

- 1.1 Recommendations for the o/n risk-free rate €STR as a replacement of EONIA
- 1.2 Recommendations for the transition path to move from EONIA to €STR
- 1.3 Recommendations for a fallback to the o/n risk-free rate €STR

EURIBOR

- 1.4 Recommendations for €STR-based term structure methodologies as fallback to EURIBOR

1.1 Recommendations for the o/n euro risk-free rate €STR as a replacement of EONIA

An important starting point for the working group was the selection of the euro risk-free rate. The working group started at the beginning of 2018 with the selection process to recommend a euro risk-free rate. The working group developed key selection criteria against which they assessed a number of candidate rates. Subsequently, the working group also launched a market-wide consultation on the most suitable three candidates before voting. On 13 September 2018, the working group announced that it unanimously recommends €STR as the alternative euro risk-free rate and replacement for EONIA.

1.2 Recommendations for the transition path to move from EONIA to €STR

Next step for the working group was to explore different transition paths in order to select the one which would ensure a smooth and fair transition from EONIA to the new risk-free rate €STR. In December 2018, the working group published the outcome of this analysis in a report:

1. Recommending a “recalibrated approach”, in which the current EONIA methodology will change from the current transaction-based methodology to an €STR + fixed spread methodology. This would form a temporary stable solution to facilitate a gradual, smooth transition to €STR, with the objective of discontinuing the recalibrated EONIA by the end of 2021; and
2. Seeking feedback.

The final recommendation on the transition path to move from EONIA to €STR was made in March 2019¹. As part of the final recommendation, the working group will also identify which party is going to calculate the fixed EONIA-€STR spread in case the EONIA methodology will change to €STR + fixed spread. This party will take into account the spread calculation methodology as included in the final recommendation.

Once the working group has published the final recommendation, the BMR requires EONIA’s administrator EMMI to first publically consult on the recommended change in the EONIA

¹ See: https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190314_1~af10eb740e.en.html.

methodology before making any change to the current EONIA methodology. Given the limited time frame for EONIA, EMMI will already start the consultation in March 2019.

In the market adoption phase, the working group will further detail (1) the discounting regime to be used once EONIA will evolve to €STR + fixed spread and (2) a possible compensation mechanism to smooth out the effects of the transition from EONIA to €STR.

1.3 Recommendations for a fallback to the o/n risk-free rate €STR

As a contingency measure to avoid future financial instability, the BMR requires EU supervised users to have robust written plans setting out the actions they will take in the event a benchmark ceases to exist, including the inclusion of fallbacks in their contracts where feasible and appropriate. This requires supervised entities to include a fallback to €STR in their written plans and in their contracts where feasible and appropriate, once €STR will start its publication by October 2019. The working group is aiming to recommend a fallback measure to €STR by that date.

1.4 Recommendations for €STR-based term structure methodologies as fallback to EURIBOR

As a contingency measure to avoid future financial instability, the BMR requires EU supervised users to have robust written plans setting out the actions they will take in the event a benchmark ceases to exist, including the inclusion of fallbacks in their contracts. This requires supervised entities to include a fallback to EURIBOR in their written plans and contracts.

As a first step towards developing such fallbacks, the working group has considered a variety of potential €STR-based forward-looking term rate methodologies that could function as a robust and resilient fallback to EURIBOR, based on the current market conditions. In December 2018, the working group published the outcome of this consideration in a public consultation, seeking feedback on the need for term rates in different products and on the analysis of forward-looking methodologies to obtain term rates. A final recommendation on the €STR-based forward-looking term structure methodology as a fallback to EURIBOR was published in March 2019². NB: The use of backward-looking methodologies and possible interactions with forward-looking methodologies will be part of the analysis of the next phase (see section 2.2).

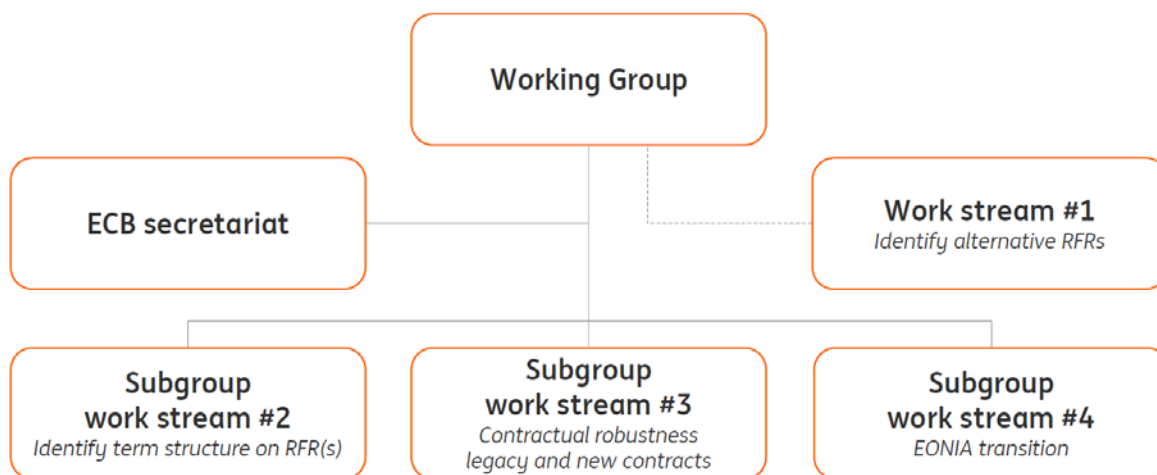
Next steps for the working group are to:

- Ensure that this benchmark can be calculated by an administrator on a daily basis (e.g. data collection/source).
- Engage with potential administrators of this new benchmark.

² See: https://www.ecb.europa.eu/pub/pdf/annex/ecb.sp190314_annex_recommendation.en.pdf

- Analyse and make recommendations for how to deal with the spread difference between EURIBOR and an €STR-based term structure.
Targeted date is ultimately October 2019, once €STR will be published.

Organisation chart working group euro risk-free rates – phase 1



2. Ensuring that alternative benchmarks are adopted by market participants

In addition to the steps required for phase 1, to ensure that available benchmarks to EONIA and EURIBOR based on a risk-free rate are readily available, these benchmarks must still be adopted across the whole market place. Market participants must be made aware of this upcoming change that will significantly impact a large part of their activities across the full value chain. The following main steps of the market adoption phase are:

Implementation of new benchmarks

- 2.1 Legal implications
- 2.2 Cash products & derivatives implications
- 2.3 Financial accounting & risk management implications
- 2.4 Communication & education

2.1 Legal implications

For EONIA/€STR-linked contracts, the working group will propose fallback language for:

- Legacy contracts referencing EONIA without any fallback (with specific focus on the ones expiring after the recalibrated EONIA ceases to be provided after 31 December 2021);
- New contracts referencing EONIA with a fallback to €STR; and
- New contracts referencing €STR with a fallback to an alternative risk-free rate (dependency on step 1.3).

Target date is to present an EONIA legal action plan during the working group meeting on 14 March 2019, with final consultation after the working group meeting on 10 May 2019.

For EURIBOR-linked products, the working group will propose fallback language for not only new but also for legacy contracts referencing EURIBOR as a contingency measure to avoid future financial instability in the event EURIBOR might cease to exist. The language should be generic and consistent with the guiding principles but will specify further details and modalities of implementation, with the possibility to tailor to different asset classes and countries' specificities if required. Target date is to start the EURIBOR legal action plan after the finalisation of the EONIA legal action plan, i.e. 2Q 2019.

2.2 Cash products & derivatives implications

The working group should investigate per product from an operational and valuation standpoint (1) how to transition from EONIA to €STR and (2) how to embed fallbacks to EURIBOR based on an €STR-based term structure methodology (both forward or backward looking), as EURIBOR contingency measure, in order to avoid market disruption. This includes:

- Detail the new discounting regime to enable the transition from EONIA to €STR.
- Design a possible methodology for closing out or transitioning legacy EONIA exposure. In particular, setting up a possible compensation mechanism to smooth out the effects of the transition from EONIA to €STR.
- Identify use cases for the €STR in cash products.
- Establish a liquid €STR derivatives market, in order to replace the current EONIA derivatives market and to construct the recommended €STR-based term structure methodology as fallback to EURIBOR (preparations required with market participants, trading venues, clearing houses, etc. to ensure this market will arise).
- Analyse and make recommendations for (1) how €STR-based forward-looking and backward-looking term structures can co-exist as potential fallback to EURIBOR and (2) the most relevant EURIBOR fallback methodology applicable for each financial product, e.g. discuss and review a €STR-based term structure methodology as fallback to Euribor for both retail and non-retail products.
- Liaise with ISDA and similar initiatives in other jurisdictions through the Alternative Reference Rates Committee (ARRC) cross currency swaps working group, in order to ensure international coordination.
- Identify possible system and infrastructure issues that will arise due to the transition, and provide guidance for market participants to mitigate those issues.

Target dates differ for EONIA and EURIBOR, where EONIA is a more pressing issue.

2.3 Financial accounting & risk management implications

The working group will analyse the impact on financial accounting and risk management of (1) the transition from EONIA to €STR and (2) the inclusion of fallbacks to EURIBOR based on an €STR-based term structure methodology and the possible fallback triggers. This includes analysing the impact on:

- Day 1 P&L, once the market moves from EONIA to €STR or EURIBOR to the €STR-based fallback (in the event EURIBOR will cease to exist).
- Hedge accounting, to avoid the unwinding of current hedge relationships.
- Valuation.
- Historical market data to be used in models.
- Liaise with IASB and ISDA, and provide input to international coordination efforts led by the Official Sector Steering Group (OSSG).

Target dates differ for EONIA and EURIBOR, where EONIA is a more pressing issue.

2.4 Communication & education

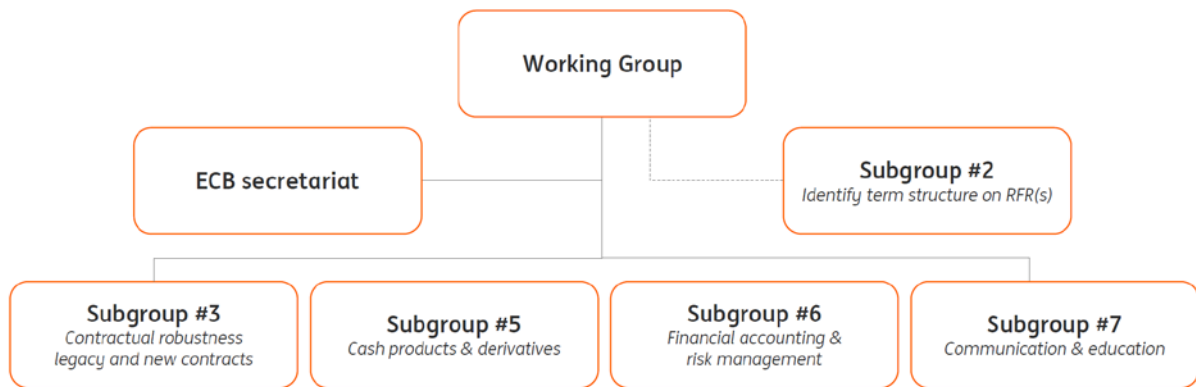
For a smooth transition from current benchmarks to the new risk-free rate €STR, communication towards and education of market participants is essential. The working group on euro risk-free rates already strives for the transparency of its recommendations and seeks feedback from a wide range of market participants on its crucial recommendations, whenever possible. However, given the specificity of the euro area benchmarks users, notably for EURIBOR, additional efforts should be made to foster public understanding of the reforms. In this regard, the communication and education subgroup could focus on the following tasks:

- Establishing a clear working group communication strategy, notably on how to approach, inform and educate market participants, improve the visibility of the working group, possibly designing common communication tools for the working group (communication chart pack, newsletter...);
- Act as an “editorial committee” for general public inquiries, i.e. providing replies on behalf of the working group to questions about the benchmark reforms and role of the working group.

Organisation chart working group euro risk-free rates – phase 2

The current organisation of the working group on euro risk-free rates does not cater for the requirements for market adoption. The working group therefore introduces new subgroups to work on the steps required to ensure that alternative benchmarks will be adopted by all market participants, while some of the initial subgroups will be phased out progressively:

- The overall working group will remain responsible for recommending a fallback to the o/n risk-free rate €STR as described in paragraph 1.3. This is targeted for October 2019, once €STR starts its publication.
- Subgroup #2 on identifying a term structure for RFR(s) will finalise the tasks on recommending an €STR-based term structure methodology as fallback to EURIBOR as described in paragraph 1.4. Target date for this work is set as October 2019, once €STR starts its publication. After that date, subgroup #2 will cease to exist.
- Subgroup #3 on contractual robustness for legacy and new contracts will continue its work during the market adoption phase, detailing fallback language for new and legacy contracts that are linked to EONIA and EURIBOR, as described in paragraph 2.1.
- Subgroup #4 on EONIA transition will finalise the work on recommending the transition path to move from EONIA to €STR as described in paragraph 1.2, with an envisaged end date for the remaining tasks set as March 2019. Therefore, subgroup #4 on EONIA transition will cease to exist as part of this organisational change.
- A new subgroup #5 on cash products & derivatives will investigate from an operational and valuation standpoint per product (1) how to transition from EONIA to €STR and (2) how to embed fallbacks to EURIBOR based on an €STR-based term structure methodology (both forward and backward looking) in order to avoid market disruption, as described in paragraph 2.2. This subgroup will start at the end of March 2019.
- A new subgroup #6 on financial accounting & risk management will closely follow subgroup #5's analysis per product on (1) how to transition from EONIA to €STR and (2) how to embed fallbacks to EURIBOR based on an €STR-based term structure methodology, in order to determine and advise on the impact on financial accounting and risk management. The next steps for subgroup #6 are further described in paragraph 2.3. The subgroup will start at the end of March 2019.
- A new subgroup #7 on communication & education will actively approach, inform and educate market participants on why and how (1) to transition from EONIA to €STR and (2) to embed fallbacks to EURIBOR based on an €STR-based term structure methodology. The next steps for subgroup #7 are further described in paragraph 2.4. The subgroup will start at the end of March 2019.



Market participants are welcome to join the new subgroups, in order to broaden the range of market participants to cover the full industry, including end-users.

The organisational change will take effect once the working group has made recommendations for the transition path to move from EONIA to €STR and on the €STR-based term structure methodology (targeted end of March 2019).

Phase	Objective	Deliverables	Start date	Due Date	Who is in charge
Phase 1- Preparation phase: making alternative benchmarks readily available	EONIA	1.1. Recommendations for the o/n RFR as a replacement of EONIA			
		a) Selection Criteria for o/n RFR	Feb-18	Apr-18	Completed
		b) Assessment of o/n candidates against selection criteria	Apr-18	May-18	Completed
		c) Consultation paper on remaining o/n candidates and selection criteria	Jun-18	Jul-18	Completed
		d) Recommendation and selection of o/n RFR	Jul-18	Sep-18	Completed
		f) Publication of recommended o/n RFR ESTER	By Oct 2019		ECB
		1.2. Recommendations for the transition path to move from EONIA to € STR			
		a) Recommendations for the transition path to move from EONIA to €STR and come to agreement on the methodology with key stakeholders	Aug-18	Mar-19	Completed
		b) Identify which party is going to calculate the fixed EONIA-€STR spread once EONIA methodology will be recalibrated to €STR + fixed spread	Feb-19	Mar-19	Completed
		1.3. Recommendations for a fallback for €STR	Jan-19	Oct-19	Working group
	Euribor	1.4. Recommendations for €STR-based term structure methodologies as a fallback to Euribor			
		a) Scorecard/ selection criteria for the forward looking term structure methodology	Jul-18	Oct-18	Completed
		b) Assessment of the forward looking term structure methodologies against scorecard/ selection criteria	Oct-18	Dec-18	Completed
		c) Consultation paper on forward looking term structure methodologies	Dec-18	Feb-19	Completed
		d) Recommendations on a forward looking term structure methodology as fallback to Euribor	Jul-18	Mar-19	Completed
		e) Ensure that this benchmark can be calculated by an administrator on a daily basis (e.g. data collection/source)	Mar-19	Oct-19	Subgroup 2
f) Engaging with potential administrators of this new benchmark		Mar-19	Oct-19	Subgroup 2	
h) Analyse and make recommendations on how to deal with the spread difference between EURIBOR and the €STR-based term structure methodologies		Mar-19	Jun-19	Subgroup 2	

Phase 2: Transition /adoption phase	2.1. Legal implications	2.1. Legal implications for the adoption			
		a) Analysis of Eurozone legal framework and market practices per asset class	May-18	Oct-18	Completed
		b) Guiding principles for fallback provisions in new contracts for euro-denominated cash products	Jul-18	Jan-19	Completed
		c) Define legal action plan for transition from EONIA to €STR with regard to existing and new contracts.	Jul-18	May-19	Subgroup 3
		d) Consultation paper on legal action plan for transition from EONIA to €STR with regard to existing and new contracts.	May-19	Jul-19	Subgroup 3
		e) Recommendation of legal action plan for transition from EONIA to €STR with regard to existing and new contracts.	Jul-19	Jul-19	Subgroup 3
		f) Define legal action plan for fallback clauses for Euribor with regard to existing and new contracts.	Apr-19	Oct-19	Subgroup 3
		g) Consultation paper on legal action plan for fallback clauses for Euribor with regard to existing and new contracts.	Oct-19	Nov-19	Subgroup 3
		h) Recommendation of legal action plan for fallback clauses for Euribor with regard to existing and new contracts.	Nov-19	Dec-19	Subgroup 3
	2.2 Cash and Products derivatives implications	2.2. Cash and derivatives implications			
		a) Detail the new discounting regime to enable transition from EONIA to €STR	Apr-19	Sep-19	Subgroup 5
		b) Design a possible methodology for closing out or transitioning legacy EONIA exposure. In particular, setting up a possible compensation mechanism to smooth out the effects of the transition from EONIA to €STR	Apr-19	Sep-19	Subgroup 5
		c) Identify use cases for the €STR in cash products	Apr-19	Oct-19	Subgroup 5
		d) Establish a liquid €STR derivative markets, in order to replace the current EONIA derivatives market and to contract the recommended €STR-based term structure methodology as fallback to EURIBOR.	Apr-19	Oct-19	Subgroup 5
		e) Analyse and make recommendations for (1) how €STR-based forward-looking and backward-looking term structures can co-exist as potential fallback to EURIBOR and (2) the most relevant EURIBOR fallback methodology applicable for each financial product.	Apr-19	Oct-19	Subgroup 5
		f) Liaise with ISDA and similar initiatives in other jurisdictions through the ARRC cross-currency swaps group, in order to ensure international coordination	As of April 2019		Subgroup 5
		g) Identify possible system and infrastructure issues that will arise due to the transition, and provide guidance for market participants to mitigate these issues	Apr-19	Oct-19	Subgroup 5
	2.3. Financial accounting and risk management implications	2.3. Financial accounting and risk management implications			
		a) Impact on Day 1 P&L once the market moves from EONIA to €STR or Euribor to €STR-based fallbacks	Apr-19	Oct-19	Subgroup 6
		b) Hedge accounting issues to avoid the unwinding of current hedge relationships	Apr-19	Oct-19	Subgroup 6
	c) Valuation	Apr-19	Oct-19	Subgroup 6	
	d) Historical market data to be used in models	Apr-19	Oct-19	Subgroup 6	
	e) Liaise with IASB and ISDA, and provide input to international coordination efforts led by the OSSG	As of April 2019		Subgroup 6	
2.4 Communication and education	2.4. Communication and education				
	a) Establishing a communication strategy for the WG, inform and educate market participants, improve the visibility of the WG, communication tools	As of Apr-19		Subgroup 7	
	b) Act as an "editorial committee" for general public inquiries, i.e., providing replies on behalf of the working group to questions about benchmark reforms and role of the WG.	As of Apr-19		Subgroup 7	