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The Benchmark Rates Reform Continues: The Two Ongoing Public Consultations on EURIBOR Fallback Provisions

The developments in the Eurozone benchmark rates

The reform of the Eurozone Benchmark interest rates (including the overnight EONIA rate and the EURIBOR) that includes, among others, the update of their calculation methodology and / or their replacement, is underway. It is based on the EU Benchmarks Regulation (BMR), the regulation applied to the EU from 1 January 2018 on indexes used as benchmarks in financial instruments and financial contracts. The need for the reform emerged in the aftermath of the LIBOR and EURIBOR market manipulation scandals and the 2008 financial crisis.[1]

The working group on euro risk-free rates (the working group in what follows), set up jointly, in early 2018, by the ECB, the Belgian Financial Services and Markets Authority, the European Securities and Markets Authority and the European Commission, and – in accordance with the BMR – is responsible for:[2]

a) identifying risk-free rates (RFRs) which could serve as the basis for an alternative to the current benchmarks (EONIA and EURIBOR rates), used in a variety of financial instruments and contracts in the euro area,

b) identifying best practices for contractual robustness, and

c) developing adoption plans – and, if necessary, a transition plan – for legacy contracts which reference existing benchmarks.

The transition from EONIA to €STR – that started with the respective recommendation of the working group – is already under way.[3] The discontinuation of the EONIA rate is expected at 3 January 2022. Below we will focus on the reform of the EURIBOR benchmark rate.

The EURIBOR, is the rate at which wholesale funds could be obtained by credit institutions in the EU and EFTA countries (EMMI (2020)). The benchmark, as of late 2020, includes five tenors (1 week, 1 month, 3 months and 12 months). The rate is calculated from mid-2019 onwards using a new hybrid methodology that is based on transactions data to the extent that this is possible. A panel of banks that are active in the euro money market contribute daily for the calculation of the EURIBOR.

[1] For more information on the reasoning behind the reform please refer to: https://www.bis.org/publ/qtrpdf/r_qt1903e.pdf

[2] For more information: https://www.ecb.europa.eu/paym/interest_rate_benchmarks/WG_euro_risk-free_rates/shared/pdf/2017_11_29_terms_of_reference.pdf

[3] For more information on the transition from EONIA to €STR: https://www.ecb.europa.eu/paym/interest_rate_benchmarks/WG_euro_risk-free_rates/html/transition.en.html

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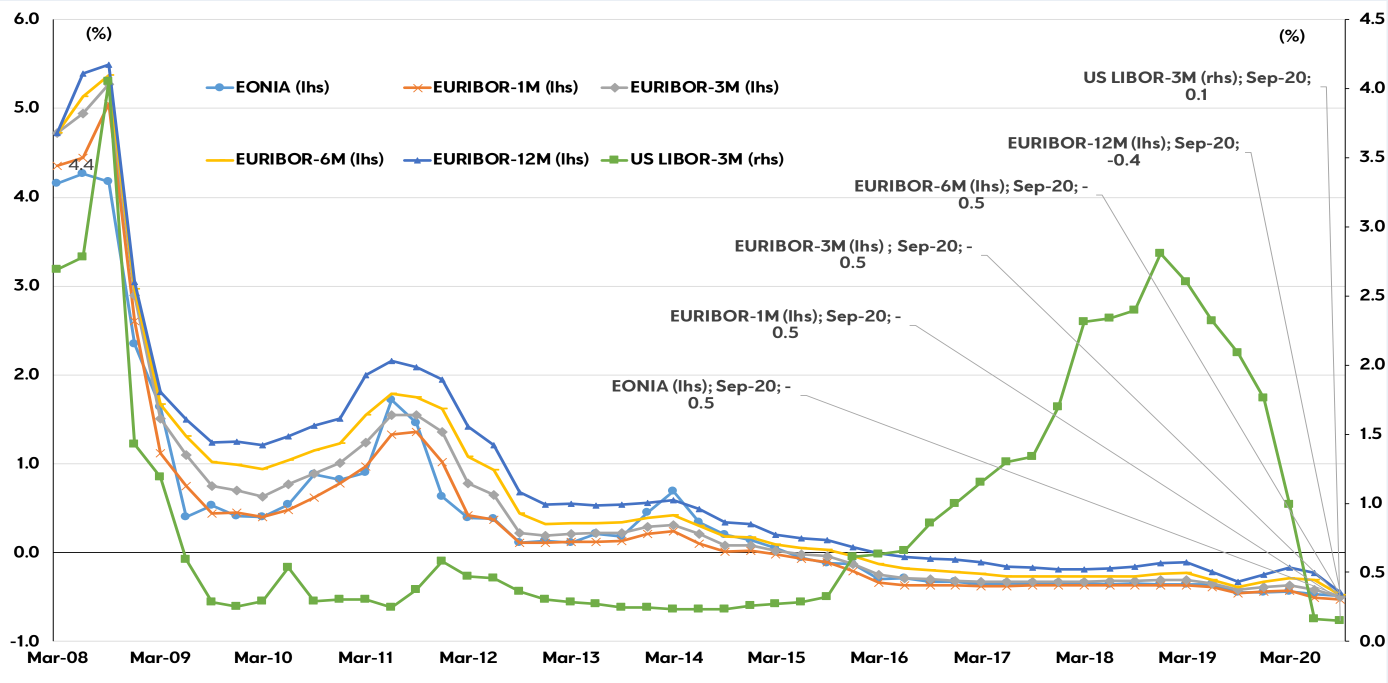
Figure 1: Selected Benchmark Rates (2008-2020, quarterly basis, %)



Source: Bloomberg

The European Money Markets Institute (EMMI), its administrator, has been authorized by the Belgian Financial Services and Markets Authority (FSMA) on 2 July 2019 for the administration of EURIBOR under its new calculation methodology and has been included in the ESMA register of benchmark administrators on 4 July 2019.[4, 5]

Unlike other benchmark rates (LIBOR and EONIA are two prominent examples), the EURIBOR will continue to exist post-2021. However, the administrator of the EURIBOR is obliged by the BMR (2016), to introduce robust fallback provisions in case the benchmark rate permanently ceases to exist or materially changes.

As a fallback provision we define the clause in a contract that determines the rate the involved parties in a transaction should use in the event that a certain rate – in our case the EURIBOR – is not available. From the aforementioned definition it became obvious that the two main characteristics of a fallback provision include:

- The trigger event that defines event and the future date that the fallback rate will be applied
- The fallback rate, i.e. the alternative reference rate to be used in case a trigger event materializes.

Another important characteristic of the activation of a fallback provision includes the possible compensation for the involved parties in a transaction in case that the activation of the fallback provision created an economically different outcome compared to the previous environment.

In this context, the working group, published in mid-November 2020, two public consultations on the aforementioned three fallback provision characteristics for the EURIBOR.

[4] For more information the updated EURIBOR methodology: https://www.emmi-benchmarks.eu/assets/files/D0034A-2019%20Euribor%20Hybrid%20Methodology_2019_02_12.pdf

[5] For more information on the decision of the FSMA: https://www.emmi-benchmarks.eu/assets/files/D0251A-2019%20-%20PR%20Benchmark%20Statement_Final.pdf

Fallback provisions and trigger events

The first public consultation, namely the Public Consultation on EURIBOR fallback trigger events,[6] is related to the identification of a set of potential events that would trigger the activation of the fallback provisions. The said events include:

1. A public statement or publication of information by or on behalf of the regulatory supervisor of the administrator of EURIBOR stating that the said administrator has ceased or will cease to provide EURIBOR permanently or indefinitely.
2. A public statement or publication of information by or on behalf of the administrator of EURIBOR stating that the said administrator has ceased or will cease to provide EURIBOR permanently or indefinitely.
3. A public statement by the supervisor of the EURIBOR administrator that, in its view, EURIBOR is no longer representative, or will no longer be representative.
4. The administrator of EURIBOR determines that EURIBOR should be calculated in accordance with its reduced submissions or other contingency or fallback policies.
5. It has become, for any reason, unlawful under any applicable law and regulation for relevant parties to the agreement to use EURIBOR.
6. EURIBOR is permanently no longer published without a previous official announcement by the competent authority or the administrator.
7. Material change of EURIBOR methodology.

Market participants are invited to provide feedback on the proposed EURIBOR fallback trigger events.

Fallback provisions and the definition of the fallback rate

The first issue examined in the context of the second public consultation (namely the Public Consultation on EURIBOR fallback measures for cash products),[7] is related to the identification of the most appropriate EURIBOR fallback rate for each financial product based on:

1. A €STR-based term structure methodology assessed against a list of criteria. Two general term structures were used. The first one, namely **the backward-looking term structure** is based on simple mathematical calculations on the value of past realized daily fixings of the €STR over a given period of time. Among the backward-looking term structure methodologies presented in the public consultation, the working group acknowledges that for more sophisticated and globally operating market participants the most appropriate EURIBOR fallback measure would be the backward-looking lookback period one. The second general term structure methodology, namely **the forward-looking term structure**, is based on the €STR derivatives markets, reflecting market expectations on the evolution of the €STR during the upcoming interest rate period. This term structure requires a developed derivatives market. The working group acknowledges that for some use cases for certain products or for less sophisticated and locally operating market participants (that mainly focus on retail mortgages, consumer loans, SME loans, trade finance loans and export and emerging markets finance loans), where there is a clear necessity to know the

[6] For more information on the said consultation: https://www.ecb.europa.eu/pub/pdf/other/ecb.pubcon_EURIBORfallbacktriggerevents.202011~e3e84e2b02.en.pdf

[7] For more information on the said public consultation: https://www.ecb.europa.eu/pub/pdf/other/ecb.pubcon_ESTRbasedEURIBORfallbackrates.202011~d7b62f129e.en.pdf

interest rate in advance, and thus the forward-looking term structure methodology would be more suitable.

2. A spread-adjustment methodology to mitigate potential value transfers in case the fallback is triggered. In this case, the working group recommends adding the historical mean / median spread adjustment to the €STR-based term structure methodology to establish a EURIBOR fallback that is economically equivalent, to allow for a value neutral transition to the extent possible in the event EURIBOR ceases to exist.

The second issue examined in the context of the said public consultation, is related to the proposed market conventions to be used for the calculation of compounded term rates based on the €STR. The recommendations of the working group for the said issue are present briefly below:

1. For those cash products where the working group proposes the use of a backward-looking term structure, the working group recommends that market participants use the compounded average methodology as described in the public consultation on the publication by the ECB of compounded term rates using the €STR.[8]
2. The working group seeks market feedback on whether there is an appetite to use a spread adjustment and / or an all-in rate to at least facilitate a EURIBOR fallback measure that consists of (i) compounded €STR rates as proposed, and (ii) a spread adjustment.
3. The working group proposes using the compounded average methodology without the inclusion of a floor on the daily €STR value, but only to apply any floor on the sum of the compounded term rate plus spread adjustment.
4. Based on its simpler calculation methodology and consistency with the derivatives market, the working group proposes using the compounding the - rate methodology rather than the compounding – the balance methodology.
5. The working group proposes the use of the backward looking lookback period with an observation shift, where the working group notes that the lag approach is a viable and robust alternative for market participants wishing to use that approach.

Conclusion

In the preceding paragraphs, we briefly described the current developments on the reform of the Eurozone benchmark rates with a special focus on the EURIBOR.

The summary of the two ongoing public consultations on EURIBOR was presented based on material provided by the working group. For the full list of the working group's recommendations and questions that require the feedback of the market participants, please refer to the aforementioned public consultation papers (**consultations deadline: 15 January, 2021**)

[8] For more information on the said ECB publication: https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200724~6aab0ffe50.en.html

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