



Establishing a euro risk-free rate

By *David Hiscock*



Considering the topic of transition to new near risk-free rates (RFRs) in the context of the euro, the background is that the most widely used interest rate benchmarks for financial contracts denominated in euro are EONIA, the Euro Overnight Index Average, and EURIBOR, the Euro Interbank Offered Rate, 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, have both been designated by the European Commission as "critical benchmarks" - which makes them subject to certain specific provisions, notably regarding the modalities for their supervision.

More than 20 trillion euros worth of interest rate derivatives and securities are linked to EONIA. However, underlying volumes have fallen substantially from approximately 35 billion euros per day before the financial crisis to 8 billion euros per day in recent years. In addition, EONIA has become increasingly determined by a minority of participants, as the five largest lending banks contribute approximately 80% of the total volume, raising concerns about representativeness.

Most recently in 2018, underlying volumes 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 these developments, EMMI has made public its conclusion that, under current market conditions, EONIA's compliance with the EU Benchmarks Regulation by January 2020 "cannot be warranted".

Meanwhile, EURIBOR is presently a quote-based interest rate benchmark available for eight tenors; and is currently undergoing reforms, led by EMMI. Its 2016-17 "pre-live verification" exercise led to the conclusion that basing EURIBOR on a fully transactions-based methodology was not possible, given the current low level of transactions in

the euro money markets. This exercise also more specifically confirmed the low levels of activity in the underlying markets which the two week, two month and nine month tenors intend to represent. In light of this, coupled with subsequent feedback that reliance on contracts and instruments pricing these tenors is also less significant, EMMI has announced the cessation of these three tenors, as of Monday 3 December 2018.

Considering the other five tenors - one week, as well as one, three, six and twelve months - as the current, quote-based methodology is not compliant with the EU Benchmarks Regulation, EMMI is working on a hybrid methodology, combining transactions, market data and, should reliance on transactions be deemed impossible, well-framed expert judgment, with the aim of EURIBOR achieving compliance with the Regulation. Following a public consultation, which closed on 15 May, EMMI is currently undertaking in-depth testing of the proposed methodology under live conditions - with further consultation on some of the details anticipated ahead of year-end 2018.

In light of international work on transition to near risk-free rates and aware of the specific challenges associated with these critical euro benchmarks, in September 2017 the European Central Bank, the Belgian Financial Services and Markets Authority, the European Securities and Markets Authority and the European Commission collectively announced the launch of the [Working Group on Euro Risk-Free Rates](#). This working group was tasked with the identification and adoption of a "risk-free overnight rate" 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.

The working group is chaired by a private sector representative and the ECB provides the secretariat. The working group is comprised of 21 credit institutions as voting members and five institutions as non-voting members -



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namely, EMMI; the European Fund and Asset Management Association (EFAMA); the Loan Market Association (LMA); the International Swaps and Derivatives Association (ISDA); and ICMA. The European Investment Bank also participates in the group, as an invitee, and the four public institutions that were involved in the launch of the working group have observer status.

At its inaugural meeting, held in Frankfurt on 26 February, the working group decided to set up three workstreams to flesh out more specific proposals:

- workstream 1 - identify and recommend an alternative RFR, or RFRs;
- workstream 2 - identify and recommend term structure on RFR; and
- workstream 3 - contractual robustness for legacy and new contracts.

Subsequent working group meetings have been held, on 20 April, 17 May, 11 July and 13 September, and another is scheduled for 18 October. To ensure transparency throughout the entire process, the working group:

- is regularly reporting on its meetings, with information made publicly available on the ECB's website; and
- is committed to consult market participants and end-users, as well as to gather feedback from public authorities.

Calls and meetings of the workstreams complement the work of the overall group, which is kept updated on progress being made by each workstream, and recently it was identified that a workstream 4 needed to be created, specifically to focus on EONIA transition to the euro RFR.

Concerning the determination of the euro RFR, the working group developed key selection criteria for a robust alternative rate and assessed a number of candidate rates against these criteria. After careful consideration, the working group concluded that three rates had characteristics that could potentially qualify them to become the euro RFR. The working group also agreed that a market-wide consultation to assess the potential advantages and disadvantages of these rates could provide valuable input into the decision-making process.

Accordingly, on 21 June, the working group published a call for market participants and all other interested parties to comment on its assessment of candidate euro RFRs against key selection criteria; and making clear that the new euro RFR will replace EONIA, which will no longer meet the criteria of the [EU Benchmarks Regulation](#) as of 2020 - when the current transition period ends. The three candidates proposed for the euro RFR in this public consultation were:

1. the euro short-term rate (ESTER), 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;
2. GC Pooling Deferred, a one-day secured, centrally cleared, general collateral repo rate, which is produced by STOXX, a wholly owned subsidiary of the Deutsche Börse Group; and
3. RepoFunds Rate, a one-day secured, centrally cleared, combined general and specific collateral repo rate, which is produced by NEX Data Services Limited, a wholly owned subsidiary of NEX Group plc.

This public consultation closed on 13 July and a summary of the responses was published, on 13 August. The consultation drew considerable interest from the financial sector, with 66 market participants - 41 of which are from the banking sector - submitting responses or comments. It is considered that this response sample ensures suitable geographic coverage and adequately reflects relevant sectoral views. The main messages from the financial sector may be summarised as follows:

1. Respondents broadly agreed with the working group's analysis of candidates for the euro RFR in terms of the analytical approach, selection criteria, results and conclusions - while highlighting some additional aspects that could have merited assessment.
2. Respondents generally concurred with the working group's conclusion that ESTER is the most reliable and robust - and consequently the most appropriate - unsecured candidate rate; and also, largely shared the conclusion that the GC Pooling Deferred Funding Rate and the RepoFunds Rate

are the most reliable and robust secured candidate rates - although some qualified their backing or expressed a preference for one of these two.

3. Regarding the question of which of these final three candidate rates would be the most appropriate future euro RFR, 58 respondents - or 88% of responses - supported ESTER, predominantly on the grounds of its unsecured nature, compilation methodology and low volatility, as well as the fact that the ECB - an EU institution - is the administrator. However, many respondents urged that both the start of the regular production and the daily publication time of ESTER be brought forward.

Based on further discussion and the feedback received, on 13 September, the working group [announced](#) its recommendation that [ESTER](#) be used as the risk-free rate for the euro area; and as the replacement for EONIA. This recommendation is a key step in moving to alternative euro benchmarks, as the usage of non-compliant benchmarks will be restricted from 1 January 2020.

On 9 November, at the ECB in Frankfurt, the working group will be hosting a roundtable, which will be webcast on the ECB website shortly after the event, in order to: explain to market participants the reasons behind the recommendation of ESTER as the preferred euro risk-free rate; make the features of ESTER better known to future users; and discuss the next steps in the transition.

Also, looking ahead, workstream 4 will be analysing available paths for the transition of EONIA to the euro RFR and will provide its recommendations on this to the working group. This work will be closely coordinated with work already being progressed under the other workstreams.

Concretely, the working group has tasked workstream 2 with the following deliverables:

1. explore the possible fallback arrangements for EURIBOR; and
2. determine and recommend a term structure methodology on RFR, as a fallback in EURIBOR linked contracts.

And, the working group has tasked workstream 3 with the following deliverables:

1. analyse the legal risks and impact of:
 - embedding fallback provisions referencing newly defined RFRs; or
 - the replacement of references to EONIA and EURIBOR with references to newly defined RFRs (and, where appropriate, applicable term and/or credit spreads) in legacy contracts;
2. define solutions to embed fallbacks, and replacements where appropriate, for EONIA and EURIBOR; and

3. suggest measures to enhance the legal soundness of references to newly defined RFRs (and, where appropriate, applicable term and/or credit spreads) in new contracts, taking into account consumer protection interests.

Acting on behalf of its members, ICMA is actively engaged in this important ongoing work.

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