Transition to risk-free rates in the euro area

By Katie Kelly

EONIA to €STR

Following an announcement by EMMI, the administrator of EONIA, that EONIA would not be compliant with the EU Benchmarks Regulation, the Working Group on Euro Risk-Free Rates (Euro RFRWG) endorsed recommendations to market participants regarding the transition from EONIA to €STR in March 2019. Since 2 October 2019, EONIA has been published daily on the basis of a reformed determination methodology, which is €STR + 8.5 basis points (as calculated by the ECB). EMMI will continue to publish EONIA every TARGET day until 3 January 2022, the date on which EONIA will be discontinued.

€STR reflects the wholesale euro unsecured overnight borrowing costs of euro area banks, in contrast to EONIA that measures interbank lending. The €STR rate is published for each TARGET business day, based on transactions conducted and settled on the previous day (reporting date T) with a maturity date of T+1.

According to the ECB, the launch of €STR was successful from both a technical and a market perspective: neither the launch of the rate nor the change to the EONIA methodology resulted in any serious disruptions, and the process for producing €STR on a daily basis has worked smoothly and reliably. Major CCPs started clearing swaps indexed to €STR towards the end of 2019, and approximately €4bn of FRNs[1] linked to €STR have been issued.

The market conventions used in these €STR FRNs to date are aligned with those typically used to date in the SONIA bond market: ie €STR compounded in arrears over an interest period, with a margin added and a "lag" of five days. It is worth noting that these SONIA bond market conventions may change as a result of the announcement of the publication of a SONIA Compounded Index by the Bank of England which is compatible with, and might steer the SONIA bond market towards, a "shift" approach rather than a "lag" approach (as more fully described in the Q2 2020 edition of this Quarterly Report). As there are no indications as yet of the publication of an €STR index, this might result in a divergence of conventions.

In terms of EONIA legacy transactions, EONIA is not typically referenced in bonds, but any contracts with EONIA as the underlying rate that mature before December 2021 would be covered by the ongoing publication of EONIA until the end of 2021. However, any legacy EONIA contracts that expire after the end of 2021 will have to be amended before then to replace EONIA as the underlying rate, or to include fallback provisions.

There has been some limited usage of EONIA in the European repo market. In July 2019 (later updated in September 2019), the ICMA European Repo and Collateral Council Committee produced recommendations for the repo market in relation to the transition from EONIA to €STR. This has significantly reduced the volume of such repo activity, easing the necessary process of transition from EONIA to €STR for the remainder.

EURIBOR

EURIBOR is not currently scheduled to be discontinued. EU authorities anticipate that the use of EURIBOR will persist for the foreseeable future following a period of reform that has now been completed.

However, authorities have also highlighted that users of EURIBOR should be prepared for all scenarios, including the possible disappearance of EURIBOR. The Euro RFRWG therefore recommends that market participants incorporate fallback provisions in all new contracts referencing EURIBOR; and where no specific fallback provision is recommended, a generic EURIBOR fallback provision should be incorporated instead.

To this end, the Euro RFRWG is identifying €STR-based fallbacks for EURIBOR in the event that EURIBOR permanently ceases to exist, and expects to release two related public consultations in the course of 2020. The first will cover the preferred EURIBOR fallback rates for a variety of financial products, and the preferred spread adjustment to avoid potential value transfers upon activation of the fallback. The second public consultation will cover a set of trigger events for the application of the respective fallback rates.

The Euro RFRWG has established a sub-group to identify and recommend an €STR-based forward-looking term structure for use as a EURIBOR fallback. The Euro RFRWG has already recommended a preferred forward-looking methodology using the future €STR-based OIS firm quotes observed in trading venues to build term rates, and has yet to work on possible backward-looking methodologies that could be used for some EURIBOR-linked products.

In the meantime, some guiding principles have already been published by the Euro RFRWG on how to introduce €STR-based fallbacks to EURIBOR in contracts, including the risk management and financial accounting implications of their introduction.

Contact: Katie Kelly
katie.kelly@icmagroup.org

1. Source: Bloomberg