# Discussion on term rates initiatives

Alberto López Martín, European Money Markets Institute

Michele Mazzoni, European Securities and Markets Authority

Dominique Le Masson, BNP Paribas

Ciarán McGonagle, International Swaps and Derivatives Association

Jaap Kes, ING

Q&A session

# Euribor

## Roundtable on euro risk-free rates

9 November 2018

European Central Bank, Frankfurt am Main

**Alberto López Martín**
Senior Benchmarks Officer

- **Euribor** is a major euro interest reference rate, administered by the European Money Markets Institute (EMMI), and calculated from the contributions of a panel of 20 panel banks across Europe.

- **Euribor Reform**—evolving the current quote-based determination calculation to a fully transaction-based methodology, in order to provide the market with a more transparent, robust, and representative index.

- **2016/17 pre-live verification program**—given the current market conditions, a transition from the current quote-based methodology to one fully based on transactions is not feasible.

- The current quote-based methodology for Euribor is not BMR-compliant.

# Use of Euribor



Euribor was categorized as a *critical benchmark* by the European Commission, given its systemic importance for financial stability. It is used as a benchmark for a wide variety of financial products and contracts, like loans, debt securities, derivative products, as well as deposits.

***Estimates* of outstanding amounts linked to EURIBOR by asset class**
*(Dec. 2017, Mar. 2018 and Oct. 2017; EUR trillion, percentages)*

| Asset class | Date | Estimated amounts outstanding | Of which outstanding after 2020 | |
|---|---|---|---|---|
| | | (EUR trillion) | (EUR trillion) | Percentage |
| Loans | Dec-17 | 9.7 | 2.9 | 29.9% |
| Debt securities | Mar-18 | 1.62 | 1.3 | 80.0% |
| Interest rate derivatives | Oct-17 | 108.7 | 58.4 | 53.7% |

Source: ECB.

Notes: see presentations to the working group on euro risk-free rates:

- 20 April 2018 presentation: Item 4.1: Mapping exercise of the usage of EONIA and Euribor
- 17 May 2018 presentation: Item 3.1: Update on quantitative mapping exercise

EUR 62.6 trillion of Euribor-linked financial transactions will remain outstanding on 1st January 2020.

- **Euribor** is a major euro interest reference rate, administered by the European Money Markets Institute (EMMI), and calculated from the contributions of a panel of 20 panel banks across Europe.
- **Euribor Reform**—evolving the current quote-based determination calculation to a fully transaction-based methodology, in order to provide the market with a more transparent, robust, and representative index.
- **2016/17 pre-live verification program—**given the current market conditions, a transition from the current quote-based methodology to one fully based on transactions is not feasible.
- The current quote-based methodology for Euribor is not BMR-compliant.

# Hybrid methodology for Euribor

- **Hybrid methodology**—supported by transactions whenever available, but relies on other techniques or data sources according to input criteria established by EMMI.

- The hybrid methodology follows a hierarchy. For each day in which the index is calculated, contributing banks will have to base their submissions, for each tenor, on:

**Schematic description**
**Hybrid Euribor methodology**

| | |
|---|---|
| **Level 1** | Submission based solely on transaction in the Underlying Interest at the Defined Tenor from the prior TARGET date, using a formulaic approach provided by EMMI. |
| **Level 2** | Submission based on transactions in the Underlying Interest across the money market maturity spectrum and from recent TARGETdays, using a defined range of formulaic calculation techniques provided by EMMI. |
| **Level 3** | Submission based on transactions in the Underlying Interest and/or other data from a range of markets closely related to the unsecured euro money market, using a combination of modeling techniques and/or the Panel Bank's judgement. |

| | |
|---|---|
| **Level 2.1** | Spread Adjustment Interpolation based on Level 1 submissions at adjacent tenors |
| **Level 2.2** | Use of Non-Standard Maturity Transactions |
| **Level 2.3** | Submission based on market-adjusted Level 1 submissions from prior dates |

- **Hybrid Euribor Testing Phase:** from May until the end of July 2018

- **Publication of Second Consultation Paper** on the Hybrid methodology: summary of findings and EMMI's proposals

- Following the analysis of the data and submissions collected as part of the Hybrid Euribor Testing Phase, EMMI is confident that **the hybrid methodology is a robust evolution of the current quote-based methodology**, compliant with the regulatory requirements of the EU BMR.

- The Belgian FSMA has commended EMMI on the work done to develop and test the hybrid methodology, indicating that it represents a significant step towards an EU BMR compliant Euribor. The FSMA has also mentioned that it would make an effort to expedite the authorization process once EMMI files for authorization.

European Securities and Markets Authority

09 November 2018 | ECB,Frankfurt am Main

# BMR: written plans by users

**Michele Mazzoni, Senior Officer**

# BMR: written plans by users

- Since 1st Jan 2018 supervised entities using benchmarks are required to fulfil Article 28(2) of the BMR*:

  - *Supervised entities (…) that use a benchmark shall produce and maintain robust **written plans** setting out the actions that they would take in the event that a **benchmark materially changes or ceases to be provided**.*

  - ***Where feasible and appropriate**, such plans shall nominate one or several **alternative benchmarks** that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives.*

  - *Supervised entities shall, upon request, provide the relevant competent authority with those plans and any updates and **shall reflect them in the contractual relationship with clients**.*

*Text of BMR (Regulation [EU] 2016/1011) is available here: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32016R1011

# BMR: written plans by users

- ESMA published two Q&As* on Article 28(2):

  - Written plans should include:
    - ✓ operational procedures,
    - ✓ detailed courses of action,
    - ✓ relevant communication channels, and
    - ✓ arrangements for different scenarios and contingencies.

  - *Contractual relationships with clients* are governed by national law.
  - Supervised entities should be able to demonstrate to their Competent Authority that:
    - ✓ they have communicated their written plans to theirs clients, and
    - ✓ the written plans are legally effective under applicable national law.

*ESMA Q&As and other ESMA documents related to BMR are available here: https://www.esma.europa.eu/policy-rules/benchmarks

# Update on the term rates discussions by the working group on euro risk-free rates

Dominique Le Masson (BNP Paribas)

Chair of the Subgroup 2
on the identification and recommendation
of a term structure on RFRs

# Outline

- Why?
- Work done so far?
- What's next?
- What are the main take-away points?

# Why? (1)

- Mandate
  - Explore the possible fallback arrangements for Euribor
  - Determine and recommend a term structure methodology on risk-free rate(s) as a fallback in Euribor-linked contracts.
- High level implementation plan
  - Define the selection criteria for term structure methodology
  - Assess the term structure methodologies against the selection criteria
  - Organize a public consultation on the selected approach

# Why? (2)

- Parallel initiatives or developments
  - Euribor reform
  - EONIA transition
  - FSB recommendations
  - ISDA consultation on benchmark fallbacks for derivatives
  - Work done by other groups
    - GB: Working Group on Sterling Risk-Free Reference Rates
    - US: Alternative Reference Rates Committee (ARRC)

# Work done (1)
# Agreement on selection criteria

| Earlier work | First step: bundling along main categories | Second step: further clustering along IOSCO Principles |
|---|---|---|
| **Underpinned by a broad base of transactions** | Term Structure Qualities | IOSCO Principle 7: Data Sufficiency |
| **Transactions represent sufficient volume/depth** | | |
| **Existence of active related markets** | | |
| **Representative of near risk free bank borrowing costs (at any time), (minimal counterparty risk)** | Term Structure Characteristics | IOSCO Principle 6: Benchmark Design |
| **Reasonably aligned with policy rates** | | |
| **Underlying interest that the benchmark seeks to measure must be easy to understand** | Methodological Qualities | IOSCO Principle 9: Transparency of benchmark determination |
| **Eligible transactions clearly defined / accessible data sources** | Governance and Accountability | |
| **Calculation methodology easy to understand on a rudimentary basis** | | |
| **Appropriate euro area representation** | | |
| **Minimal opportunities for market manipulation** | Other Requirements | |

# Work done (2)
# Assessment of available methodologies

| | + | - |
|---|---|---|
| **01** Futures based | • Forward looking<br>• Simple from a modelling perspective<br>• Transparent and robust<br>• Rate directly reconstructable by market participants<br>• Based on a heavily regulated underlying market<br>• Less open to manipulation | • Model risk related to the model calibration<br>• Reliant on liquid Future markets<br>• Understanding for the real economy potentially challenging<br>• Model assumptions may not match economic reality<br>• An administrator may not be comfortable with the influence they have on the model |
| **02** OIS quote based | • Forward looking<br>• Robust even when only a limited number of actual transactions available<br>• Basic methodology already in use for BMR/IOSCO benchmarks (for example ICE Swap rate)<br>• Underlying data comes from heavily regulated sources | • Not based on actual transactions<br>• Reliant on dealers providing liquidity on individual electronic trading platforms with tight bid/ask pricing |
| **03** OIS transaction based | • Forward looking<br>• Provided sufficient transactions and volumes are available, least risk of manipulation<br>• Simple to understand | • Reliant on sufficient volumes in spot transactions<br>• Reliant on sufficient activity in the market in all monetary policy conditions<br>• Not suitable for a point in time fixing |
| **04** Backward looking | • Very simple calculation<br>• Most market participants are familiar with the calculation method<br>• Could be easily published by the administrator of the RFR on a daily basis<br>• Calculation method similar to the pay-out for the hedging instrument OIS<br>• In line with the ISDA proposal as described in the consultation paper | • Some products might need a longer period between fixing and payment, therefore fixing in arrears with a short payment lag will not fit<br>• Backward looking does not reflect expected future rate developments, so fixing in advance might open a gap between underlying and hedging product |

# What’s next

- Public consultation
  - Scope: validate a recommendation by the working group on euro risk-free rates
  - Focus: concentrate on forward-looking methodologies
  - Supplement: collect additional views or input

- Additional analyses

# What are the main take-away points?

- Multiple parallel and interdependent initiatives call for major coordination efforts
- Working group discussions on term structure methodologies well advanced
- Watch out for and reply to the working group public consultation on term rates

# ISDA Benchmark Initiatives

ISDA Safe, Efficient Markets

November 2018

# Differentiating Benchmark Initiatives

## IBOR Transition

- Led by the Risk Free Rate Working Groups (Public sector-Private sector)
- Selection of nearly risk free rate (RFR) as alternative to IBOR
- Voluntary transition process during the lifetime of IBOR.
- For transition of legacy portfolio only, spread may be required to compensate for lack of IBOR-style bank credit spread RFR.
- Term reference rates need to be developed for some products.
- Joint Associations published IBOR Global Transition Roadmap (February 2018) and Report (May 2018)

## IBOR Fallbacks

- Led by ISDA at request of the OSSG
- Improve contractual robustness of derivatives referencing an IBOR
- 'Emergency' provisions triggered by the permanent discontinuation of the relevant IBOR
- Fallback to a nominated alternative rate (RFRs) plus a spread
- Spread to adjust for
    - lack of IBOR-style bank credit spread in alternative rate.
    - Lack of IBOR-style term fixing structure in alternative rate to make fallback effective.
- Market consultation on approaches to term and spread adjustments

## Article 28(2) European Benchmark Regulation

- Led by ISDA for derivatives
- Requires supervised users to plan for cessation or material change of any benchmark (large or small across all products) and reflect in contracts.
- Nomination of alternative rates where feasible and appropriate
- ISDA Benchmarks Supplement published in September 2018 and is designed to give firms the ability to improve contractual robustness of derivatives that reference interest rate, FX, equity and commodities benchmarks.
- ISDA will publish a protocol to amend legacy contracts (expected early December).

# IBOR Fallbacks: ISDA's mandate

- IOSCO *Principles for Financial Benchmarks* Principle 13

  *"Users should be encouraged to have robust fallback provisions in contracts or financial instruments that reference a benchmark in the event of cessation of the referenced benchmark."*

- FSB OSSG Market Participants Group Final Report (July 2014)

  *"In most cases, fallback provisions are not sufficiently robust for a permanent discontinuation of a key IBOR."*

- FSB OSSG Letter to ISDA (July 2016)

  *Invites ISDA to participate in work to enhance the robustness of derivatives contracts referencing widely used interest rate benchmarks and mitigate potential systemic risks that could arise if a key benchmark is permanently discontinued.*

- Per the request of the FSB OSSG in 2016, ISDA is currently undertaking work to amend the 2006 ISDA Definitions to implement fallbacks for EUR LIBOR, EURIBOR and certain other IBORs (USD, GBP, JPY and CHF LIBOR, JPY and Euroyen TIBOR, BBSW and HIBOR).

# IBOR Fallbacks: Key features

- The IBOR fallbacks will apply:
  - Upon the ***permanent discontinuation*** of the relevant IBOR (based on pre-determined, objective triggers);
  - Will be to the ***relevant alternative risk-free rate*** ('RFR'), subject to term and spread adjustments;
  - will not apply until the **actual discontinuation** of the relevant IBOR (if that is after the announcement date).
- For EURIBOR and EUR LIBOR the fallback will be to ESTER (subject to term and spread adjustments).
- The 2006 ISDA Definitions will be amended to include:
  - The objective triggers that would activate the selected fallbacks in respect of each IBOR; and
  - The fallback that would apply upon the occurrence of that trigger, which will be the relevant RFR adjusted using methodologies to account for any term and spread adjustment.
- ISDA will also publish a protocol to facilitate inclusion of the amended definitions into existing derivatives contracts as amendments to the 2006 ISDA Definitions apply to transactions entered into on or after the date of such amendments only.

# IBOR Fallbacks: Market Consultation on Approaches to Term and Spread Adjustments

- On July 12, 2018, ISDA launched a market consultation (of ISDA members and non-members) to inform final decisions regarding the approaches to term and spread adjustments for derivatives fallbacks.

- It is necessary to address these issues because the fallback RFRs are overnight and risk-free (or nearly risk-free) whereas the relevant IBORs have term structures and incorporate a bank credit risk premium and a variety of other factors (*e.g.,* liquidity, fluctuations in supply and demand).

- ISDA is analyzing the responses to this consultation to determine the approach for calculating the term and spread adjustments (or determine appropriate next steps) and will publish a full explanation of how it made the determination based on the responses received. ISDA expects to publish this information by the end of 2018.

- Before implementing any changes to its standard documentation, ISDA will publish the final approach for review and comment. ISDA expects that this will occur sometime in mid-2019.

- ISDA will launch supplemental consultations covering EURIBOR and EUR LIBOR (and other IBORS), beginning in 2019.