Report by the working group on euro risk-free rates

On €STR fallback arrangements

12 November 2019

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1 Executive summary

The purpose of this report is to provide supervised entities with guidance on potential ways to comply with Article 28.2 of the EU Benchmarks Regulation (BMR) when using the euro short-term rate (€STR), as the euro risk-free rate, in contracts.

Article 28.2 of the BMR requires supervised entities to have robust written plans setting out the actions they would take in the event that a benchmark materially changes or ceases to be provided. Those plans should be reflected in the contractual relationship with clients. Where feasible and appropriate, the plans should include the nomination of one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives.

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 private sector working group with the task of identifying and recommending alternative euro risk-free rates. In addition, the working group will prepare a market adoption plan to ensure all market participants transition smoothly to the alternative euro risk-free rates.

One of the base-case scenarios for the working group is to provide recommendations for:

- a robust replacement euro risk-free rate for EONIA; and
- a fallback for the euro risk-free rate.

On 13 September 2018, the working group announced that it unanimously recommends the €STR as the alternative euro risk-free rate and replacement for EONIA.

In this report, the working group considers two options for recommending a fallback arrangement for the €STR:

- to select (one of) the alternative rates that were considered in the consultation before the euro risk-free rate was selected;
- to take into account (a) the review of the methodology that the €STR's administrator (ECB) will conduct on a regular basis to ensure that the underlying interest of the €STR is adequately measured and captured, as well as (b) the policies and procedures to be followed in the event of the possible cessation of the €STR, in line with the ECB's legal framework, combined with the use of contractual fallbacks for products which reference the €STR that are consistent with the relevant parts of those already recommended with respect to EONIA.

Based on an assessment of both options, the working group recommends that market participants consider the measures that might be taken by the ECB as part of the regular review of the €STR methodology, as well as the policies and procedures to be followed in the event of the possible cessation of the €STR, along with the fallback provisions provided by the working group in the EONIA to €STR Legal Action Plan. The working group is of the opinion that this combination will provide sufficient contingency as fallback measures for the €STR.

2 Benchmarks Regulation

In 2014, the Financial Stability Board (FSB) made the following recommendations on "Reforming major interest rate benchmarks"[1]:

- to strengthen existing benchmarks by underpinning them to the greatest extent possible with transaction data;

- to develop alternative, nearly risk-free reference rates.

Following the FSB recommendations, reforms are under way in different jurisdictions across the globe. In the European Union, the FSB recommendations have been incorporated in the EU Benchmarks Regulation (BMR), which entered into force in June 2016[2]. The BMR requires supervised entities to use only registered or authorised benchmarks that comply with the BMR in new contracts as of the end of the relevant transition period[3]. In addition, the BMR requires supervised entities to have robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided. These plans should be reflected in the contractual relationship with clients. Where feasible and appropriate, these plans should include the nomination of one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives.

1 "Reforming Major Interest Rate Benchmarks", Financial Stability Board (FSB), 22 July 2014.

2 "EU Benchmarks Regulation (BMR)", European Union, 8 June 2016.

3 For EU non-critical benchmarks, the transition period is due to expire at the end of 2019. Political agreement has been reached to extend the transition period for EU critical benchmarks and for third-country benchmarks until the end of 2021.

3 EONIA reform

Before the ECB started publishing the €STR in October 2019, the most important euro-denominated overnight interest rate benchmark was the euro overnight index average (EONIA). Based on the FSB recommendations and the implementation of the BMR, the administrator of EONIA, the European Money Markets Institute (EMMI), conducted an exercise aimed at reforming EONIA, called the EONIA Review. The outcome of the EONIA Review revealed a lack of underlying transactions and a high concentration of volumes on just a few contributors supporting the benchmark[4]. EMMI concluded that, in its original form, EONIA would not become BMR-compliant and, consequently, unless its methodology was reformed, EONIA in its original form could no longer be used in new contracts as of 1 January 2020.

4 "State of play of the EONIA review", European Money Market Institute (EMMI), February 2018.

4 Working group on euro risk-free rates

Based on the outcome of the EONIA Review, the ECB, the FSMA, the ESMA and the European Commission established a working group in February 2018 with the task of identifying and recommending alternative euro risk-free rates[5]. 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, the working group will prepare a market adoption plan to ensure a smooth transition to the alternative euro risk-free rates by all market participants.

As a consequence of the BMR and the outcome of the EONIA Review, one of the base case scenarios for the working group is to provide recommendations for:

1) a robust replacement euro risk-free rate for EONIA;

2) a fallback for the euro risk-free rate.

4.1 Recommendation of €STR as replacement for EONIA

An important starting point for the working group was the selection of the euro risk-free rate. The selection process to recommend a euro risk-free rate started at the beginning of 2018. The working group developed key selection criteria[6] against which a number of candidate rates were assessed. Subsequently, a market-wide consultation[7] was also launched to ascertain the most suitable three candidates, before proceeding to a vote:

- €STR: the new rate reflecting euro area banks' borrowing costs in the wholesale unsecured overnight market to be produced by the ECB;
- GC Pooling Deferred: a one-day secured, centrally cleared, general collateral repo rate produced by STOXX;
- RepoFunds Rate: a one-day secured, centrally cleared, combined general and specific collateral repo rate produced by NEX Data Services Limited.

Based on the outcome of the consultation[8], the working group announced on 13 September 2018 that it unanimously recommended the €STR as the alternative euro risk-free rate and replacement for EONIA[9].

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5 "Joint press release FSMA, ESMA, ECB and EC: New working group on a risk-free reference rate for the euro area", 21 September 2017.

6 "Euro risk-free rate selection criteria", Working group on euro risk-free rates, 20 April 2018.

7 "Consultation on the assessment of candidate euro risk-free rates", Working group on euro risk-free rates, 21 June 2018.

8 "Summary of responses on consultation on the assessment of candidate euro risk-free rates", Working group on euro risk-free rates, 13 August 2018.

9 "Recommendation €STR as euro risk-free rate", Working group on euro risk-free rates, 13 September 2018.

4.2 Recommendation for fallback arrangements for €STR

As a contingency measure to avoid future financial instability, the BMR requires supervised entities to have robust written plans setting out the actions they would take in the event that a benchmark that they are using – in this case the €STR – materially changes or ceases to be provided. Where feasible and appropriate, such plans should 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. The supervised entities must, upon request, provide the relevant competent authority with those plans and any updates and reflect them in the contractual relationship with clients.

The working group considered two options for recommending a fallback measure for the €STR that could be considered by supervised entities:

1. to select (one of) the alternative rates that were considered in the consultation before the selection of the euro risk-free rate; or

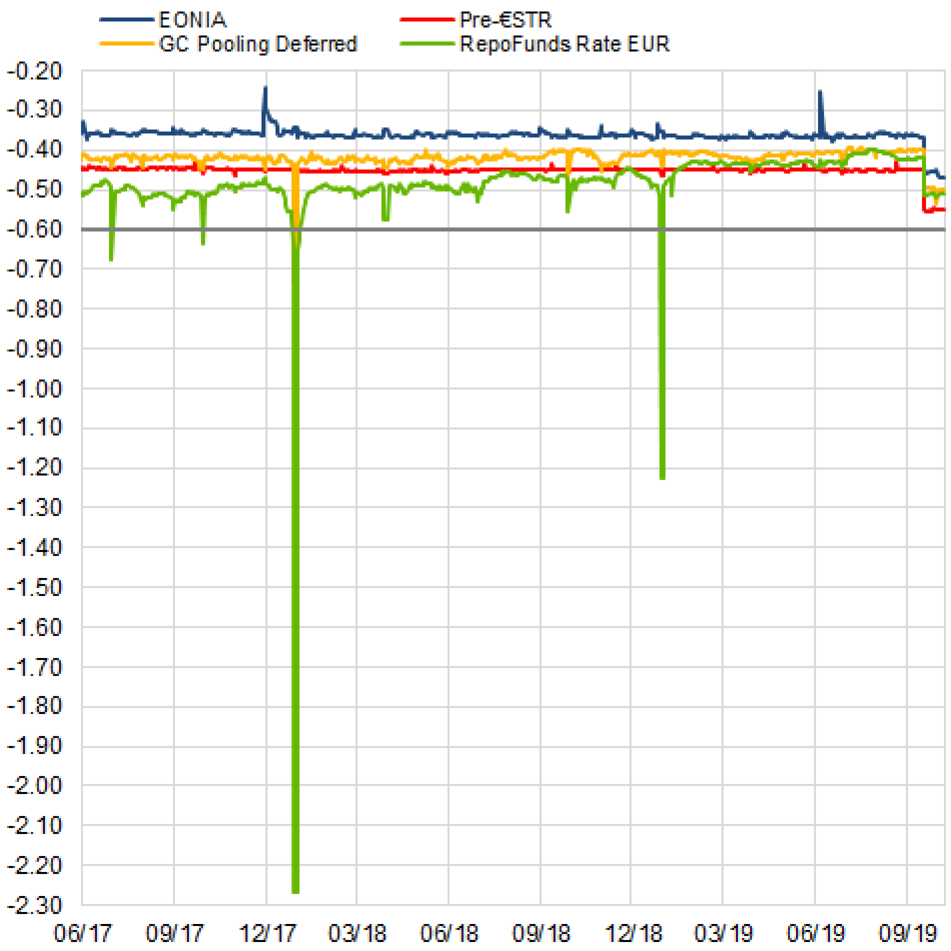
2. to take into account (a) the review of the methodology that the €STR's administrator (ECB) will conduct on a regular basis to ensure that the underlying interest of the €STR is adequately measured and captured and (b) the policies and procedures that the ECB will establish to provide for the possible cessation of the €STR in line with its legal framework, combined with the use of contractual fallbacks for products which reference the €STR that are consistent with the relevant parts of those already recommended with respect to EONIA.

Option 1: To select (one of) the alternative rates that were considered in the consultation before the selection of the euro risk-free rate

The key advantages of selecting GC Pooling Deferred and/or RepoFunds Rate as a fallback for the €STR are the transactions-only non-panel-based methodologies of both rates, combined with high volumes. More importantly, however, both rates reflect the secured market, while the €STR reflects the unsecured market. In times of market stress, market participants may change their funding strategy from unsecured to secured funding, which would make secured rates such as GC Pooling Deferred or RepoFunds Rate a natural alternative to the unsecured euro risk-free rate €STR if the €STR were to permanently cease to exist due to a lack of underlying transactions.

However, due to the regulatory framework and balance sheet constraints, one cannot ignore the reduced volumes and increased volatility at quarter-ends and year-ends that are common to the secured rates. This volatility could complicate a smooth transition from the €STR to (one of the) alternative secured rates that were considered in the consultation before the selection of the euro risk-free rate.

Chart 1 Trend analysis of EONIA, Pre-€STR, GC Pooling Deferred, RepoFunds Rate



Option 2: To take into account the regular review of the methodology of the €STR by the ECB and the policies and procedures established by the ECB to provide for the possible cessation of the €STR, combined with the use of fallbacks consistent with the relevant parts of the EONIA fallback

As administrator of the €STR, the ECB aims to ensure that the design and implementation of the €STR are consistent with international best practice as set out in the Principles for Financial Benchmarks of the International Organization of Securities Commissions (IOSCO)[10]. These IOSCO principles require, among other things:

- "The periodic review by the administrator of the conditions in the underlying interest that the benchmark measures to determine whether the interest has undergone structural changes that might require changes to the design of the methodology";

[10] "IOSCO Principles for Financial Benchmarks", IOSCO, July 2013.

- "Clearly written policies and procedures that address the need for possible cessation of a Benchmark, due to market structure change, product definition changes, or any other condition, which makes the Benchmark no longer representative of its intended function. These policies and procedures should be proportionate to the estimated breadth and depth of contracts and financial instruments that reference a Benchmark and the economic and financial stability impact that might result from the cessation of the Benchmark."

The ECB has adopted the periodic review requirements in Chapter 8 ("Review of methodology") of "The €STR methodology and policies"[11], and will adopt clear written policies and procedures on actions to be taken in the event of the possible cessation of the €STR in accordance with Article 10 on "Cessation of the euro short-term rate" of the Guideline on the euro short-term rate[12]. These actions by the ECB are expected to ensure the prolonged existence of the euro risk-free rate €STR and will minimise the likelihood of a possible cessation of the €STR, given that the €STR is administered by the ECB and will function as a backstop reference rate for the euro market. The periodic review requirements and actions to be taken in the event of a possible cessation of the €STR are in line with the key features and policies of the sterling risk-free rate, Sterling Overnight Index Average (SONIA)[13], and the data and calculation methodology of the US dollar risk-free rate, Secured Overnight Financing Rate (SOFR)[14].

The working group considers that the potential drawbacks associated with falling back from the €STR to an existing secured rate mean that market participants may consider that this option is not appropriate as a fallback measure for the €STR. In coming to this conclusion, the working group took into account:

- the robust nature of the €STR, which is based on money market transactions in accordance with the Money Market Statistical Reporting (MMSR) Regulation;
- the nature of the administrator of the €STR (being the ECB);
- the periodic review measures of the €STR methodology by the ECB;
- the upcoming policies and procedures on actions to be taken in the event of the possible cessation of the €STR by the ECB.

The working group therefore instead recommends that:

- supervised users' plans in relation to Article 28.2 of the BMR take into account the factors listed above;
- fallback provisions broadly consistent with the relevant parts of the EONIA fallback provisions[15] suggested by the working group in the EONIA to €STR Legal Action Plan are used in contracts which reference the €STR.

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11 "The €STR methodology and policies", ECB, June 2018.

12 "Guideline on the euro short-term rate", ECB, July 2019.

13 "SONIA key features and policies - Review and evolution of the methodology", Bank of England, November 2018.

14 "SOFR data and calculation methodology - Changes in the methodology and public consultation policy", Federal Reserve Bank of New York.

15 "The EONIA to €STR legal action plan - Annex 1", Working group on euro risk-free rates, May 2019.

In relation to this second point, the EONIA fallback provisions result in the following:

- a first-level fallback to the €STR plus a spread upon the permanent cessation of EONIA;
- in the event that the €STR is not available, however, the contract falls back to a rate (inclusive of any spread or adjustment) formally designated, nominated or recommended as a replacement for EONIA by a relevant nominating body;
- if no such rate has been designated, the final fallback is to the European Deposit Facility Rate (EDFR) and a spread whose methodology is specified (EDFR/EONIA spread).

The working group recommendation for a fallback for the €STR in accordance with (2) above, therefore, is to broadly follow the EONIA fallback provisions, assuming that the €STR is not available at the time of EONIA cessation, i.e.:

- the first-level fallback should be to a rate (inclusive of spread or adjustment) designated by a relevant nominating body;
- if no such rate is designated, the second-level fallback should be to the EDFR plus the EDFR/€STR spread (instead of the EDFR/EONIA spread used in the EONIA fallback provisions).

The advantage of this approach is that these fallbacks will allow one of the secured rates or any alternative appropriate rate to be designated by a relevant nominating body at or before the time of any €STR cessation, when prevailing circumstances can be taken into account in determining the most appropriate fallback rate.

In relation to derivatives, the working group notes that the International Swaps and Derivatives Association (ISDA) has taken a broadly consistent approach in its recently published compounding €STR Floating Rate Option (FRO)[16] under the 2006 ISDA Definitions.

The working group wishes to draw the attention of all market participants to the fact that the application of the recommendations by the working group will be entirely voluntary. Each market participant will need to make its own independent decision, taking into account their individual circumstances, about whether – and, if so, to what extent – it should adopt any of the recommendations and apply them in their written plans and contracts.

16 "ISDA supplement on €STR FRO to the 2006 ISDA Definitions", ISDA, October 2019.

Annex

For information purposes only, below is a tabular representation of the working group's recommended fallbacks for the permanent cessation of EONIA and the €STR, along with those set out in ISDA's compounding €STR Floating Rate Option. No representation is made as to its accuracy or completeness.

Fallback upon permanent cessation	EONIA	€STR	ISDA's compounding €STR FRO
First-level	€STR + 8.5bps	Alternative rate (inclusive of spread or adjustments) formally designated, nominated or recommended as a replacement to €STR by a relevant nominating body	Alternative rate (inclusive of spread or adjustments) formally designated, nominated or recommended as a replacement to €STR by a relevant nominating body
Second-level	Alternative rate (inclusive of spread or adjustments) formally designated, nominated or recommended as a replacement to EONIA by a relevant nominating body	EDFR + EDFR/€STR spread	EDFR + EDFR/€STR spread (if first-level fallback never applies) or EDFR + spread between EDFR and the rate nominated under first-level fallback
Third-level	EDFR + EDFR/EONIA spread		

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