Transition to alternative benchmark rates

Feedback report on the survey

Publication date: 25-Sep-2019

Background

An industry-wide transition to alternative benchmark rates is under way.[1] The EU Benchmark Regulation ((EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds – BMR) sets out a statutory framework for the use of interest rate benchmarks. The BMR stipulates that critical interest rate benchmarks may only be used in new transactions if their administrators comply with the BMR requirements from 1 January 2022 onwards.

The role of the AFM and DNB

The Dutch Authority for the Financial Markets (AFM) and De Nederlandsche Bank (DNB) consider it is essential for the financial sector to make the transition to alternative benchmarks, and that the institutions relying on interest rate benchmarks prepare themselves well in order to safeguard market integrity and financial stability. We have compiled a comprehensive overview of the latest information from the various international bodies and sectoral organisations involved to help institutions with the transition, and thus contribute to a stable financial sector.

In April 2019, we asked the chairpersons of a selection of banks, insurers and pension funds to complete a survey on the interest rate benchmark transition. The aim of the survey was to gain an understanding of the use of interest rate benchmarks, the risks involved in the transition to alternative benchmarks and the extent to which institutions are preparing themselves for the transition.[2]

We urge market parties using interest rate benchmarks to take note of this letter and to make the necessary preparations for the transition. Given the implications of the transition for the sector as a whole, we decided to disclose our general findings in this report.

About this report

We distilled a number of best practices from the responses to the survey. These best practices should not be regarded as prescriptive policy, but as practical guidance for institutions preparing themselves for the transition. Chapter 1 presents our findings at an aggregated level. Chapter 2 sets out the background to the transition with an emphasis on the interest rate benchmarks that are most relevant to the Netherlands, i.e. Euribor and EONIA.

---

[1] The interest rate benchmark transition involves the transition from existing interest rate benchmarks to alternative benchmarks.

[2] The letter accompanying the survey was also published on the AFM's website.
https://www.afm.nl/~/profmedia/files/onderwerpen/benchmarks/afm-dnb-libor-transition-letter-eng.pdf

Summary of findings and best practices

1. Use of interest rate benchmarks: The respondents to the survey make use of Euribor, EONIA and LIBOR in one or more capacities and possibly also other interest rate benchmarks in their financial products and contracts. The use of benchmark rates is diverse and touches upon numerous aspects of institutions' operations. Best practice: institutions have a detailed and comprehensive overview of the use of benchmarks within their organisation, including the residual maturity of exposures to each benchmark.

2. Identification of alternative benchmarks: Some respondents have not yet identified suitable alternative benchmarks. Best practice: respondents identify suitable alternative benchmarks, assign them to specific product groups, and already start using them where possible.

3. Transition risks: The respondents perceive the transition as a high-risk operation, involving significant operational and legal risks. They also mention financial and economic risks and customer-related risks. The ongoing lack of clarity about timelines and the ultimate outcome of the transition exacerbates these risks.

4. Approach to the transition: All respondents have set up an internal project team, or will do so in the near future. Best practice: compile a centralised project team to oversee all benchmark-related activities in the institution. This team should report to the management board and operate according to a schedule based on the timelines envisaged for the transition. Well-prepared parties have initiated their transition to alternative interest rate benchmarks before entering into new contracts.

5. Scenarios: The extent to which respondents use scenarios in their transition preparations varies widely. Scenario planning can be a very useful tool given the uncertainties surrounding transition planning. Well-prepared parties have identified various scenarios and use these as input for their planning.

6. Obstacles: Respondents mention the ongoing lack of clarity about timelines and the ultimate outcomes of the transition as the main impediments.

7. External advice: Most respondents indicate that they have engaged the services of external consultants to help them prepare for the transition. They also participate in market events, such as round table sessions. Best practice: participation in such initiatives and active contributions to consultations and surveys.

8. Provision of information to customers: Given the uncertainties surrounding the transition and its impact on the different types of customers, most institutions are still reluctant to inform their customers about the transition. Well-prepared parties have a communication plan in place and have started informing their customers.

Summary: Current status of the transition

What is EONIA?

EONIA is an interest rate benchmark based on unsecured interbank transactions. It is no longer fit for purpose due to the limited number of underlying transactions, and is gradually being phased out. The ECB's working group on euro risk-free rates has designated the €STR as the alternative. As of 2 October 2019, EONIA will be replaced by the €STR, and EONIA will then be discontinued on 1 January 2022. Unlike EONIA, the €STR is also based on transactions with financial institutions other than banks. The €STR is 7 to 9 basis points below EONIA as a result. To align the two, EONIA will be recalibrated as the €STR plus a fixed spread of 8.5 basis points. The European Money Markets Institute (EMMI) will publish the "revised" EONIA until 1 January 2022.

What is Euribor?

Prior to the reform, the Euribor benchmark used to be based on the interbank rates charged for short-term transactions of 1 week, 1 month, and 3,6, and 12 months. The reform will be achieved through applying a new methodology which also takes into account transactions with other types of financial institutions, and a number of public sector institutions. Following several amendments to the methodology, Euribor has been granted a benchmark authorisation. Pursuant to the BMR, benchmark users should have a fall-back option in the event that the benchmark ceases to exist. If a term structure is developed for the €STR, then this may be suitable for this purpose.

Fall-back options

A number of organisations are developing uniform fall-back options for a number of financial product types. For example, the International Swaps and Derivatives Association (ISDA) is working on a derivatives protocol, the Loan Market Association (LMA) is working on a protocol for syndicated loans and the Association for Financial Markets in Europe (AFME) is developing a protocol for securitisations. Standard developers and the legislature are also looking into the issues surrounding hedge accounting and the margin and clearing obligations ensuing from the transition.

CHAPTER 1: Findings

We have worked out eight findings, based on the respondents' answers. They are the aggregated responses from the sectors involved: banks, insurers and pension funds. Based on these findings we have distilled a number of best practices.

1. **Analysis of the use of interest rate benchmarks:**
   There is widespread use of interest rate benchmarks by financial institutions throughout the product chain. They mainly use Euribor, EONIA and LIBOR, as well as certain other, local, interest rate benchmarks for their activities outside the Netherlands. These benchmark rates are set for varying periods, e.g. 1 day or 6 months, and will differ depending on the period. They are used in many different products, such as loans, interest rate derivatives and debt instruments. Interest rate benchmarks are an important tool for investors to measure an investment portfolio's or investment strategy's performance. Last but not least, benchmark-based interest rate term structures are used as input to set the discount rate for establishing pension funds' coverage ratios and insurers' future liabilities.

   The respondents have conducted a comprehensive analysis of their use of benchmarks and have prepared an overview of their exposures, broken down by product type and residual maturity of the products. Products with a maturity date after 31 December 2021 are of particular relevance here, as on that date, the transition period for critical benchmarks laid down in the BMR will end. If EONIA is no longer authorised for use in the European Union by that date, it may no longer be used for new contracts as of then. In addition, the existing contracts must have been converted to alternative benchmarks before this date, as EONIA will cease to exist by 1 January 2022. The Financial Conduct Authority, the authority supervising the LIBOR administrator, has also indicated it will no longer support LIBOR after that date.[3] Generally speaking, the longer a product's residual maturity, the greater the risk that the original benchmark will change to a material degree or cease to exist altogether before the maturity of the contract.

2. **Identification of alternative benchmarks:**
   Most respondents have indicated that they have identified alternatives for the most commonly-used benchmarks. The €STR, SONIA and SOFR are most frequently cited in this context, which means the respondents do not deviate from the officially designated alternative interest rate benchmarks. Some respondents mention the hybrid Euribor as an alternative for Euribor. Since this will only replace the existing Euribor, we do not regard it as a real alternative. Some respondents have not yet identified alternative benchmarks.

   Some note that the newly-designated benchmarks mostly involve overnight rates, while there is a need for benchmark rates with a longer maturity (term rates). The respondents also note

[3] https://www.fca.org.uk/markets/libor

that there is still uncertainty as to whether the designated alternative benchmarks will be adopted by the market - which is a crucial factor. Finally, they point out that the transition causes fragmentation in the global landscape: there are secured and unsecured alternative benchmarks and their publication dates vary widely. This results in operational complications.

Well-prepared respondents have identified alternative benchmarks for the main currencies and have allocated them to their various product types. At the same time, some institutions have considered switching from term rates to overnight rates.

3. **Transition risks:**

The most cited risk categories are i) operational, ii) financial/economic, iii) legal, iv) conduct risk and v) uncertainty surrounding the timing and the outcome of the transition. These risks are set out below.

Operational: The transition has drastic implication for the respondents. For example, they consider that the models, IT systems and data processes will not be set up on time, and not adequately tested before switching to alternative benchmark rates. As a result, the model outcomes may prove to be incorrect, with adverse effects for risk assessments, investment decisions and valuations. The operational implementation of amending the contracts affected by the transition is also often cited as a risk. Many institutions have assigned high priority to the system transition from T to T+1 when the €STR is published for the first time on 2 October 2019. As of this date, EONIA will also be published on T+1. Furthermore, respondents consider other operational risks to be closely related to other risks, and a holistic approach to the transition is therefore required. The risk of suppliers and service providers being unable to cope with all the activities involved in the transition due to capacity constraints was only mentioned a few times. Due to the extent of the transition, this risk is difficult for parties to mitigate.

Financial: The transition affects the valuation of many financial products. For example, interest rate benchmarks are used to set the cash flows of interest rate derivatives, variable rate mortgages and loans, and for the discounting of financial instruments. The impact on valuations could potentially be major, particularly for parties with a market-based balance sheet valuation and for parties with many long-term interest rate products. A change in the valuation also leads to hedging risks. For example, a hedging instrument may be less effective if the benchmark rate changes, or if the benchmark rate of the hedging instrument is adjusted at a later date than the benchmark rate of the hedged instrument. Respondents also see the risk that certain hedging relationships will no longer meet the conditions required for applying hedge accounting principles. The risk for hedging relationships may be exacerbated if no interest rate term structure is available for the alternative benchmark, or if the underlying market of the hedging instruments based on the alternative benchmarks is insufficiently liquid. Lastly, respondents envisage the risk that not all market infrastructure, such as clearing institutions, will switch to the alternative benchmarks at the same time. This can lead to uncertainty about valuations, payments and amendments to contracts.

Legal: The required amendments to contracts present a risk to financial market participants. To begin with, it is challenging to identify all contracts which are based on interest rate benchmarks. Subsequently these contracts, if possible, have to be provided with a fall-back option or amended so they are based on an alternative benchmark rate. Here, institutions envisaged the risk that a conflict may arise with the counterparty over the amendment or termination of the contract. For the purpose of estimating risk, several parties distinguish between the type of contract. For standardised contracts with professional counterparties, which is the case for most derivatives, the risk is considered to be lower as it is expected that professional organisations will take the initiative to prepare standardised clauses for these contracts. The risk of legal disputes is considered to be greater for contracts with non-professional parties, such as private loans. Another risk cited is that a change to the benchmark rate would mean that contracts will fall under regulations from which they are currently exempt, such as margin and clearing obligations and inclusion in transaction registers.

Customer relationships: In terms of customer relationships, the main risk is that customers may feel disadvantaged if their contracts are amended due to the transition. The respondents consider there is significant information asymmetry between institutions and customers regarding the transition. Potentially, this may lead to the risk of customers assuming that the transition has been misused, if the outcome turns out to be unfavourable for them. A lack of transparent communication and provision of information to customers therefore increases the risk of reputational damage or a legal challenge. Respondents are aware that customers must be informed carefully and timely about the transition in order to mitigate this risk. Nevertheless, most parties have not yet proactively started informing their customers. The main reason cited for this is the current uncertainty about the exact form that the transition will take. Most parties have however made general information available to customers, and have provided staff with training about the transition.

Uncertainty: The ongoing uncertainty about alternative interest rate benchmarks is a risk element often cited by respondents. There is still considerable uncertainty about what the alternative benchmark rates will ultimately be, and whether these alternatives will be sufficiently adopted by market operators. This uncertainty means that the full adjustment of systems is not yet possible, valuation shocks are difficult to estimate, and contracts cannot yet be amended to ensure they are future-proof. This uncertainty therefore magnifies the above-mentioned risks. In the best cases, institutions base their approach to the transition on various scenarios so that they can take action despite the uncertainties. Finally, respondents indicated that they would like to see more guidance and instructions from supervisory institutions about the course of the transition.

4. **Approach to the transition:**

All respondents indicate that they have set up a project team, or that they will do so shortly. Some institutions are still preparing an inventory of the possible impact, while others have projects that are at a more developed stage. The majority of the project teams report at board level, indicating that the transition is of major significance. This is also evident from the fact that a centralised approach is generally used, whereby employees from all departments of the organisation are involved in the project groups. This ensures there is oversight of all aspects of the transition, and provides the necessary coherence of approach. In the best cases, parties have set an end objective or an end date.

Some respondents have already included a fall-back option for new contracts, which takes into account the development of new benchmarks and the permanent discontinuation of existing benchmarks. The texts are generally derived from international market standards. In this way, contracts can be adjusted to the alternative benchmark on a previously-agreed basis. It is however important that any power to make unilateral contract amendments is carefully communicated to the counterparty or customer.

5. **Scenarios**

There is great variation in the extent to which respondents work with different scenarios. Respondents either considered that the hybrid Euribor would gradually replace Euribor, that both benchmarks would exist at the same time or that Euribor would switch abruptly to the hybrid Euribor. The first scenario, a gradual transition, is what is actually happening. The scenario whereby Euribor stops in the medium term was also specifically taken into account. In addition, a number of respondents took into account the insufficient liquidity of alternative benchmarks, which preclude the development of a term structure.

In the best cases, various transition paths for crucial interest rate benchmarks are identified, such as an abrupt stop to the publication of a benchmark, a pre-announced stop to the publication of a benchmark, a gradual transition whereby the benchmark is still available for legacy contracts and, lastly, a situation where an interest rate benchmark remains available but good alternative reference interest rates are also available. In general, the most comprehensive answers provided an overview of various realistic scenarios, and these scenarios clearly provided input for the planning made for the transition

6. **Obstacles**

The continuing uncertainty is clearly cited as the greatest obstacle to making concrete preparations. For respondents it is not clear what the final standard benchmark would be in Europe, and when this would appear. It was also unclear to respondents when a term structure would be created, and how this term structure would be calculated. It should be noted that there is greater uncertainty for euro benchmarks than for GBP and USD benchmarks, partly due to a lack of clear guidance from supervisory authorities in this respect. This can be explained by the fact that LIBOR and US LIBOR are managed from - and primarily used in - a national market (the UK and the US respectively), while the euro benchmarks are managed in a European Member State, but are used throughout the whole of the EU. There were calls for supervisory authorities to provide more guidance and information to the market.

Respondents realised that the market bears ultimate responsibility for the transition from Euribor and EONIA. Institutions are therefore expected to contribute actively to the transition through involvement in international bodies and public consultations. Several institutions indicated that they are well connected to international bodies that are working on the development of alternative benchmarks. However, according to respondents, rules governing competition are an obstacle to close cooperation in this area. The possibility that making the necessary adjustments to contracts has an impact on certain exceptions for margin and clearing obligations under European legislation could also inhibit parties from amending contracts.

7. External advice

The majority of the respondents indicated that they had made use of external advisory services. This primarily relates to legal advice and obtaining knowledge about the transition, and not so much about implementation of the transition itself. This last aspect may arise when contracts need to be amended on a large scale, but will also come with confidentiality risks.

In addition to advisory services, respondents also gained information from market events about the interest rate benchmark transition. This for example includes banks participating in round-table discussions organised by banking interest groups. Participation in these discussions is a good way to gain knowledge about the transition and to learn from the experiences of others. Respondents also considered such initiatives by other sectoral interest groups to be desirable.

8. Provision of information to customers

The extent to which customers are already provided with information about the transition varies from one institution to the next. The current uncertainty is considered as the main reason for not presently engaging in customer communication. Parties found it problematic to determine exactly what information they should share with which customers, and when. However, a number of institutions did indicate that they provide general information to customers, or respond to customer queries about this.

In the best cases, respondents have set up platforms to keep customers informed. Customers for products affected by the transition, such as variable rate mortgage loans, are provided with the latest information. A number of parties are working on a concrete communications plan for customers.

CHAPTER 2: The transition

This chapter contains information on the key interest rate benchmarks in the euro area, the background to the transition and the information provided by the parties involved.

Interest rate benchmarks play an essential role in the effective functioning of financial markets and a well-functioning financial system. The majority of interest rate benchmarks are *interbank offered rates* (IBORs). These are rates that banks charge each other for credit transactions. The three most important benchmarks are currently the *London Interbank Offered* Rate (LIBOR), the *Euro Overnight Index Average* (EONIA) and the *European Interbank Offered Rate* (Euribor). EONIA and Euribor are the most important interest rate benchmarks for the euro area and for the Netherlands. The transition discussed in this section is limited to these two benchmarks.

There is widespread use of interest rate benchmarks in a wide range of financial products. These include, for example, variable rate mortgages, numerous financial derivatives and corporate loans. Interest rate benchmarks also play an important role in price transparency, as they provide an independent measure for the valuation of contracts. They are also used by investors to compare the performance of investment portfolios, investment funds or investment strategies. Lastly, interest rate benchmark are used to determine the discount rate for establishing pension funds' coverage ratios and insurers' liabilities, among other things.

If administrators of critical benchmarks[4] do not meet the requirements of the BMR by 1 January 2022, these benchmarks may no longer be used for new transactions in the EU. As a result of the observed manipulations of interest rate benchmarks, several international bodies have recommended a reform of the current interest rate benchmarks. For example, in 2013 the *International Organization of Securities Commissions* (IOSCO) published principles for the administration, calculation and transparency of financial benchmarks[5] and in 2014 the Financial Stability Board (FSB) subsequently made recommendations to strengthen existing benchmarks and develop new risk-free benchmark rates[6]. In order to implement these recommendations, reforms are under way in various parts of the world, including the US, the UK, Switzerland, Japan and the EU.

In the EU, the recommendations are embedded in the BMR, which entered into force in June 2016. This implies, inter alia, that administrators of critical interest rate benchmarks must comply with the requirements of the BMR by 1 January 2022 to ensure these benchmarks can be used for new transactions. The BMR sets out general rules on how benchmark administrators must conduct their activities, provides requirements about input data and the methodology of benchmarks, and also establishes specific requirements for interest rate benchmarks and for critical benchmarks. For example, the BMR prescribes that interest rate benchmarks must use

[4] As defined in Article 3 of the BMR.
[5] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf
[6] www.fsb.org/wp-content/uploads/r_140722.pdf

input data in a specific order. Interest rate benchmarks that make use of contributions[7], such as Euribor, must subject themselves to an external audit and draw up a code of conduct. Key benchmarks are also subject to additional requirements, such as a supervisory board and the possibility for the supervisory authority to oblige contributors to provide data for the benchmark.

The current European interest rate benchmarks (EONIA and Euribor), in their original form, did not meet the requirements resulting from the BMR. The transition period under the BMR for these critical benchmarks runs until 1 January 2022. The European Money Markets Institute (EMMI) – the benchmark administrator of both the EONIA as well as Euribor – is currently cooperating to develop alternatives with a working group under the auspices of the ECB (working group on euro risk-free rates, the RFR Working Group).[8] The ECB website provides an overview of the work of the RFR Working Group. The RFR Working Group is made up of market participants, with the ECB providing the secretariat, and it has set up various workflows that are working towards solutions to the problems of the transition.

EONIA

EONIA is a reference interest rate based on real transactions. EONIA is calculated on the basis of the weighted average of all unsecured[9] overnight interbank credit transactions of banks on the panel (currently 28). The ECB acts as the calculation agent for EONIA on behalf of the EMMI, the administrator of EONIA. The EMMI concluded that there is insufficient perspective to bring this benchmark in line with the BMR. The most important problems underlying the creation of EONIA are the increasing concentration of participating banks and lack of transactions in the underlying market, which are partly the result of over-liquidity in the interbank market. These market characteristics make it difficult to ensure that the benchmark is sufficiently robust, reliable and resilient, as required by the BMR. One of the risks is for instance the increasing volatility, and hence uncertainty, for users of this benchmark. The RFR Working Group has looked extensively at alternatives to EONIA, and held a market consultation to this end.[10] Both secured and unsecured alternatives to EONIA were examined.

The RFR Working Group ultimately proposed introducing the €STR as an alternative to EONIA. The €STR (euro short-term rate) is a new benchmark administered by the ECB. The ECB receives input data based on the MMSR[11], which means it no longer relies on voluntary contributions. The €STR is an unsecured, overnight interest rate for the euro, derived from short-term interbank loans and wholesale loans extended to banks by other parties. The fact that the €STR is not only based on interbank transactions, but also on transactions with other entities, such as money market funds and insurance companies, ensures there are sufficient transactions to provide a solid foundation

[7] Contributing to a benchmark means providing input data to a benchmark administrator, within the meaning of the BMR.
[8] https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html
[9] Unsecured interest rate benchmarks are based on transactions that do not involve the exchange of collateral. In the case of a hedged transaction, collateral is exchanged.
[10] https://www.ecb.europa.eu/paym/pdf/cons/euro_risk-free_rates/consultation_details_201806.en.pdf
[11] Money Market Statistical Reporting dataset

for this benchmark. Although the €STR and EONIA are both interest rate benchmarks for unsecured overnight loans, they are not exactly equal in practice. Due to the current excess liquidity in the market, non-banks have to pay a fee below the ECB's negative deposit rate in order to deposit cash with these banks. Subsequently, banks can deposit their money with the ECB at the deposit rate, which means the interest rate on the ECB deposit facility has a lower limit for them. There is a difference of around 7-9 basis points between EONIA and the €STR. The €STR is also less volatile than EONIA. In order to facilitate the transition from EONIA, the RFR Working Group has proposed that EMMI should adapt the EONIA calculation methodology before 1 January 2020. The new EONIA will be calculated as €STR plus a fixed spread of 8.5 basis points. The EMMI will publish the "revised" EONIA from 2 October 2019 to 1 January 2022. This period should give market participants sufficient time to switch fully to the €STR. In addition to the actual level of the benchmark, an important difference between the old and the new EONIA is the time of its publication. Until 30 September 2019 EONIA will be published in the evening. The ECB will publish the €STR in the morning at 8:00 am, and EMMI will publish the recalibrated EONIA at around 9:15 am.

Euribor

Up until recently, the Euribor benchmark was based on the interbank rates charged for short-term credit operations with maturities of 1 week, 1 month, and 3, 6, and 12 months. These were not actual operations, but estimates. For many years, Euribor was calculated on the basis of a daily survey of banks located mainly in the euro area. The point of departure for the BMR is that benchmarks such as Euribor should be based as far as possible on actual transactions. In practice, however, it has proved impossible to base Euribor on actual transactions because there are too few of them, and they are only carried out by a limited number of contributors. There are now 18 panel banks that contribute to the Euribor; once there were over 40.

EMMI has therefore developed a 'hybrid' model (see the table below), which will be introduced in phases. Contributors of input data to Euribor will switch one-by-one to the new contribution method in order to minimise disruption to the market. This process will run until the end of 2019. In principle, the input data will be based on the actual transactions subject to the underlying interest rate for the relevant maturity (level 1). If no transactions are available for the specific maturity, then the input data will be based on actual transactions with a close maturity (level 2). Finally, it is possible to base the input data on transactions in similar markets, possibly using quotes offered by institutions for transactions, or based on the contributor's judgement (level 3).

Euribor hybrid methodology

Level 1	Level 1 contributions are based solely on eligible transactions in the underlying interest based on a formula provided by EMMI	
Level 2	Level 2 contributions are based on transactions in	2.1 Adjustment based on linear interpolation of adjacent maturities

	the underlying interest across the money market maturity spectrum based on a formula provided by EMMI	
		2.2 Transactions at undefined maturities
		2.3 Eligible past transactions
Level 3	Level 3 contributions are 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 modelling techniques and/or the panel bank's judgement based on EMMI guidelines.	

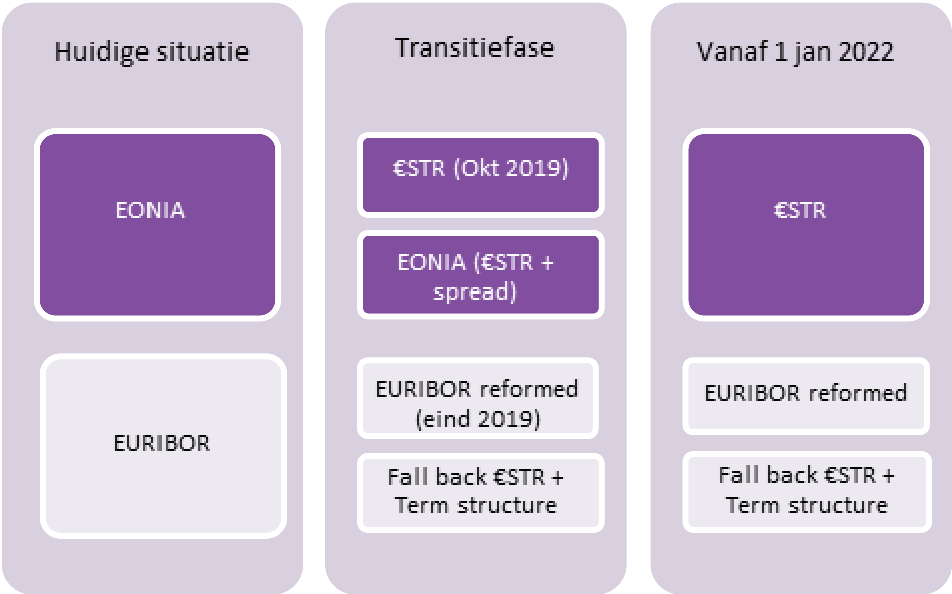
Initial results show that the hybrid Euribor will also be partly based on judgement (level 3). EMMI has prepared an initial estimate of the extent to which the hybrid methodology depends on the various possibilities for submitting the contributor's input. The results show that for all term structures, there is still a need to rely heavily on alternatives, which involve the professional judgement of the contributor. In addition, for those benchmarks with longer term structures, it is more difficult to base the benchmark on actual transactions. It has since become clear that the reformed Euribor meets the requirements of the BMR. On 3 July 2019 the Belgian supervisory authority, the Financial Services and Markets Authority (FSMA), authorised EMMI as the administrator of Euribor. The reformed Euribor rate will differ from the old Euribor. According to EMMI, the average difference between the old Euribor and the hybrid Euribor for all maturities is between 1 and 5 basis points.[12] An alternative term structure for the €STR that could be used as a fall-back for Euribor is currently being considered. Pursuant to the BMR, benchmark users should have a fall-back option in the event that a benchmark ceases to exist. By adding a term structure to the €STR, it may serve as a fall-back option for the reformed Euribor. This will nonetheless depend on various factors, including the extent to which the market makes use of the €STR.

[12] https://www.emmi-benchmarks.eu/assets/files/D0373-2018%20Second%20Consultation%20Hybrid%20EURIBOR_full.pdf

€STR term structure

Adding a term structure to an overnight interest rate could be problematic due to a potential lack of liquidity in the market. In order to be able to add a term structure to a reference interest rate, it will be necessary to make use of derivatives transactions. This can for example be effected by looking at market transactions in the futures market or swap market which reference the reference interest rate. The market for such contracts does not currently exist. The risk is, therefore, that if this market does not sufficiently take off, the lack of liquidity will mean the term structure cannot be determined, or cannot be reliably determined.

Schematic overview of the transition



International bodies and sectoral organisations

Uniform fall-back options are being developed for several standardised financial products. The International Swaps and Derivatives Association (ISDA) is in the process of drawing up a protocol with fall-back options for derivatives contracts. For example, ISDA recently published a consultation on fall-back options for LIBOR benchmarks in, inter-alia, GBP, JPY, USD and CHF.[13] As a fall-back option for all benchmarks, a large majority of market participants prefer the "compounded setting in arrears" rate as an alternative risk-free component, and the "historical mean/median approach" for the spread adjustment. ISDA expects to publish a consultation of this nature for Euribor and EUR LIBOR at the end of 2019. The Loan Market Association (LMA) is working on a general fall-back option for syndicated loans. Finally, the Association for Financial Markets in Europe (AFME) has developed a fall-back option for securitisations[14]. The provision for securitisations is primarily intended for residential mortgage-backed securities (RMBS), but it can

[13] https://www.isda.org/2019/07/30/isda-publishes-preliminary-results-of-supplemental-benchmark-fallbacks-consultation/
[14] https://www.afme.eu/globalassets/downloads/consultation-responses/afme-sts-modifications-to-securitisation-issues-without-direct-noteholder-consent-model-wording-august-2014.pdf

according to AFME also be used for other assets. Initiatives have still not yet been put forward for floating rate notes and bilateral loans, but fall-back options have been consulted for USD-denominated contracts. It is therefore perfectly conceivable that there will be a similar consultation for EUR contracts in due course.

Central counterparties (CCPs) play a major role in the adoption of the new benchmarks as they use interest rate benchmarks to discount cash flows and to determine the earnings on cash collateral arising from margin requirements. Eurex Clearing has indicated that on 18 November 2019 it intends to start clearing €STR-linked derivatives, and that it is preparing a report on the discounting of future cash flows based on the €STR.[15] LCH SwapClear will offer clearing of €STR swaps up to a maturity of 51 years as from 21 October 2019.[16] In other jurisdictions, such as the US, initiatives have already been launched concerning clearing of transactions based on alternative benchmarks. CCPs therefore play a significant role in building up liquidity for alternative benchmarks.

The International Accounting Standards Board (IASB) is developing proposals for amending IFRS9 in the context of hedge accounting. In May 2019, the IASB published an exposure draft[17] in which it sets out recommendations on hedge accounting issues arising prior to the transition to alternative interest rate benchmarks, referred to as "pre-replacement issues". It proposes that institutions can assume the interest rate benchmark will remain unchanged until the adjustment to an alternative benchmark has occurred. This would allow hedge accounting relationships to be maintained. The IASB will also closely monitor the effects on hedge accounting as of when contracts are transferred to alternative benchmarks. For example, the transition may affect the hedge effectiveness between the hedged instrument and the hedging instrument, or the hedge documentation may stipulate that only the original interest rate benchmark is permitted to be used in the hedge relationship. IASB plans to ensure that hedge accounting relationships can be maintained, provided that the economic relationship between the hedged instrument and the hedging instrument is maintained.

In early 2019, the BCBS and IOSCO announced there is international consensus that the amendment of contracts for the sole purpose of compliance with the BMR may not result in new margin and/or clearing requirements from which the original contract are exempt.[18] The European Commission, in agreement with the European supervisory authorities, intends to enshrine this in European legislation. This will ensure European parties are treated in the same way as parties outside the EU.

---

[15] https://www.eurexclearing.com/clearing-en/resources/initiatives/ibor-reform
[16] https://www.lch.com/membership/ltd-membership/ltd-member-updates/benchmark-reform-impact-swapclear-eur-products
[17] https://www.ifrs.org/news-and-events/2019/05/iasb-proposes-targeted-amendments-to-ifrs-standards-in-response-to-ibor-reform/
[18] https://www.bis.org/press/p190305a.htm

De Nederlandsche Bank
T +31(0)20 524 9111 | F +31(0)20 524 2500
Postbus 98 | 1000 GS Amsterdam
www.dnb.nl

Dutch Authority for the Financial Markets
T +31(0)20 797 2000 | F +31(0)20 797 3800
Postbus 11723 | 1001 GS Amsterdam
www.afm.nl