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Benchmark reform: transition from IBORs to risk-free rates in euro area

Jan Lundstrom
Managing Director, Head of Euro Rates Trading

ECB BMCG 6 February 2018

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Benchmark reform

22 July 2014 Financial Stability Board publishes “Reforming Major interest Rate Benchmarks”

The paper outlines proposals, plans and timelines for the reform and strengthening of existing major interest rate benchmarks and for additional work on the development and introduction of alternative benchmarks.

1 January 2018 the new EU Benchmark Regulations (BMR) came into effect

The BMR will introduce a **common framework and consistent approach to benchmark regulation** across the EU. It aims to ensure benchmarks are robust, reliable, and to minimize conflicts of interest in the benchmark-setting processes

- Benchmarks not fulfilling these requirements by Jan 1 2020 **cannot** be used in financial instruments or financial contracts in the EU, or by funds to measure performance
- Regulators will have the power to compel banks to contribute to critical benchmarks for up to 2 years. To date, EONIA, EURIBOR and LIBOR have been deemed critical.
- Regulations identify three key benchmarking activities
  - Administration
  - Contribution
  - Usage

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The current state of LIBOR

ICE Benchmark Administration (IBA) – (LIBOR administrator) is expected to introduce a new submission methodology in 2018

- LIBOR question ***(11am London time)*** to be replaced by an output statement
- Submissions will be non-subjective and fully transaction-based wherever feasible
- IBA will implement a uniform submission methodology for LIBOR panel banks
- IBA will publish a single, clear, comprehensive and robust LIBOR definition

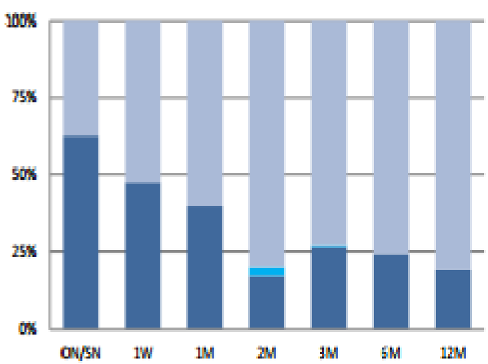
Waterfall Approach:

- Level 1: Volume Weighted Average Price (VWAP) in unsecured deposits, CP's and CD's
- Level 2: Transaction derived data including time-weighted historical transactions for market movements and interpolation
- Level 3: If insufficient data in L1 and L2, internally determined by panel banks **expert judgment based procedure** approved by IBA

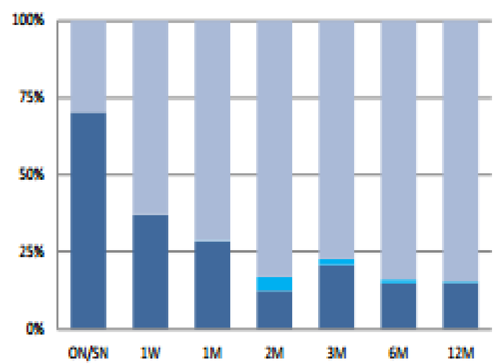
Benchmark Reform – Transactions Use Not Uniform Across All CCYs and Tenors

IBA Quarterly volume report. Q4 2017

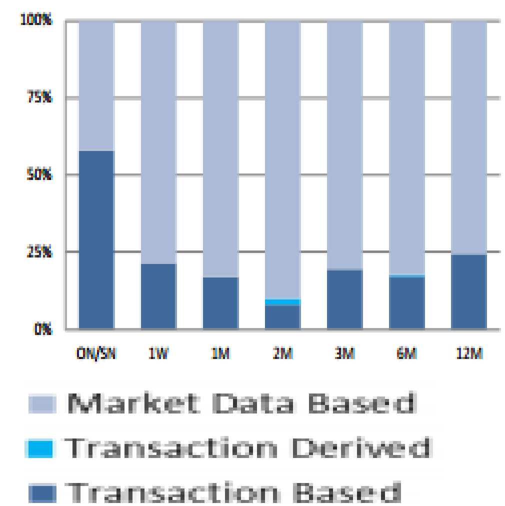
USD



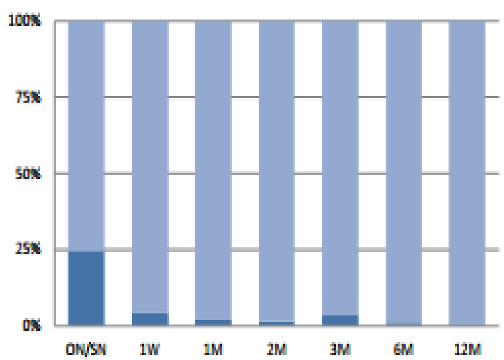
GBP



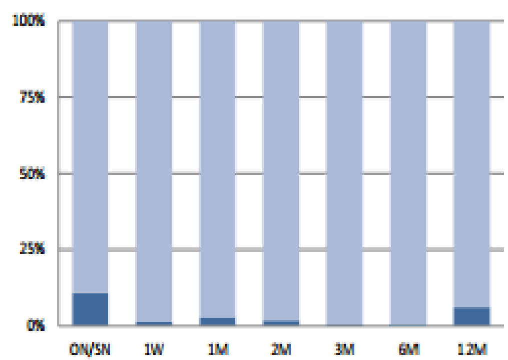
EUR



JPY



CHF



An estimated $400 trillion notional gross volumes are tied to IBOR fixings.*

*FSB Market Participants Group on Reforming Interest Rate Benchmarks 2014.

Source: https://www.theice.com/publicdocs/ICE_LIBOR_Quarterly_Volume_Report_Q4_2017.pdf

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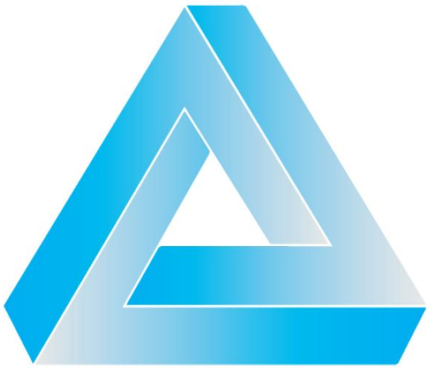
Regulatory headwinds hamper interbank funding market – unlikely to change



*'The **absence of active** underlying markets raises a serious question about the sustainability of the LIBOR benchmarks that are based upon these markets.'*

'Work must begin in earnest on planning transition to alternative reference rates that are based firmly on transactions'

Our intention is that, at the end of this period [end of 2021] it would no longer be necessary for the FCA to persuade, or compel, banks to submit to LIBOR. It would therefore no longer be necessary for us to sustain the benchmark through our influence or legal powers.

*I cannot entirely discount the **risk of earlier panel degradation**, or having to fall back to use of our powers to compel, with all the costs and risks of a messier and more costly transition that this might crystallise.*

Andrew Bailey Chief Executive, FCA, 27 July 2017

Benchmark reform – are there alternatives?

UK

Sterling Risk Free Rate (RFR) Working Group selected reformed (unsecured) SONIA as its proposed alternative benchmark.

- The average daily transaction volume underpinning reformed SONIA is £39 billion, on average around four times that for current SONIA, to be implemented effective 23 April 2018
- Reformed SONIA is on average a little more than 1 basis point lower than current SONIA and is highly correlated. Beneficial in that the correlation lends to a seamless transition.

Source: http://www.bankofengland.co.uk/markets/Documents/soniareformresponse0317.pdf

USA

Alternative Reference Rates Committee (ARRC) Selected the Secured Overnight Funding Rate (SOFR) as its RFR – to include tri-party and bilateral repo data

- In April 2017 an average of $770 billion a day traded across markets underlying the SOFR to be published mid 2018
- Commitment required by banks, administrators, and regulators to develop infrastructure to make this a successful transition.
- SOFR anticipated go live Q3-Q4 2018

Source: Barclays research and www.federalreserve.gov/newsevents/pressrelease/bcrg20170824a.htm

Benchmark reform – are there alternatives?

Europe

Euribor: EMMI **(European Money Markets Institute)** attempted a seamless transition to a transaction based Euribor. However the Pre Live Verification program, which collected data from over thirty banks over a six month period concluded in May 2017 there were <u>not</u> sufficient transactions to progress.

EMMI is now developing a 'Hybrid methodology' which will rely on transactions to the greatest possible extent before January 2020 - Similarities to LIBOR are expected.

EONIA: In 2015 EMMI initiated an EONIA review programme to ensure its continued viability, with the second phase of the review starting in summer 2017. On 1 Feb 2018, EMMI announced that 'should market conditions and dynamics remain unchanged, Eonia's compliance with the EU BMR by January 2020 cannot be warranted, as long as its definition and calculation methodology remain in its current format'. Furthermore, EMMI's governing bodies have decided that pursuing a thorough Eonia Review is no longer appropriate.

ECB RFR: Announcement on 21 September 2017 on 'new euro unsecured overnight interest rate benchmark ' ready by 2020 – ***complimented*** by EONIA Index.

The signatory public authorities therefore express their appreciation for the continued commitment of those banks contributing to the Euribor and EONIA benchmarks and expect that they will remain supportive of these benchmarks *as necessary*.

Source: www.esma.europa.eu

Benchmark reform – Working Groups and consultations

- FSMA, ESMA, ECB and European Commission new Working Group on Risk-Free Reference Rate for the Euro Area Review of MMSR data, volatility, market representatives and back testing
- First ECB consultation on Euro unsecured overnight interest rate
- ISDA/SIFMA/AFME/ICMA Global Benchmark Survey

Transition to the new Euro RFR

Keys Challenges & Focus for Development

- RFR working group including variety of market experts (private and public)
- Review of MMSR data, volatility, market representatives and back testing
- Definition (borrowing, lending, overnight only, non financials, geographical representation)
- New swap market based on EUR RFR – buy-in of CCPs, new Futures markets
- Parallel run of swap markets to help transition the market
- Will the market accept an EUR RFR or will certain participants (e.g. corporates) prefer a term curve (as with Euribor)?

Advantages

- No expert judgement
- Volume expected to increase
- Broader participation of banks (28 members of EONIA Panel vs. at least 52 MMSR participants)
- Reduction in potential conflicts of interest
- In line with international peers

Challenges

- Transition period
- Legacy exposures vs new transactions
- Potential competition and liquidity fragmentation: New Repo Index~~,~~ ECB rate, and Eonia?
- Development costs

Additional transition considerations

Implementation considerations

- Need for a term structure?   3mth, 6mth, 12mth fixings, or everything to reference RFR?
- International comparisons – secured USD RFR vs unsecured JPY & GBP RFR, with implications for cross-currency swaps market?
- Sequencing considerations (e.g. requirements for swaps market – CCP, Futures, market infrastructure)
- Contract frustration questions
- Co-ordination of implementation, e.g. uniform implementation of discounting practices
- Exposure assessments?

Term Structure options

- Term rates based on historical relationship?
- Term rates lock in forward tenor basis at a set point/interval in time?
- Re-strike legacy IBOR trades to RFR?
- Compromise between a number of factors including ease of transition, risk management considerations etc.

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