Working group on euro risk-free rates

High level implementation plan

Executive summary

Benchmark regulations and the Euro risk-free rate Working Group

- The EU Benchmark Regulation (BMR) will enforce that as of the 1st of January 2020 only benchmarks that are compliant with these new regulations may be used by EU firms in new contracts.
- EMMI, the administrator of two of the most critical benchmarks in Europe, EONIA and EURIBOR, has announced that EONIA will not become BMR compliant. The reform of EURIBOR on the other hand is still in progress. As a consequence, the Working Group on euro risk-free rates is now actively working on (1) the replacement of EONIA with ESTER and (2) the creation of an ESTER-based term structure that can be used as an alternative benchmark to EURIBOR.
- The BMR timelines and the end of the transition period by the 1st of January 2020, clearly are challenging:
  - A legal and operational transition from EONIA to ESTER is quite complex to achieve and various steps need to be taken (as further detailed in the remainder of this document). It is currently highly uncertain if all these required steps can be taken in time by all market participants to ensure a smooth and timely transition before 2020.
  - The creation of an ESTER-based term structure that can be used as an alternative benchmark to EURIBOR cannot be completed before the 2020 deadline. In order to create this term structure a liquid derivative market based on ESTER is required. The market in ESTER based derivatives can only start after this new benchmark is published on a daily basis by its administrator the ECB. The planned daily publication of ESTER, at the latest in October 2019, offers too little time for a liquid derivative market to be established before the 2020 deadline.
- The above stated challenges, in combination with the potential instability in financial markets if market participants would not be prepared in time, have led to the formulated call to the legislators as presented on the following page.
- It must be noted that despite the challenging timelines, the Working Group continues to strive to achieve the transition from EONIA to the new euro risk-free rate before the 1st of January 2020.

Call on the co-legislators

Based on the high-level implementation plan for the euro risk-free rate, the Working Group on Euro risk-free rates requests the following legislative adjustments:

1. **An extension of the transition period for index providers of all designated critical benchmarks and the use of those critical benchmarks themselves of minimum 2 years:**
    - To anticipate a potential delay in the implementation of the EONIA transition towards the new euro risk-free rate ESTER;
    - To ensure sufficient time is reserved to be prepared for all scenario's;
    - To align BMR deadline with international initiatives.
2. **The Working Group requests the EU Commission to designate ESTER and possibly the ESTER-based term structure as critical benchmarks, thereby ensuring the market will understand these to be the successor rate(s) to non-BMR compliant benchmark(s).**

As stated above, the working group is fully committed to achieve the transition from EONIA to ESTER before the 1st of January 2020. The Working Group on euro risk-free rates will, in close conjunction with the administrator of the new risk-free rate, EMMI and the FSMA, work on a concrete transition plan for replacement of EONIA. The transition plan will entail the type of transition to be chosen being either a 'market-led approach' or a 'successor rate approach' and assess whether the Working Group will request EMMI to voluntarily cease publication or reform of EONIA once publication of its successor ESTER begins. This to maximise the chances for ESTER to be adopted by all EONIA users, thereby avoiding a parallel run between EONIA and ESTER.

High level implementation plan

Benchmark regulations

In 2014, the FSB made recommendations on 'Reforming major interest rate benchmarks'. The main elements were recommendations to strengthen existing benchmarks by underpinning them to the greatest extent possible with transaction data and to develop alternative, nearly risk-free reference rates. Following the FSB recommendations reforms are underway in all jurisdictions. The FSB recommendations have been incorporated in the EU Benchmarks Regulation (BMR) that entered into force in June 2016. The transition provision that allows the use of benchmarks in new contracts that do not comply with BMR regulations ends on 1 January 2020. As of that date, only BMR compliant benchmarks may be used by EU firms in new contracts.

Working group on euro risk-free rates

In February 2018, the ECB, the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission set up a Working Group with the task to identify and recommend alternative euro risk-free rates. 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. The group also needs to work on ensuring a smooth transition to these rates, if needed in the future. Therefore a careful transition planning by market participants will be needed to minimise disruption to markets and consumers and to safeguard the continuity of contracts to the greatest extent possible, including contracts that currently reference a term rate rather than an overnight rate as we have seen in other international initiatives. The above-listed tasks require the involvement of public authorities and a concerted effort by all market participants to facilitate a gradual reduction in the current reliance on interbank offered rates.

Status of critical euro denominated benchmarks

The most important euro denominated interest rate benchmarks are EONIA and EURIBOR. EMMI, the administrator of both benchmarks, has announced that it will no longer pursue a thorough review of EONIA and its compliance with the BMR can therefore not be warranted. EMMI is currently conducting a review on EURIBOR and intends to apply for authorisation for the reformed benchmark in 1H2019. Nevertheless, the working group considers the outcome of the reform as uncertain at this stage.

Important deliverables of the working group on euro risk-free rates

As a consequence of the BMR and developments around the most important benchmarks, the base case scenario for the working group's most important benchmarks (and related deliverables) is therefore:

1. EONIA will not become BMR compliant. The BMR requires new contracts to only contain compliant benchmarks as of 2020. As a consequence, EONIA will need to be replaced with ESTER, the newly recommended risk-free rate.
2. The outcome of the EURIBOR reform is not yet certain.

This base case scenario forms the basis for the high level implementation plan presented on the following pages.

Usage of EONIA and EURIBOR

Both EONIA and EURIBOR are widely used in both cash and derivative products representing underlying gross notional volumes exceeding EUR 150 trillion. EONIA is widely used in derivatives and to a lesser extent also in cash products and instruments. Its usage is largely concentrated in the professional market. Besides EONIA's usage as index in overnight index swaps (OIS), it is also used for the valuation of EONIA and EURIBOR derivatives for margin and collateral calculations, for risk management purposes and for financial accounting and hedge accounting purposes. Replacing EONIA by ESTER will therefore not only require changes to outstanding and new contracts and an agreement on the transition, it will also bring consequences for the valuation of derivatives and require operational changes within the user community. EURIBOR is widely used in both derivatives and cash products. Its usage is not limited to the professional world but also widely spread to corporates and individuals.

High level implementation plan

The implementation requires thorough preparation and sufficient time. This implementation time is required to give market participants time to adapt, to ensure a fair solution is implemented across all market participants and ultimately to avoid market disruption. Several sequential steps are required to ensure a smooth transition and implementation. In this plan we distinguish the phases below, namely the preparation phase and the market adoption phase.

1. Preparation phase

The main purpose of this phase is to implement a robust replacement benchmark for EONIA and to create an alternative benchmark to EURIBOR ready for use across the whole market place. The following main steps have been identified for this preparation phase (please refer to the appendix of this document for a more granular reflection of the required actions and an indication of the required timelines):

1.1 Selection and publication of the o/n risk-free rate ESTER
1.2 Creation of a liquid derivative market based on ESTER
1.3 Selection of term structure methodology based on ESTER
1.4 Contractual robustness and continuity for both existing and new contracts
1.5 EONIA-ESTER transition methodology

1.1 Selection of the new o/n euro risk-free rate

The preparation phase is composed of several stages. An important starting point was the selection of the euro risk-free rate. The working group started at the beginning of 2018 with the selection process to recommend a euro risk-free rate. The working group developed key selection criteria against which they assessed a number of candidate rates. Subsequently, the working group also launched a market-wide consultation on the most likely three candidates before the vote. On 13 September 2018, the working group announced that it recommends ESTER as alternative euro risk-free rate and replacement for EONIA.

1.2 Creation of a liquid derivative market based on the new o/n euro risk-free rate, ESTER

A liquid derivative market based on the new o/n euro risk-free rate, ESTER, is required for multiple purposes:

- To ensure a new OIS curve is established based on ESTER that can be used for valuation, risk management and accounting purposes and;
- To form the basis for the term structure based on ESTER.

The daily publication of ESTER is expected at the latest in October 2019 and as a result the working group foresees very significant challenges to meet the 1 January 2020 BMR deadline. The establishment of a liquid derivative market for this rate can only start after daily publication of ESTER begins. Similar initiatives in other jurisdictions show that the establishment of a liquid derivative market for an o/n risk-free rate will take at least one year. Looking at international initiatives that started in an earlier stage, it is clear that the current BMR deadlines leave too little time to create a liquid derivative market for ESTER before the start of 2020.

1.3 Selection of term structure methodology

The methodology to determine a term structure for this o/n risk-free rate is expected to be set somewhere in the first quarter of 2019. The working group is striving to find a workable and robust solution for all market participants regarding the creation of the term structure. Additionally, the working group is striving for alignment with similar working groups on risk-free rates in other jurisdictions to ensure a consistent worldwide approach and to avoid international market disruption.

1.4 Developing templates to ensure contractual robustness and continuity

Preparations on the legal/contractual side are also currently taking place in the form of an assessment of the legality of the methodologies and an inventory of the required contractual changes across all products and financial instruments. The transition from EONIA to the new risk-free rate and the actual changing of the existing and new contracts that follows from this transition also requires sufficient implementation time. The timelines required for this transition depend on the transition methodology that needs to be agreed with the key stakeholders across the market place.

1.5 EONIA-New o/n RFR transition methodology

The working group is exploring different transition paths in order to come to a smooth and fair transition from EONIA to the new risk-free rate ESTER. Potential transition paths entail a 'successor rate' approach or 'market-led' approach. A successor rate approach would be helped by regulatory involvement to enforce a transition from the old benchmark to the new benchmark on a certain date. The market-led approach would leave it to the market place to come to an agreement on the transition and would imply that EONIA and ESTER would run in parallel for a certain period. The additional complexity with the transition is that EONIA is used in contracts within and outside of the European Union, whose governing law may be that of an EU state or third country. The Working Group will come with a recommendation on the transition methodology and will try to find alignment with the various stakeholders to come to an agreement on this transition methodology before the end of 1H2019.

The current BMR and the related timelines provide a clear challenge for a timely transition of EONIA and the creation of an alternative benchmark to EURIBOR due to the following reasons:

- **The late publication of ESTER at the latest by October 2019 and the limited time left to create a liquid derivatives market;**
- **The legal and operational complexities that come with a transition from EONIA to ESTER**

2. Market adoption phase

In addition to the steps required for the preparation phase, to get proper replacement benchmarks installed and ready to use, these benchmarks must still be adopted across the whole market place. Market participants must be made aware of this upcoming change that will significantly impact a large part of their activities across the full value chain. Market participants can however only be properly informed once more clarity can be given on the specificities of the transition from EONIA to ESTER. Market participants will then need enough time to implement these benchmarks.

The main elements of the market adoption phase are:

2.1 New and legacy contract templates for adopting the new rates

The time and effort required to change legacy and new contract templates depends very much on the transition methodology, a 'regulatory endorsed successor rate' or a 'market-led approach'. Timelines for the latter approach could range up to several years.

2.2 Trading platforms and all market participants need to be operationally ready for the transition to the new rates

The implementation of these benchmarks requires changes across the full value chain: commercial product offering, infrastructure, valuation and risk management, tax, contractual/legal and accounting. Depending on the transition methodology, the market adoption phase of the new o/n risk-free rate as required replacement of EONIA is expected to take one to two years.

Also dependent on the final transition methodology, the adoption phase required for a full market adoption of ESTER could be challenging in terms of meeting the BMR deadline of 2020.

Phase	Objective	Deliverables	Start date	Due date
Preparation phase (1)	1. Selection and publication of o/n RFR	a) Selection criteria for o/n RFR	Feb-18	Apr-18
		b) Assessment of o/n RFR candidates against selection criteria	Apr-18	May-18
		c) Consultation paper on remaining o/n RFR candidates and selection criteria	Jun-18	Jul-18
		d) Recommendation and selection of o/n RFR	Jul-18	Oct-18
		e) Recommendation and selection of fallback for o/n RFR	Dec-18	Mar-19
		f) Publication of o/n RFR	tbd	tbd
	2. Creation of a liquid derivative market for the o/n RFR	a) Operational set-up of the value chain (e.g. market making banks, tier 2 banks, CCP's, voice brokers, trading venues, etc) required to facilitate trading in both cleared and bilateral OIS and Futures in the new RFR	Oct-18	Jul-19
		b) CSA negotiations between market participants	Oct-18	Dec-19
		c) Start trading in both cleared and bilateral OIS and Futures in the new RFR and establishment of a liquid derivative market for the new o/n RFR	Oct-19	tbd
	3. Selection of term structure methodology	a) Scorecard/selection criteria for term structure methodology	Jul-18	Oct-18
		b) Assessment of term structure methodologies against scorecard/selection criteria	Oct-18	Dec-18
		c) Coordinate on term structure methodologies with working groups in other jurisdiction and ISDA	May-18	Dec-18
		d) Consultation paper on term structure methodology	Dec-18	Feb-19
		e) Recommendation and selection of term structure methodology	Jul-18	Mar-19
		f) Approaching vendors/administrators for publication	Apr-19	Jun-19
		f) Publication of the term structure levels	Oct-19	
	4. Contractual robustness for both existing and new contracts	a) Analysis of Eurozone legal framework and market practices per asset class	May-18	Dec-18
		b) Recommendation on temporary fallback clauses	Jul-18	Dec-18
		c) Create legal action plan for implementing replacement of EONIA and fall back for EURIBOR in existing and new contracts	Jul-18	Mar-19
		d) Consultation paper on legal implications for existing and new contracts for EONIA and EURIBOR fallbacks	Apr-19	May-19
		e) Recommendation on contracts, protocols and potential regulatory amendments.	Jun-19	Jul-19

Phase	Objective	Deliverables	Start date	Due date
Preparation phase (2)	5. EONIA-New o/n RFR transition methodology	a) Determining the transition methodology (e.g. successor rate or market led transition) for the transition to the new o/n RFR from EONIA and come to agreement on the methodology with key stakeholders	Aug-18	Mar-19
		b) Actual transition to the new o/n RFR from EONIA (dependent on transition methodology) and come to agreement on the methodology with key stakeholders	Tbd	tbd
	6. EURIBOR-New o/n RFR transition methodology (necessity dependent on EURIBOR reform)	a) Determining the transition methodology (e.g. successor rate or market led transition) for the transition to the new o/n RFR from EURIBOR and come to agreement on the methodology with key stakeholders		
		b) Actual transition to the new o/n RFR from EURIBOR (dependent on transition methodology)		
Market adoption phase	1. EONIA-New o/n RFR transition for market participants	a) Market awareness	High-level estimation of 1 year after the preparation phase is fully completed.	
		b) Infrastructure		
		c) Commercial product offering		
		d) Valuation and risk management		
		e) Tax		
		f) Regulatory		
		g) Contractual/Legal		
		h) Accounting		
	2. EURIBOR-new o/n RFR transition for market participants	a) Market awareness		
		b) Infrastructure		
		c) Commercial product offering		
		d) Valuation and risk management		
		e) Tax		
		f) Regulatory		
		g) Contractual/Legal		
		h) Accounting		