

# Working group on euro risk-free rates

**EURIBOR fallback trigger events**

**EURIBOR fallback measures for cash products**

## Use, purpose and scope of this presentation pack



### Use

- For working group on euro risk-free rates ambassadors to engage with internal and external stakeholders on the public consultations regarding EURIBOR fallback provisions



### Purpose

- To explain the key elements of the public consultations on EURIBOR fallback trigger events and EURIBOR fallback measures for cash products published by the working group on euro risk-free rates
- To ask market participants to respond to the public consultations by 15 January 2021, 17:00 CET



### Scope

- The presentation covers the following areas:
  - Background
  - Objective and scope
  - Public consultation on EURIBOR fallback trigger events – proposals and questions
  - Public consultation on EURIBOR fallback measures for cash products – proposals and questions

# Background

Why does the market need EURIBOR fallback provisions?

## Critical benchmarks are undergoing significant reforms

- **Financial Stability Board recommendations on “[Reforming major interest rate benchmarks](#)”** in 2014:
  - strengthen existing benchmarks by underpinning them with transaction data to the greatest extent possible;
  - develop alternative nearly risk-free reference rates.
- These recommendations came in parallel to, or have resulted in the introduction of:
  - [IOSCO principles for financial benchmarks](#) in 2013
  - [EU Benchmark Regulation \(BMR\)](#) in 2016 (came into force in January 2018)
- **The BMR requires that providers of benchmarks such as EURIBOR be authorised or registered for market participants to continue using a valid benchmark in financial contracts.**
- In addition, to cover for a scenario in which an authorised benchmark permanently ceases or materially changes, **the BMR and IOSCO principles for financial benchmarks require the introduction of robust fallbacks in contracts referencing benchmark rates.**

## Status of the EURIBOR reform

### What is EURIBOR?

- **EURIBOR is a critical interest rate benchmark** administered by the [European Money Markets Institute \(EMMI\)](#).
- EURIBOR reflects the rate at which wholesale funds in euro could be obtained by credit institutions in the EU and EFTA countries on the unsecured money market. It aims to measure banks' costs of borrowing on the unsecured money markets.
- EURIBOR is the commonly used term rate for euro-denominated financial contracts.

### What is the status of the EURIBOR reform?

- **EMMI has conducted in-depth EURIBOR reforms over the last years to meet the BMR requirements by:**
  - strengthening its governance framework;
  - developing a hybrid methodology in order to ground the calculation of EURIBOR, to the extent possible, in euro money market transactions.
- **Authorisation was granted on 2 July 2019** by the Financial Services Market Authority (FSMA) under BMR art. 34.
- This authorisation **allows EU supervised entities to continue using EURIBOR.**

## The need for a EURIBOR fallback provision

The BMR contains regulatory requirements in relation to fallback provisions

**The requirements for fallback provisions are laid out in BMR article 28(2)\***

Supervised entities are required to:

- **produce and maintain robust written plans** setting out the actions they would take in the event that a benchmark they are using materially changes or ceases to be provided. **This includes the nomination of alternative benchmark(s) that could be referenced to substitute the benchmark no longer provided, where feasible and appropriate;**
- **provide** their written plans, upon request, **to the relevant competent authority;**
- **reflect** the written plans **in their contractual relationships with clients.**

**Robust fallback provisions reduce contract uncertainty and the risk of legal disputes in the event that the initially agreed upon benchmark rate is no longer available**

\* ESMA has published a Q&A that provides guidance on the implementation of BMR article 28(2)

## Fallback provisions and their main elements

### What is a fallback provision?

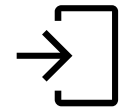
- A fallback provision is a clause in a contract that determines what rate parties should use in the event that the initially agreed upon benchmark rate (such as EURIBOR) is not available.



Without a fallback, a party tied to a contract could potentially dispute actions taken in response to the unavailability of the referenced benchmark rate.

### Key elements of a fallback provision:

- Fallback provisions are defined by three key elements which determine the application of, and the conditions applicable to, the provision:



Trigger event: defines events and the future date the fallback will be applied on



Fallback rate: identifies the alternative reference rate



Spread adjustment: if the new fallback rate provides an economically different outcome to the original rate, a spread is included to avoid or minimise the transfer of value.

# Objective and scope of public consultations

**EURIBOR fallback trigger events**

**EURIBOR fallback measures for cash products**



## Public consultations on EURIBOR fallback provisions

- EURIBOR is not scheduled to be discontinued .
- However, EURIBOR fallback provisions are required in order to (1) cover for a scenario in which the benchmark will permanently cease; and (2) comply with IOSCO principles and BMR article 28(2).
- As part of its mandate, with the aim of ensuring a smooth transition in case EURIBOR permanently ceases to exist, **the working group on euro risk-free rates is now consulting** on:
  1. EURIBOR fallback trigger events
  2. EURIBOR fallback measures for cash products, i.e. €STR-based term structures and spread adjustment, and market conventions
- **The working group encourages interested stakeholders to respond to these public consultations, and would appreciate feedback from as broad a range of respondents as possible, including users of EURIBOR-linked products from different sectors and product categories.**
- Responses to this consultation can be sent to [EuroRFR@ecb.europa.eu](mailto:EuroRFR@ecb.europa.eu) by 15 January 2021, 17:00 CET.
- The final recommendations on the EURIBOR fallback provisions are expected by end of Q1 2021.

# **Public consultation on EURIBOR fallback trigger events**

## Public consultation on EURIBOR fallback trigger events – objective/scope

### Objective

- **Identify a generic set of potential events that would trigger the activation of EURIBOR fallbacks** that market participants could consider including in their contracts and financial instruments referencing EURIBOR. Market participants are invited to provide feedback on the proposed EURIBOR fallback trigger events.

### Scope

- Four main **considerations regarding the scope** of the public consultation on EURIBOR trigger events:
  - ✓ Covers all asset classes and proposes the use of the same trigger events for all to ensure as much consistency as possible
  - ✓ Covers the permanent discontinuation of EURIBOR, but does not cover any potential temporary unavailability of EURIBOR
  - ✓ Covers the permanent discontinuation of all EURIBOR tenors. The discontinuation of some tenors, but not all, is out of the scope of both consultations.
  - ✓ Acknowledges recommendations made by market associations (e.g. ISDA, LMA, AFME)

### EU legislative framework

- **The consultation paper is based on the current legislative framework in the EU.** It should be noted that on 24 July 2020, the European Commission published a proposal for a Regulation of the European Parliament and of the Council amending the BMR as regards the exemption of certain third country foreign exchange benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation (LIBOR). The proposal is currently being discussed by the Member States in the EU Council and the European Parliament and is expected to be published at the end of 2020.

# Public consultation on EURIBOR fallback trigger events - proposals

#	Description of events	What	Who? Issuer		How? Decision			
		Public Statement	Supervisor	Admin	Cessation	Non-representative	Contingency	Illegality
1	A public statement or publication of information by or on behalf of the regulatory supervisor of the administrator of EURIBOR stating that the said administrator has ceased or will cease to provide EURIBOR permanently or indefinitely	✓	✓	—	✓	—	—	—
2	A public statement or publication of information by or on behalf of the administrator of EURIBOR stating that the said administrator has ceased or will cease to provide EURIBOR permanently or indefinitely	✓	—	✓	✓	—	—	—
3	A public statement by the supervisor of the EURIBOR administrator that, in its view, EURIBOR is no longer representative, or will no longer be representative	✓	✓	—	—	✓	—	—
4	The administrator of EURIBOR determines that EURIBOR should be calculated in accordance with its reduced submissions or other contingency or fallback policies	—	—	✓	—	—	✓	—
5	It has become, for any reason, unlawful under any applicable law and regulation for relevant parties to the agreement to use EURIBOR	—	—	—	—	—	—	✓
6	EURIBOR is permanently no longer published without a previous official announcement by the competent authority or the administrator	—	—	—	✓	—	—	—
7	Material change of EURIBOR methodology*	—	✓	✓	—	—	—	—

(\* ) Note that this event would not be understood as an automatic trigger event and, so it could cover either (i) an acknowledgment that EURIBOR may materially change and references to EURIBOR shall continue to be references to EURIBOR as changed; or ii) an option for parties to discuss whether to continue the contract with the materially changed EURIBOR or to fall back to the EURIBOR fallbacks included in the contract

## Public consultation on EURIBOR fallback trigger events – questions

#	Description of events	Question
1	<b>A public statement or publication of information by or on behalf of the regulatory supervisor of the administrator of EURIBOR</b> stating that the said administrator has ceased or will cease to provide EURIBOR permanently or indefinitely	Do you agree with the inclusion of “Event 1” as a trigger event in EURIBOR fallback provisions?
2	<b>A public statement or publication of information by or on behalf of the administrator of EURIBOR</b> stating that the said administrator has ceased or will cease to provide EURIBOR permanently or indefinitely	Do you agree with the inclusion of “Event 2” as a trigger event in EURIBOR fallback provisions? (yes / no / no opinion)
3	<b>A public statement by the supervisor of the EURIBOR administrator that, in its view, EURIBOR is no longer representative</b> , or will no longer be representative	Do you agree with the inclusion of “Event 3” as a trigger event in EURIBOR fallback provisions? (yes / no / no opinion)
4	The administrator of EURIBOR determines that EURIBOR should be calculated in accordance with its <b>reduced submissions or other contingency or fallback policies</b>	Do you agree with the proposal of <u>not</u> including “Event 4” as a trigger event in the EURIBOR fallback provisions? (yes / no / no opinion) Please elaborate.
5	It has become, for any reason, <b>unlawful</b> under any applicable law and regulation for relevant parties to the agreement to use EURIBOR	Do you agree with the inclusion of “Event 5” as a trigger event in EURIBOR fallback provisions? (yes / no / no opinion)
6	EURIBOR is <b>permanently no longer published</b> without a previous official announcement by the competent authority or the administrator	Do you agree with the inclusion of “Event 6” as a trigger event in EURIBOR fallback provisions? (yes / no / no opinion)
7	<b>Material change</b> of EURIBOR methodology	Do you agree that the inclusion of a material change in EURIBOR methodology (as defined by EMMI) should <u>not</u> result in an automatic trigger event and parties are free to agree when entering into the contract that either <b>(i) references in contracts to EURIBOR shall be understood to be references to EURIBOR as changed, or (ii) discuss between parties to continue the contract with the materially changed EURIBOR or to fall back to the EURIBOR fallback rates included in the contract?</b> (yes / no / no opinion)

# **Public consultation on EURIBOR fallback measures for cash products**

## Public consultation on EURIBOR fallback rates for cash products – objective/scope

### Objective

- **Identify the most appropriate EURIBOR fallback rate** for each financial product based on:
  - a) an €STR-based term structure methodology assessed against a list of key criteria;
  - b) a spread-adjustment methodology to mitigate potential value transfers in case the fallback is triggered.
- **Propose market conventions to use** for the calculation of compounded term rates based on the €STR.

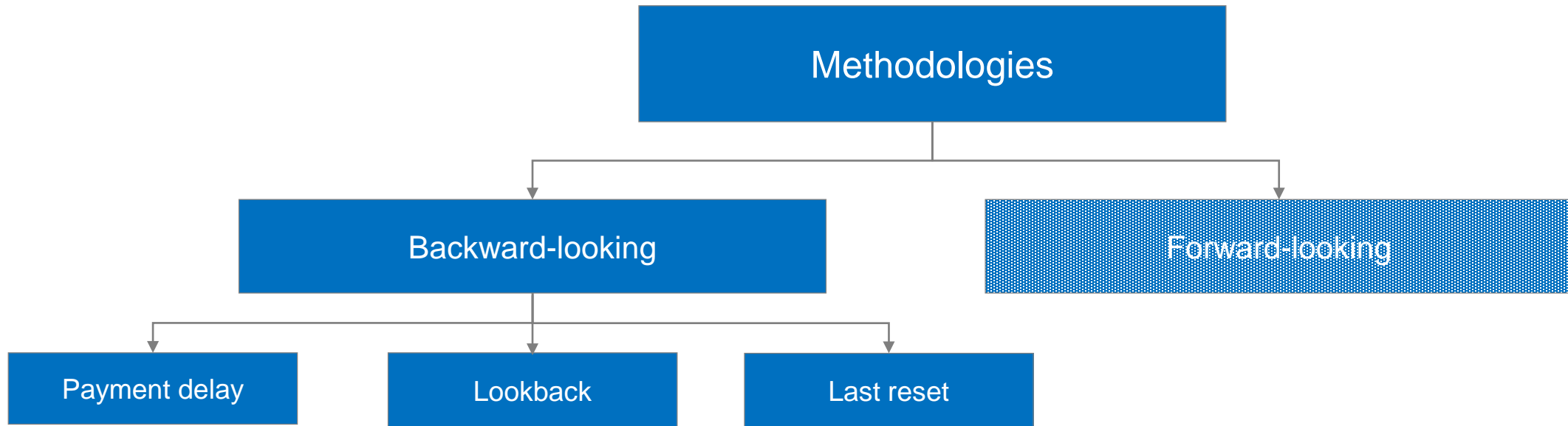
### Scope

- Three main **considerations regarding the scope** of the public consultation on EURIBOR fallback measures:
  - ✓ All EURIBOR fallback rates are based on the euro risk-free rate, the €STR.
  - ✓ Only covers cash products, acknowledging ISDA's EURIBOR fallback measures for derivatives products included in (1) Supplement 70 to the *2006 ISDA Definitions* for new transactions; and (2) the *IBOR Fallbacks Protocol* for legacy contracts.
  - ✓ Acknowledges (i) the work done by market associations, (ii) the recommendations of other RFR WGs in other jurisdictions, and (iii) the FSB recommendations.

### EU legislative framework

- **The consultation paper is based on the current legislative framework in the EU.** It should be noted that on 24 July 2020 the European Commission published a proposal for a Regulation of the European Parliament and of the Council amending the BMR as regards the exemption of certain third country foreign exchange benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation (LIBOR). The proposal is currently being discussed by the Member States in the EU Council and the European Parliament and is expected to be published at the end of 2020.

## €STR-based term structure methodologies – suitable options



- **Backward-looking term structures:** based on simple mathematical calculations on the value of past realised daily fixings of the €STR over a given period of time. The **payment delay** and **lookback period** will only be known at the end of the interest rate period, while the **last reset** will be known at the start of the interest rate period.
- **Forward-looking term structures:** based on the €STR derivatives markets, reflecting market expectations on the evolution of the €STR during the upcoming interest rate period. Will be known at the start of the interest rate period.



## €STR-based term structure methodologies – selection criteria

Assessment	Forward-looking	Backward-looking		
		Payment delay	Lookback period	Last reset
Robustness/availability	●	●	●	●
Operational ease	●	●	●	●
Client acceptance				
<i>Professional market players</i>	●	●	●	●
<i>Corporates</i>	●	●	●	●
<i>SME/consumers</i>	●	●	●	●
Hedging ease and hedge accounting impacts	●	●	●	●
Other accounting impacts	●	●	●	●
Risk management impacts	●	●	●	●
Consistency with other jurisdictions/asset classes	●	●	●	●

Colour code	
<i>Feasible</i>	●
<i>Feasible with some minor changes/drawbacks</i>	●
<i>Feasible with some relevant changes/drawbacks</i>	●
<i>Questionable feasibility</i>	●

## €STR-based term structure methodologies – proposals

Products	Corporate lending	Retail mortgages /consumer loans/ SME loans	Current accounts	Trade finance products	Export and emerging markets finance products	Debt securities	Securitisations	Transfer pricing model		Investment funds (benchmarking)
Fallback methodology recommended for the first level of the waterfall	BWL lookback	FWL	BWL payment delay	FWL	FWL	BWL lookback	<i>Depending on the underlying assets</i>	For corporates and some financials:  FWL	For most financials:  BWL lookback	FWL? BWL lookback?
Fallback methodology recommended for the second level of the waterfall (if needed)	N/A	BWL last reset up to 3M or BWL lookback	N/A	BWL last reset	BWL last reset up to 3M	N/A	<i>Depending on the underlying assets</i>	BWL last reset	N/A	BWL lookback

- The working group acknowledges that **for more sophisticated and globally operating market participants** the most appropriate EURIBOR fallback measure would be the **backward-looking lookback period term structure methodology**.
- However, **for some use cases for certain products or for less sophisticated and locally operating market participants**, where there is a clear necessity to know the interest rate in advance, the **forward-looking term structure methodology** would be more suitable.

## Spread adjustment methodology – proposal

Products	Corporate lending	Retail mortgages /consumer loans/ SME loans	Current accounts	Trade finance products	Export and emerging markets finance products	Debt securities	Securitisations	Transfer pricing model		Investment funds (benchmarking)
Fallback methodology recommended for the first level of the waterfall	BWL lookback	FWL	BWL payment delay	FWL	FWL	BWL lookback	<i>Depending on the underlying assets</i>	For corporates and some financials:  FWL	For most financials:  BWL lookback	FWL? BWL lookback?
Fallback methodology recommended for the second level of the waterfall (if needed)	N/A	BWL last reset up to 3M or BWL lookback	N/A	BWL last reset	BWL last reset up to 3M	N/A	<i>Depending on the underlying assets</i>	BWL last reset	N/A	BWL lookback
Spread adjustment	Historical mean/median methodology									

- The working group recommends **adding the historical mean/median spread adjustment to the €STR-based term structure methodology** to establish a EURIBOR fallback that is economically equivalent, to allow for a value neutral transition to the extent possible in the event EURIBOR ceases to exist.

## Market conventions – recommendations

- For those cash products where the working group proposes the use of a backward-looking term structure, **the working group recommends that market participants use the compounded average methodology as described in the [public consultation on the publication by the ECB of compounded term rates using the €STR](#).**
- **The working group seeks market feedback on whether there is an appetite to use a spread adjustment and/or an all-in rate** to at least facilitate a EURIBOR fallback measure that consists of (i) compounded €STR rates as proposed, and (ii) a spread adjustment.
- **The working group proposes** using the compounded average methodology without the inclusion of a floor on the daily €STR value, but **only to apply any floor on the sum of the compounded term rate plus spread adjustment.**
- Based on its simpler calculation methodology and consistency with the derivatives market, **the working group proposes using the compounding-the-rate methodology** rather than the compounding-the-balance methodology.
- **The working group proposes the use of the backward-looking lookback period with an observation shift**, where the working group notes that the lag approach is a viable and robust alternative for market participants wishing to use that approach.

## Disclaimer

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