European Money Markets Institute

THE FUTURE OF EURIBOR

Roundtable

Reform of Interest Rate Benchmarks in the EU

BANQUE DE FRANCE

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Agenda

1. The European Money Markets Institute
2. The EU Benchmarks Regulation
3. State of play for EURIBOR
4. The Future of Euribor
5. Conclusions

The European Money Markets Institute's (EMMI) purpose is to support the smooth functioning and facilitate the integration of the European money markets in particular and related financial markets in general.

EMMI is the administrator of two interest rate benchmarks:

Euribor

Designated critical benchmark since 13 August 2016

Euribor
the money market reference rate for the euro

Eonia

Designated critical benchmark since 28 June 2017

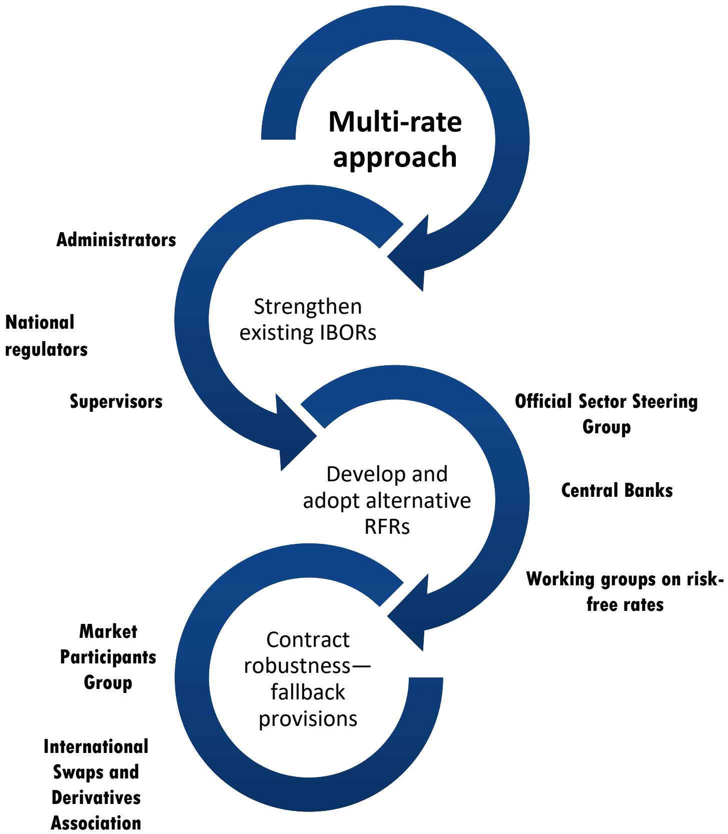
Eonia
the effective overnight reference rate for the euro

- EMMI is also involved in the STEP Market Initiative aimed at fostering the integration and transparency of the European markets for short-term paper.

- EMMI is an international non-for-profit association under Belgian law founded in 2014 and succeeding to EURIBOR-EBF which was created in 1999 with the launch of the Euro and based in Brussels, as EURIBOR-EBF first. EMMI's members are national banking associations in the Member States of the European Union,

Benchmark Reform - Background

➢ The benchmark reform process is a global endeavor initiated in 2013 at the request of the G20, in response to the cases of attempted manipulation of major interest benchmarks, such as LIBOR, TIBOR, and EURIBOR.



➢ The main recommendations of the Financial Stability Board over time:

- ✓ Strengthening existing IBORs and other potential reference rates based on unsecured bank funding costs;
- ✓ Developing alternative, nearly risk-free reference rates (meeting, then, a principle of encouraging market choice—a multiple rate approach);
- ✓ Contract robustness with appropriate fallback provisions.

EU BMR

Objectives:

- common framework to ensure accuracy and reliability of indices
  - ✓ used as benchmarks in financial instruments and contracts,
  - ✓ or to measure the performance of investment funds in the EU.
- It is also aimed at ensuring adequate level of consumer and investor protection.

Entered into application in January 2018

Transitional provisions: existing benchmarks can be used after 1 January 2018 (even if the authorisation or registration is not yet granted) and until 1 January 2020 unless the authorisation or registration of the EU index provider is refused.

Political agreement (not voted yet): 2-year extension for transitional provisions.

From 1 January 2020 (or 2022): not BMR compliant benchmarks cannot be used in new contracts or instruments; <u>for existing</u> financial contracts or instruments the use can be permitted by the competent authority under certain circumstances <u>only</u>.

EU BMR - Key requirements for Administrators

- BMR Chapter 1 – Governance & control by administrators
- BMR Chapter 2 – Input Data, Methodology and reporting of infringements
- BMR Chapter 3 – Code of Conduct and requirements for contributors

State of play for EURIBOR

- First reforms as early as 2012-13, improving the **governance** and **control framework** of Euribor towards conformity with principles published by ESMA-EBA (2013) and IOSCO (2013).

  - ✓ Euribor Steering Committee responsible for independent oversight (the governance and methodological aspects); to reduce the number of members affiliated with panel banks,
  - ✓ Code of Conduct; Code of Obligations for Panel Banks
  - ✓ Discontinuation of less used tenors
  - ✓ Change of Calculation Agent.

EU BMR - Challenges

- In the case of the IBORs, the major challenge is compliance with Chapter 2) Input Data & Methodology and the transition to a new methodology.

Input data shall be:

- sufficient to represent accurately and reliably the market.
- transaction data, if available and appropriate.
- verifiable.

The methodology must be:

- robust and reliable
- rigorous, continuous and capable of validation
- resilient
- traceable and verifiable

EURIBOR Methodology Reform

- **Euribor Reform**—evolving the current quote-based determination calculation to a methodology anchored into transactions, in order to provide the market with a more transparent, robust, and representative index.
  - ✓ Be anchored in observable transactions whenever possible;
  - ✓ Be robust in the face of market dislocation and command confidence that the benchmark remains resilient in times of stress;
  - ✓ Minimize the opportunities for market manipulation.
- **2016/17 pre-live verification program—Fully Transaction Base Methodology**

  the daily determination of the index would be based, for most tenors, on a limited number of transactions executed by a limited number of contributors: a fully transaction-based benchmark is not robust.
- **2018/19 hybrid euribor test program – EURIBOR Hybrid Methodology**

  hierarchical (waterfall) approach, with 3 levels, anchored into effective transactions; result of test phase in May-Jul 2018 and feedback received from all stakeholders indicate that this methodology provides representative and robust results,

Euribor Underlying Interest

- The current Euribor specification comes with a number of shortcomings, related to elements in its statement that may be considered open for subjective interpretation:

> *"the rate at which euro **interbank** deposits **are being offered** within the EU and EFTA countries by **one Prime Bank to another** **at 11AM Brussels time**."*

interbank ↓

...the use of interbank transactions in the original Euribor specification reflects the structure of the money markets in the 1980s and 1990s when bank-to-bank activity was a predominant source of bank wholesale funding...

↓ **wholesale**

being offered ↓

...the family of IBOR indices are based upon and aimed at representing funding markets. This is supported by the fact that LIBOR, originally evolved as a standardized benchmark for the pricing of floating-rate corporate loans.

↓ **borrowing**

Prime Bank ↓

"Prime Bank" has never been precisely defined. The Prime Bank historically represented both a concept of the financial standing of the party borrowing funds and of a substantial party supplying funds.

↓ **own cost of funds**

at 11 AM

> *"Euribor is a measure of the rate at which **wholesale funds** in euro could be **borrowed** by **credit institutions** in the EU and EFTA countries in the unsecured money market"*

The Hybrid Methodology

- **Hybrid methodology**—supported by transactions whenever available, but relies on other techniques or data sources according to input criteria established by EMMI

- The hybrid methodology follows a hierarchy. For each day in which the index is calculated, contributing banks will have to base their submissions, for each tenor, on:

Schematic description
Hybrid EURIBOR methodology

Level 1	Submission based solely on transaction in the Underlying Interest at the Defined Tenor from the prior TARGET date, using a formulaic approach provided by EMMI.
Level 2	Submission based on transactions in the Underlying Interest across the money market maturity spectrum and from recent TARGET days, using a defined range of formulaic calculation techniques provided by EMMI.
Level 3	Submission 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 modeling techniques and/or the Panel Bank's judgement.

Level 2.1	Spread Adjustment Interpolation based on Level 1 submissions at adjacent tenors
Level 2.2	Use of Non-Standard Maturity Transactions
Level 2.3	Submission based on market-adjusted Level 1 submissions from prior dates

Hybrid Methodology – Final parameters

- The methodology is organized in three levels.
  - ✓ The second consultation's feedback provided a basis for EMMI to decide on the final blueprint. The final parametrization of the methodology is as follows :

	Parameter/feature	Value
Level 1 (transaction-based)	**Maturity buckets**	Broad
	Transactions with NFCs	Excluded
	Transactions at a floating rate	Included
	Volume thresholds	20 mios
	Number of transactions threshold	1
Level 2 (transaction-derived)	**(Level 2.1) Spread Adjustment Factor**	Lookback period of 5 days and with SAF
	(Level 2.3) Market Adjustment Factor	Lookback period of 4 days and use of futures
Level 3		
Aggregation	**Outlier removal technique**	Trim 0.15

EURIBOR – Next Steps

- **Done :**
  - ✓ Proposal for a hybrid methodology
  - ✓ Test phase
  - ✓ Consultation for final parameters
  - ✓ Finalise governance framework
  - ✓ Finalise methodology
  - ✓ Confirmation on 6th May of filing with FSMA
  - ✓ Start phase-in of panel banks to the hybrid methodology
  - ✓ Obtain authorisation

- **Left to be done**
  - Finalise phase-in in Q4 2019
  - Regular revisions

Authorisation

- **On 10 April 2019 the European Money Markets Institute (EMMI) applied for authorisation as administrator of the EURIBOR benchmark.**
- **On 2 July 2019, following the positive advice of the EURIBOR College of Supervisors, the FSMA granted the requested authorisation to EMMI, by application of the European Benchmark Regulation (BMR).**
  - ✓ The authorisation granted is restricted to the EURIBOR benchmark and does not include the EONIA benchmark. EMMI already informed the FSMA of its intention to apply for authorisation as administrator of the EONIA benchmark in September 2019.
  - ✓ The fact that EMMI has obtained authorisation as administrator of the EURIBOR benchmark, confirms that the requirements contained in the BMR are met.
  - ✓ Consequently, the benchmark may also be used after 1 January 2020.
  - ✓ As such, an important step is made towards the durability of the benchmark.

Source: FSMA
https://www.fsma.be/en/news/fsma-authorises-emmi-administrator-euribor-benchmark

The Future of Euribor

- **Europe has chosen to follow a multi rate –approach**
  - According to FSB/OSSG recommendations: strengthen existing –Ibors and develop alternative risk-free rates
    - keep Euribor reliable and robust and viable in the long run
    - develop a strong O/N rate
  - Foster financial stability and consumer protection

- **Actions taken by the public sector**
  - ECB / EC / FSMA / ESMA : Provide a platform for the industry to work on alternative rates, as well as on fallback rates for EURIBOR
  - EC : Propose alterations to BMR regarding mandatory administration, mandatory contribution and transition period for critical benchmarks
  - ECB : administration of €STR as of 2 October
  - FSMA : authorization of EMMI as the administrator of Euribor

The Future of Euribor

- **Actions taken by the Private Sector**
  - EMMI
    - Compliance with BMR and reform of Euribor (phase-in to befinalized in Q4)
    - As of 2 October: recalibrated Eonia to help transition towards €STR
  - Financial institutions in RFR WG
    - Prepare for transition from Eonia towards €STR
    - Work on fall-back rates for Euribor
- **Outcome**
  - Reinforced benchmark environment ➔ complete package:
    - Reinforced Euribor + RFR + fallback rate for contract robustness
    - BMR framework for administrator + contributor + user
    - EMMI authorised for Euribor
  - Significant role of Euribor to continue in this environment

The Future of Euribor

- **Challenges for EMMI**
  - Availability of input date
    - ➔ Periodic market assessments
  - Representativeness of the underlying market activity
    - ➔ Periodic reviews of the EURIBOR methodology

Conclusions

- Systemic role of critical benchmarks like EURIBOR and EONIA
  - ✓ Safety and robustness
  - ✓ Reliance and backstop

- Regulation and existence of alternative rates
  - ✓ Push for improvement
  - ✓ Public interest
  - ✓ Communication and collaboration amongst all stakeholders
  - ✓ Understanding usage and needs

- Market operational readiness and preparation

Time for Questions