



EUROPEAN CENTRAL BANK

EUROSYSTEM

# Operational implementation of risk-free rates

OMG meeting

04/09/2019

ECB-PUBLIC  
DRAFT



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# Are you ready for EONIA and €STR publication on T+1 as of 2 October?

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# EONIA transition impact

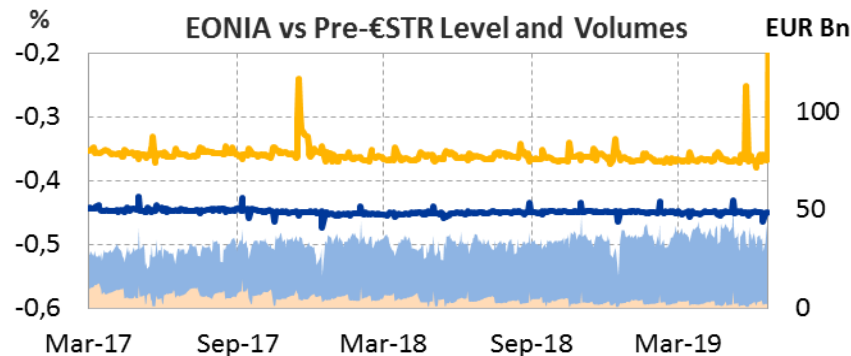
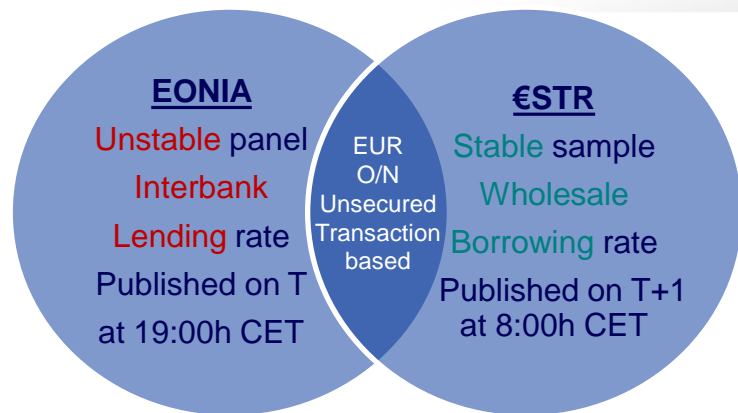
- EONIA is widely used as:
  - Reference rate in financial contracts
  - Collateral remuneration rate
  - Cash flow discounting rate for contracts referencing EONIA and EURIBOR
- Transition impact on IT systems, market conventions and documentation used in:

Products
<ul style="list-style-type: none"><li>• Derivatives</li><li>• Cash products (Securities, secured and unsecured cash products, investment funds, other products)</li></ul>

Processes
<ul style="list-style-type: none"><li>• Calculation of prices, coupons, interest or collateral remuneration</li><li>• Involving contractual settlement dates</li></ul>

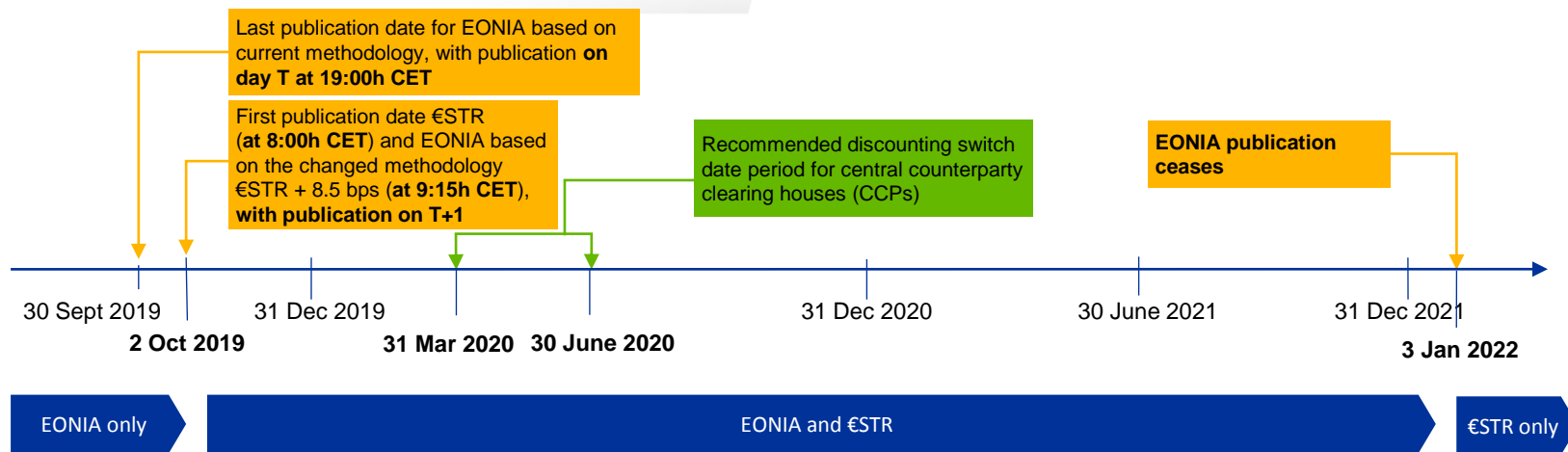
Models
<ul style="list-style-type: none"><li>• Funds transfer pricing</li><li>• Interest rate curve construction</li><li>• Interest rate term structure</li><li>• Discounted cash flow, derivatives pricing, derivatives value adjustment</li></ul>

# Transition from EONIA to €STR



- A fixed EONIA-€STR relationship: temporary stable platform to facilitate a gradual, smooth transition to €STR
- On 14 March 2019: the WG [recommends a transition path](#)
- On 31 May 2019: [EMMI confirms EONIA's change of methodology](#) and the ECB publishes the [one-off computation of the spread between €STR and EONIA](#)
- On 11 July 2019: the ECB announces the [publication time of €STR](#) at 8:00 CET and re-publication time at 9:00 CET
- On 24 July 2019: [EMMI confirms publication time for recalibrated EONIA](#) at 9:15h CET

# Timeline of the transition from EONIA to €STR



- Two sets of recommendations:

1. Recommendations for dealing with the change in EONIA's publication time resulting from the planned recalibration of EONIA as €STR + 8.5 bps as at 2 October
2. Recommendations for the transition from EONIA recalibrated to €STR between 2 October 2019 to and 3 January 2022

# Recommendations/observations: T to T+1 move (1/3)

## General

- As a first important step, market participants are encouraged to:
  - Screen their inventory of affected transactions and system environments
  - Prepare relevant teams for enhanced oversight during the cutover period
  - Design a communication strategy geared towards internal and external stakeholders
- Align main processes with the 08:00 CET publication time for €STR and 09:15 CET for EONIA, and maintain exceptional procedures for €STR re-publication events
- The change in publication time will not affect the availability of EONIA on the usual distribution channels; the unique EONIA identifiers on platforms will also remain the same. In addition, the change of the publication time will not create time series gaps.

# Recommendations/observations: T to T+1 move (2/3)

## Default settlement times

- **Derivatives/money market transactions:** switch from T+1 to T+2 settlement
- **Remuneration of variation margin for cleared derivatives:** use the last available fixing rate for price alignment interest (PAI) calculations and continue settling on T+1
- **Securities:** trade and user associations to analyse market conventions in order to provide market participants with guidance on whether a common standard will be required in the future
- **Floating rate repos:** maintain same-day settlement for the repurchase leg by using the last available fixing rate

# Recommendations/observations: T to T+1 move (3/3)

## Default settlement times

- **Current accounts, corporate and retail facilities and overdraft facilities:**

- For accounts with monthly or quarterly settlement: postpone the calculation of the CO

- For US

- **Swap** time will cause operational issues and then update systems and business processes accordingly

- **Investment** relations

and redemption/subscription processes. As the process might not be able to be modified, it is suggested to use the latest available data, in most cases referencing T-2 transactions.

- **Funds transfer funding (FTP) models:** to use the latest available rate with the possibility of using an override, in case of big fluctuations.

# Recommendations: EONIA to €STR(1/4)

## Main legal recommendations

- New contracts:
  - **Avoiding entering into new contracts referencing EONIA**, in particular those **maturing after 31 December 2021**
  - Where new contracts still reference EONIA and mature after December 2021, market participants should include **robust fallback provisions**
- Legacy contracts:
  - **Replacing EONIA as a primary rate as soon as possible**, especially for those contracts maturing after December 2021. Alternatively contracts **should embed robust fallback clauses**
  - Considering using **standard market documentation**
- **EONIA fallback rate:** €STR + 8.5 bps
- **Acknowledgement:** considering including a clarification on EONIA's change in methodology

# Recommendations: EONIA to €STR(2/4)

## Main product-specific recommendations

- **Derivatives:**

- **Floating rate options (FROs):** active approach + cash compensation, when feasible
- **Collateral remuneration rate (CRR):**
  - ❖ CCPs to align their discounting switch dates as much as possible (preferably by the end of Q2 2020) to transition from an EONIA discounting regime to a €STR discounting regime, following a “big bang” approach for cleared markets.
  - ❖ For bilateral CSA a phased approach is recommended to cater for individual discounting/compensation considerations.
  - ❖ Compensation preferably by cash. In case it is difficult to execute: move the discounting methodology first to the €STR + 8.5 bp until a move from the €STR + 8.5 bp to €STR flat could be handled without difficulty.
- The working group expects the large-scale change in discounting to drive most bilateral conversations on the FROs for EONIA legacy contracts, and recommends that conversions be as closely aligned with the change in cleared derivatives as possible.

# Recommendations: EONIA to €STR(3/4)

## Main product-specific recommendations

- **Securities:** market participants should:
  - introduce all necessary modifications in order to be able to issue, buy, trade and manage new securities indexed to the €STR, and
  - **avoid issuing new securities indexed to EONIA with maturities going beyond the transition period**
- **Non-cleared repo markets:** practicalities have been discussed by the European Repo and Collateral Council (ERCC) and agreed on the following best practices:
  - the interbank market should transact purely on a **fixed rate basis** and should no longer use floating rate repos
  - in the case of non-interbank transactions (such as dealer-to-client), where firms agree to transact on a floating rate basis), best practice will be to **apply the fixing of the penultimate accrual date of the transaction to the final (repurchase) date + Possibility to claim** in case the difference is equal or higher than an agreed threshold per transaction

# Recommendations: EONIA to €STR(4/4)

## Main product-specific recommendations

- **Investment funds:** amendments to the calculation formulas, operational procedures and adjustments to the systems used by fund administrators. It will also trigger prospectus updates.
- **Models:**
  - **FTP:** liquidity premium calculations need to be corrected accordingly when replacing EONIA
  - **Interest curve construction models:** It is recommended to use a **single curve** for valuation purposes **per counterparty for all types of contract** (i.e. new and legacy contracts). However, the working group acknowledges that during the transition period several curves could coexist in the market: EONIA and €STR curves built from sufficiently liquid markets and EONIA and €STR shifted curves derived from the existing curves through a parallel shift of  $\pm 8.5$  bps
  - **Interest term structure models**
  - **Discounted cash flow (DCF), derivatives pricing and derivatives value adjustment models:** impact on the parameters and discounting curves used in models. EURIBOR par swap rates are expected to be affected due to the change in the discounting curve and it is also possible that EURIBOR implied forward rates are also affected. Valuation adjustment models will need to be recalibrated.

# Impact on financial accounting. Report in progress

## Impact of EONIA-€STR transition on hedge accounting

- Letter sent to the IASB on 15 July including **requests for clarification and some reliefs on accounting standards** related to **modification of contracts** and **discontinuation of hedge accounting**. The letter also stressed the urgency to start phase 2 of the IASB IBOR reform project

## Impact of the introduction of €STR-based fallbacks to EURIBOR

- Overview on possible fallback rates and triggers
- Impact of potential inconsistencies on hedge accounting
- Included on a report that is foreseen to be published at the end of October

## Implications on non-hedge related accounting standards

- Overview of the impact of the benchmarks reform on non-hedge related standards
- Included on a report that is foreseen to be published at the end of October

# Impact on risk management. Report in progress

## Impact of EONIA-€STR transition on market and regulatory aspects

- €STR-based products, €STR risk factors and €STR scenarios have to be integrated into the calculations of: VaR, Stressed VaR, sensitivities and stress testing
- **€STR time series** covering ideally a full economic cycle are required for running stress tests
- Included on a report that is foreseen to be published at the beginning of October

## Impact of the introduction of €STR-based fallbacks to EURIBOR

- Impact of the possible inconsistencies that could arise from the inclusion of fallback provisions, especially for hedging relations
- Included on a report that is foreseen to be published at the beginning of October

## Implications on asset management and insurance companies

- Included on a report that is foreseen to be published at the beginning of October

# State of play of EURIBOR reform

- **EMMI's EURIBOR reform** under the **hybrid methodology** is still ongoing. Complete phased-in expected by the end of the year
- On 2 July, **EMMI granted authorisation by FSMA**, provided the reform is fully implemented
- The WG is working on identifying €STR-based fallbacks for EURIBOR:
  - Since 1 Jan 2018, supervised entities using benchmarks are required to fulfil **Article 28(2) of the EU BMR**
  - Possible methodologies:
    - ❖ Forward looking methodologies: including expectations.
    - ❖ Backward looking methodologies: based on calculations over realised rates.

# Fallbacks for EURIBOR

- Should be €STR-based fallbacks
- For derivatives, ISDA has proposed backward looking methodologies for all the currencies covered in their documentation. Euro consultation expected early 2020
- The WG is currently working on:
  - providing a description of backward looking methodologies. To be published [here](#)
  - making the recommended forward looking methodology a feasible alternative
  - Analysing the possible co-existence of backward and forward looking methodologies
- WG to analyse and make recommendations on:
  - the most relevant EURIBOR fallback methodology applicable for each financial product
  - how €STR-based forward-looking and backward-looking term structures can co-exist as potential fallback to EURIBOR
  - liaise with ISDA and similar initiatives in other jurisdictions
  - implications on financial accounting and risk management topics of the introduction of fallbacks for EURIBOR
- WG to prepare an EURIBOR fallbacks legal action plan

# Questions for OMG members

1. Are you ready for EONIA and €STR publication on T+1 as of 2 October?
2. What are you doing in order to be ready?
3. What issues do you anticipate from the move from T to T+1?

# Questions & Answers