

# Working Group on Euro Risk-Free Rate

Key messages for the transition from EONIA to €STR

# Purpose and use of this pack



## Purpose

- The purpose of this pack is to inform readers about the transition from EONIA to €STR, focusing on the key messages regarding products, models, legal, accounting and risk management implications.



## Uses

- This pack has been prepared by the Working Group on Euro Risk-free Rates to be used by its ambassadors when engaging with internal and external stakeholder on this topic.



## Scope of this pack

- It covers the following areas
  - Transition from EONIA to the €STR
  - Timeline for the transition from EONIA to the €STR
  - Key messages for the transition from EONIA to €STR

# Transition from EONIA to €STR

## What was the problem with EONIA?

- EONIA in its previous form was going to become incompliant with the EU benchmark Regulation, given the lack of underlying transactions and high concentration of volumes among a small number of contributors. Therefore its administrator, EMMI, announced that it would stop publishing it on 3 January 2022 and participants have to make sure that they do not engage in contracts with maturity beyond this date.
- As a result, after a public consultation, the working group on euro risk-free rates recommended the €STR as its replacement.

## What is the EONIA - €STR transition?

- In order to maintain EONIA for a transitional period and until its discontinuation in 2022, its methodology has been changed.
- Since 2 October 2019, the current EONIA methodology has been modified to become €STR plus a fixed spread of 8.5 basis points. This spread is a simple average of the EONIA - pre-€STR spread between 17 April 2018 and 16 April 2019, with a 15% trimming mechanism.
- The recalibration of the EONIA methodology has taken place on the first day of the daily publication of the €STR, on 2 October 2019. The publication of EONIA moved from the current timing every evening at “T” (by 7:00 CET) to “T+1” (9:15 CET), to be aligned with €STR publication (T+1 at 8:00 CET).
- NB: This methodology was suggested by the working group on euro risk-free rates to EMMI after a public consultation.

## What is the €STR?

The €STR reflects the wholesale euro unsecured overnight borrowing costs of euro area banks.

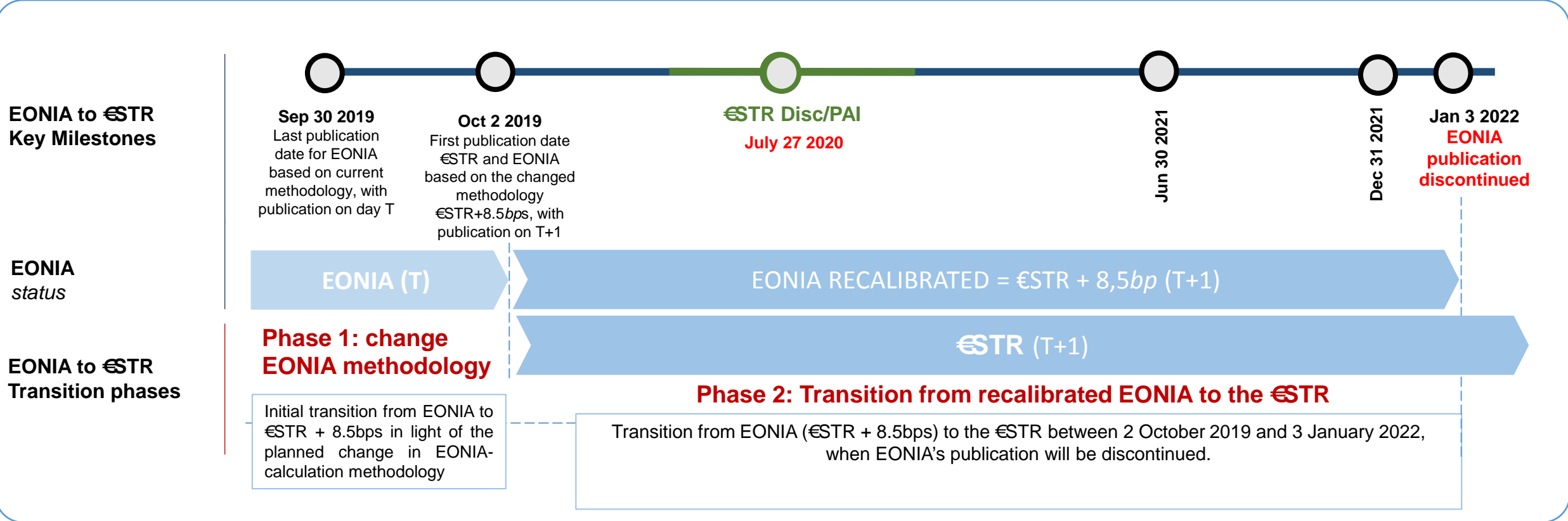
The rate is published (first date of publication: 2 October 2019 at 8:00 CET) for each TARGET2 business day based on transactions conducted and settled on the previous day (reporting date T) with a maturity date of T+1.

The €STR is based exclusively on borrowing transactions in euro conducted with financial counterparties that banks report to the ECB in accordance with the MMSR Regulation. The €STR is calculated using overnight unsecured fixed-rate deposit transactions over € 1 million.

The ECB is publishing €STR data at the end of every maintenance period at this link:

[https://www.ecb.europa.eu/paym/initiatives/interest\\_rate\\_benchmarks/euro\\_short-term\\_rate/html/index.en.html](https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/euro_short-term_rate/html/index.en.html)

# Transition from EONIA to the €STR - Timeline



**WG euro RFR recommendations**

WG euro RFR publishes recommendations for market participants to understand the EONIA to €STR transition issues from a **legal, products, accounting and risk management perspective** and encourage to **share best practices**

# 1 Key messages for the transition from EONIA to €STR

## EONIA - €STR transition path

### EONIA to €STR transition path

- The working group has recommended the Recalibration approach:
  - Modify the current EONIA methodology to become €STR plus a fixed spread, for a limited period
  - Recalibrated EONIA to be published on T+1 instead of T
  - In December 2019 EMMI was granted authorization by FSMA for recalibrated EONIA
  - EONIA to be discontinued on 3 January 2022.
- Market participants should gradually replace EONIA with the €STR as a reference rate for all products and contracts and make all necessary adjustments so as to use €STR as their standard benchmark
- Regarding the transition to the new rate, market participants are strongly encouraged to introduce all necessary modifications in order to be able to issue, buy, trade and manage new contracts indexed to €STR and avoid issuing new contracts indexed to EONIA with maturities going beyond the transition period.
- For funds using EONIA as a benchmark or a hurdle rate (e.g. money market funds, liquid strategies and total return/absolute strategies funds), the transition from EONIA to €STR will require amendments to the calculation formulas, operational procedures and adjustments to the corresponding systems of the fund administrators.
- The change in the benchmark, as of 2 October 2019, requires market participants to prepare extensively, including adaptation of IT systems to a new publication time, and a review of current documentation, processes and procedures

[link](#)

## 2 Key messages for the transition from EONIA to €STR

### Impact on derivatives and cash products

#### Derivatives

- In order to create liquidity across Risk-Free Rates and anticipate EONIA disappearance, clearing houses will switch their price aligned interest (PAI) to €STR. Simultaneously, bilateral agreements will have to move to the new risk-free rate to achieve consistency and align to regulatory recommendations.
- EONIA is used as the collateral remuneration rate for derivatives portfolios. This influences the valuation of all CSA relevant derivatives, the calculation of derivative exposure and the settlement of margin requirements. We recommend single-counterparty clean discounting using €STR flat as soon as possible. We encouraged CCP's to co-ordinate a big-bang approach and the market to migrate their remaining (non-cleared) derivatives portfolios in a phased approach (mainly for operational reasons).
- The main CCPs announced they will switch the PAI from EONIA to €STR on 27 July 2020.
- The working group considers that rebalancing the economic value changes using cash compensation may have advantages in terms of operational simplicity compared to other methods.
- Considering specific implications for physically settled and collateralized cash price swaptions, caution is required as the option is affected by the discounting change, triggering re-evaluation and compensation.

[link](#)

## 3 Key messages for the transition from EONIA to €STR

### Impact on derivatives and cash products

#### Secured Cash Products

- Interbank market participants are encouraged to stop using floating rate Repo/Reverse Repos.
- For non-interbank transactions, we follow the ICMA ERCC recommendation to use the same-day rate to calculate and settle interest payments without delay.
- Disadvantaged parties can claim the difference (thresholds may apply).

[link](#)

## 4 Key messages for the transition from EONIA to €STR

### Impact on derivatives and cash products

#### Securities referencing EONIA

- These refer to NEUCP, NEUMTN, CD and rarely ECP. The settlement process is impacted by the publication shift from T to T+1 but it is not perceived as a cause of concern by front/back offices, issuing and payment agents (IPA) or depositaries as the procedure is already being run with the T-1 value.
- However, market participants should adapt their valuation, pricing and accounting systems accordingly. taking into account the shorter time lag available to perform all necessary evaluations. Some potential issues may arise in the secondary market depending when the accrued interest needs to be calculated, i.e. whether the related transaction occurs before 9:15 CET (before the front office systems are updated with the new rate, i.e. still based on T-2) or after 9:15 CET (based on the just-published T-1 value).
- It was concluded that the settlement of deals mainly relies on bilateral agreements (agreed payment instructions, reference rate value to be used) and, for that reason, the transition should be manageable. However, a specific analysis of market conventions may be required in the future to provide market participants with guidance on how the conventions used for EONIA referencing securities may evolve due to the transition from EONIA to €STR and the development of a new market.

[link](#)



## 5 Key messages for the transition from EONIA to €STR

### Impact on models

#### Models

- Models (funds transfer pricing models, discounted cash flow models) are not expected to be impacted once €STR begins to be published but, as the transition advances, their input parameters will vary with the performance of the yield curves. So, we expect to see a gradual transition between 2020-2021.
- Until the €STR swap curve becomes directly observable, the fixed spread relation between EONIA and €STR fixings can be applied to derive a full-term structure for €STR from EONIA linked overnight index swaps. Market participants should be aware that the changes in the models may impact not only derivatives but also other assets and liabilities (e.g. loans, bonds, commercial paper) that are valued at “fair value” and require the EONIA OIS discounting curve as a pricing input. Moreover, because of the change in the discounting curve, EURIBOR par swap rates will also be affected

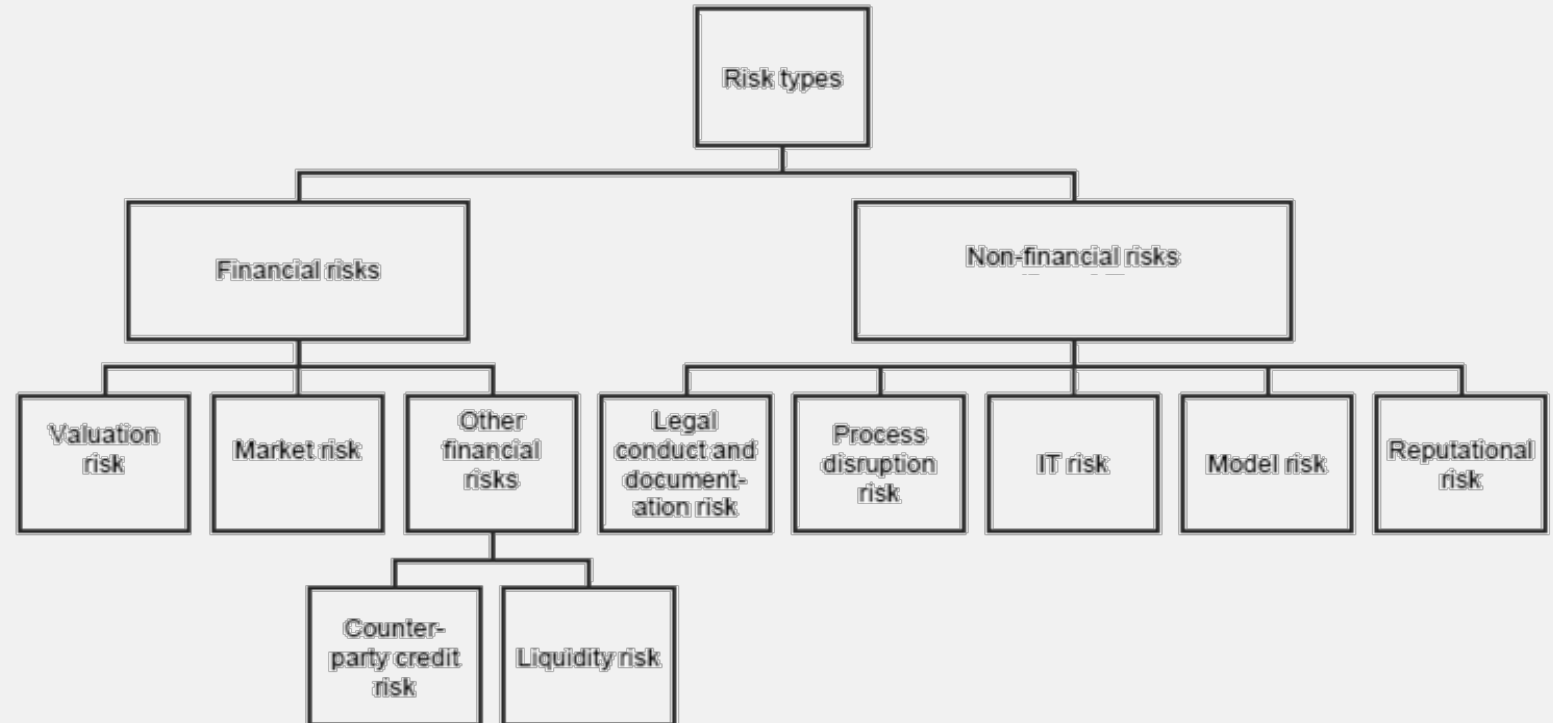
# 6 Key messages for the transition from EONIA to €STR

## Risk Management implications

### Risk Management implications

Major risk types that the WG has identified as affected by the introduction of risk-free rates resulting from the benchmark reform

- Valuation and market risk are expected to be the most affected. While the risk types mentioned serve as first guidance on possible areas of focus for financial institutions and their assessment
- The WG highlights that the severity of individual impacts strongly depends on the individual business and technical circumstances.



For more detail, see section 4.3. to 4.7 of the WG euro RFR on [risk management](#)

[link](#)

## 6 Key messages for the transition from EONIA to €STR

### Risk Management implications

#### Risk Management implications

- As €STR is published on the following day, with EONIA following this practice since 2 October 2019, market participants should consider
  - potential effects on short-term liquidity risk.
  - potential effects on settlement risks from changes in the publication schedule and their impact on fixing and payment.
- In order to assess the impact of the EONIA to €STR transition, each institution should conduct an appropriate quantitative impact assessment on key market risk figures including 1) an impact test on VaR and sensitivity limits and 2) impact test on internal models for regulatory capital charges for market risk. New products referencing €STR and €STR risk factors, €STR scenarios have to be integrated into the calculations of: VaR, Stressed VaR, sensitivities and stress testing
- Whilst compensation mechanisms when transitioning from EONIA to €STR are anticipated, financial institutions should consider the risk of price and valuation changes throughout this transition and the effects on financial accounting.
- For institutions for which EONIA is a relevant risk factor, the calculation of internal model-based market risk figures has to be adjusted. For institutions using internal model approaches for the calculation of own funds requirements, the quantification of changes in market risk figures is mandatory. For other institutions using standardised approach it is recommended.
- To fulfill regulatory requirements a €STR time series is required that should ideally cover at least a full economic cycle (including financial stress periods) in order to run stress tests and calculate risk metrics (e.g. VaR). Since €STR started to be published on October 2nd with a pre-€STR going back to 2016, an approximation of the €STR time series is necessary. Given the high correlation between EONIA and pre-€STR and the fact that since October 2019, EONIA is firmly linked to the €STR plus a fixed spread of 8.5 basis points, it seems reasonable to use a proxy based on past EONIA data.

[link](#)

## 6 Key messages for the transition from EONIA to €STR

### Risk Management implications

#### Risk Management implications

- Regarding risk reporting and limit systems, each institution must ensure that market risks arising from the new €STR based products and €STR risk factors are limited. To meet this requirement, additional limits, for example for €STR sensitivities, might be necessary.
- The working group recommends that market participants carefully assess potential impacts on their IT system landscape and processes corresponding to risk management implications, including an analysis of the technical capabilities, to be able to switch from one valuation curve to another, when required.
- For insurance companies under the Solvency II framework, implications for liability valuation and the reported capital position will arise if the market in €STR becomes sufficiently liquid, compared to EURIBOR, and the regulatory risk-free curve shifts to €STR. However, a decision from EIOPA and a change to the regulations is required to shift to €STR.
- Given their exposure to various benchmark rates (e.g. fund holdings directly linked to benchmark rates), asset managers also need transition plans, including an impact assessment of affected areas (e.g. contracts, valuation, risk models) and a definition of mitigating actions. In addition, asset managers have exposure at portfolio level as risk and performance benchmarks can be linked to benchmark rates, with consequences for the calculation of performance fees.
- Issues specific to asset management, such as outsourcing to third parties, investment guidelines and client communication, need to be taken into account for both the transition to €STR and the introduction of new fallbacks.

[link](#)

## 7 Key messages for the transition from EONIA to €STR

### Legal action plan

#### Legal action plan

- Working group recommends, whenever feasible and appropriate, no longer entering into new contracts referencing EONIA as from 2 October 2019.
- In existing contracts referencing EONIA and maturing after December 2021, market participants should replace EONIA as the primary rate as soon as possible or embed robust fallback clauses.
- For new contracts that still reference EONIA and mature after December 2021, or fall under the EU Benchmarks Regulation (BMR), robust fallback provisions should be included.
- The working group welcomes the work already done by market associations and encourages, with consideration to local law, them to continue updating their standard documentation and recommends that market participants consider using the standard market documentation and/or protocols for their contractual arrangements on a voluntary basis.

## Accounting implications

### Accounting implications

- From an accounting and financial reporting perspective, the implications of the transition from EONIA to €STR are wide-ranging, especially for the valuation of financial assets and liabilities.
- The transition from EONIA to €STR may therefore impact cash flows and net present values, which could lead to undesired accounting volatility and not provide useful relevant information on institutions' performance.
- In addition to hedge accounting implications (IFRS 9/IAS 39), potential non-hedge related implications, which should be considered as part of the transition, comprise: further IFRS 9 considerations (e.g. modification and/or derecognition of financial instruments), fair value measurement (IFRS 13) and discount rates used in other IFRS (e.g. IAS 19, IAS 36, IAS 37).
- Critical areas of accounting that could be affected by the transition from EONIA to €STR and the introduction of new fallback clauses comprise especially:
  - Modification of contracts; Derecognition of hedged item or hedging instrument; Replacement of hedging instrument; Documentation of hedging relationships & Ineffectiveness of hedging relationships.
- The working group addressed these critical accounting issues in a letter to the IASB stressing the urgency of the matter. WG recommends that the IASB address the issue of contract amendments and the potential risk of derecognition due to the IBOR reform, and provide financial statement preparers with specific guidance on how to treat contract amendments driven by the mandatory reforms. Furthermore, for hedge accounting, the working group requests that the IASB provide further clarifications and assurance that the transition from EONIA to €STR should not trigger discontinuation of a hedge relationship that is not otherwise amended. This would be appropriate when changes of hedging relationships (e.g. modification of hedging instrument, hedged item and/or hedge documentation) only take place in response to the market-wide developments driven by the EU Benchmarks Regulation. The IASB still works on the topic but already started to give comfort to stakeholders in September 2019 with amendments to IFRS 9, IAS 39 and IFRS 37.

# Useful links

## Website



[ECB Website](#)



[Terms of reference for the Working Group on Euro Risk-Free Rates](#)



[Meetings of the Working Group on Euro Risk-Free Rates](#)

## Link to other jurisdictions



[FSB progress report](#)

## WG Recommendations



1. [Report by the WG on EONIA to €STR transition](#)



2. [Recommendations of the WG on the EONIA to €STR legal action plan](#)



3. [Report by the WG on the impact of the transition from EONIA to the €STR on cash and derivatives products](#)



4. [Report by the WG on the risk management implications of the transition from EONIA to the €STR and the introduction of €STR-based fallbacks for EURIBOR](#)



5. [Report by the WG on the financial accounting implications of the transition from EONIA to the €STR and the introduction of €STR-based fallbacks for EURIBOR](#)



6. [Report on Fallback provisions in contracts for cash products and derivatives transactions referencing EURIBOR](#)



7. [Report on €STR fallback arrangements](#)

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