

## Box 2

### Update on reference rate reforms in the euro area

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#### **Sound benchmarks are necessary for the efficient functioning of the financial system.**

Benchmark rates are important because of their anchoring role for contracts in financial markets. In addition, benchmark rates play a pivotal role in the operationalisation and monitoring of the transmission of the ECB's monetary policy.<sup>17</sup> Benchmark rates have been undergoing in-depth reforms over the last few years. These reforms have been largely guided by a set of principles<sup>18</sup> issued by the International Organization of Securities Commissions (IOSCO) in 2013 as a response to the scandals related to the manipulation of LIBOR. As a result of those reforms, market practices and contracts might need to be adapted to a new environment in the years to come.

**In the euro area, the euro interbank offered rate (EURIBOR), which is the interbank unsecured benchmark in euro published for maturities ranging from 1 week to 12 months, has been gradually reformed in order to anchor its methodology in transactions rather than in quotes.** The feasibility of a fully transaction-based methodology was tested by the EURIBOR

<sup>17</sup> For example, in August 2016 the European Commission estimated the total value of contracts indexed on EURIBOR at around €180 trillion for derivatives markets and around €1 trillion for mortgages. The figure for EONIA, as reported by the European Commission in June 2017, is in excess of €5 trillion, the majority of which is in the overnight index swap market.

<sup>18</sup> "Principles for Financial Benchmarks", IOSCO, July 2013.

administrator, the European Money Markets Institute (EMMI). However, the conclusion of this test, published in May 2017, was that the volume of unsecured money market transactions was insufficient to build a robust benchmark fully based on the current flow of daily market transactions. Consequently, EMMI is working with market participants on a possible hybrid methodology for EURIBOR which would combine transaction data with expert judgement. In the meantime, the current quote-based methodology will continue to be used to calculate EURIBOR. EMMI has indicated that the development of the hybrid methodology and impact assessment should take until the first half of 2018 and will be followed by a stakeholder consultation.

**EMMI, which is also the administrator of the euro overnight index average (EONIA – an overnight benchmark based on actual interbank transactions), is leading a reform process for EONIA with the aim of making it compliant with the Benchmarks Regulation.**<sup>19</sup> This Regulation will apply fully from 1 January 2018. EMMI has already defined a new governance framework compliant with the new regulatory requirements, which should come into effect in 2018. EMMI has now undertaken the second phase of the EONIA review, which relates to the analysis of the market underpinning EONIA, to ensure that the benchmark's design is adapted to the economic reality it is intended to capture.

**The robustness of both EURIBOR and EONIA, which rely on the voluntary contributions of banks, is becoming a growing source of concern as the support of the contributing banks has been waning over time.** These banks are expected to report daily either quotes based on expert judgement (in the case of EURIBOR) or their overnight unsecured interbank lending transactions (in the case of EONIA). However, recently several banks have left one or the other panel, citing that the reform process is overburdening their procedures as the main reason for their departure, while involvement in benchmarks carries liability and reputational risks.

**On 11 August 2016 and 28 June 2017, respectively, EURIBOR and EONIA were designated as “critical benchmarks” by the European Commission under the Benchmarks Regulation in the light of their crucial importance for markets and the high number of contracts referencing them.** Special provisions of the Regulation apply to a benchmark that is designated “critical”, notably that the regulator, which in the case of EONIA and EURIBOR is the Belgian Financial Services and Markets Authority (FSMA), can require mandatory contributions to the benchmark if its representativeness is threatened, e.g. by the departure of panel banks. While this mechanism might provide a backstop solution, its application is limited to a maximum two-year period (initially only one year, which can be extended once by a further period of one year), and hence cannot be considered a long-term solution if the viability of such a benchmark is threatened.

**In the secured money market, Eurepo had served as a reference rate for the euro-denominated general collateral market until its discontinuation in January 2015 in view of its limited use and the repeated departures of panel banks contributing to the benchmark.** Since then, the launch of a new repo benchmark in euro has been examined by the private sector. EMMI and the European Repo and Collateral Council have been working on a repo benchmark based on the data captured by three of the most active automatic trading systems in Europe. An in-depth analysis of repo data since 2006 commissioned by EMMI highlighted that activity in the

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<sup>19</sup> Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 (OJ L 171, 29.6.2016, p. 1).

electronically traded repo market in euro is concentrated on very short-dated transactions, thus allowing the development of a purely transaction-based benchmark for a one-day tenor only. While the project is now at an advanced stage, the timeline for implementation has not yet been communicated by EMMI.

**For the unsecured money market, on 21 September the ECB announced that it will publish an overnight unsecured rate before 2020 on the basis of data collected under the Money Market Statistical Reporting (MMSR) Regulation.**<sup>20</sup> The interest rate would complement existing benchmark rates produced by the private sector and serve as a backstop reference rate. The high-level features of the benchmark will be communicated in the course of 2018 in the form of public consultations.

**Beyond the euro area, the question of the long-term viability of the London interbank offered rate (LIBOR) has similarly gained prominence.** In July 2017 the Financial Conduct Authority (FCA), as the UK regulator in charge of LIBOR supervision, argued that the underlying market that LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – was no longer sufficiently active and therefore the transition to a transaction-based methodology was no longer possible. Consequently, the FCA announced its intention to withdraw its support for LIBOR by 2021, possibly triggering a discontinuation of this widespread interest rate benchmark. Work on planning a transition to alternative reference rates based on transactions has therefore commenced in some jurisdictions, undertaken by private sector working groups on alternative risk-free reference rates. Such groups are usually supported by public sector participation and are tasked to look into available alternative rates and to put forward transition plans.

**A similar initiative has also been launched in the euro money market, and the alternative rates to EURIBOR will also be debated within a newly established working group on euro risk-free rates, which will be in charge of fall-back rates and issues related to the transition to possible euro short-term alternative rates.** The work of this group is aimed at following up on the recommendation of the Financial Stability Board's Official Sector Steering Group (OSSG) of July 2014 to identify and adopt one or more risk-free rates in each main currency area. The working group on euro risk-free rates will be composed of private sector entities and chaired by a representative of the private sector. It will be supported by public authorities and its secretariat will be provided by the ECB.

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<sup>20</sup> Regulation (EU) No 1333/2014 of the European Central Bank of 26 November 2014 concerning statistics on the money markets (ECB/2014/48) (OJ L 359, 16.12.2014, p. 97). Daily data collection by the ECB, conducted with the support of several national central banks, started in July 2016. Its main purpose is to provide the ECB with comprehensive, detailed and harmonised statistical information on money markets in the euro area. This is a necessary set of statistics for monetary policy purposes.