EURIBOR fallback rates for cash products

Christian Gau

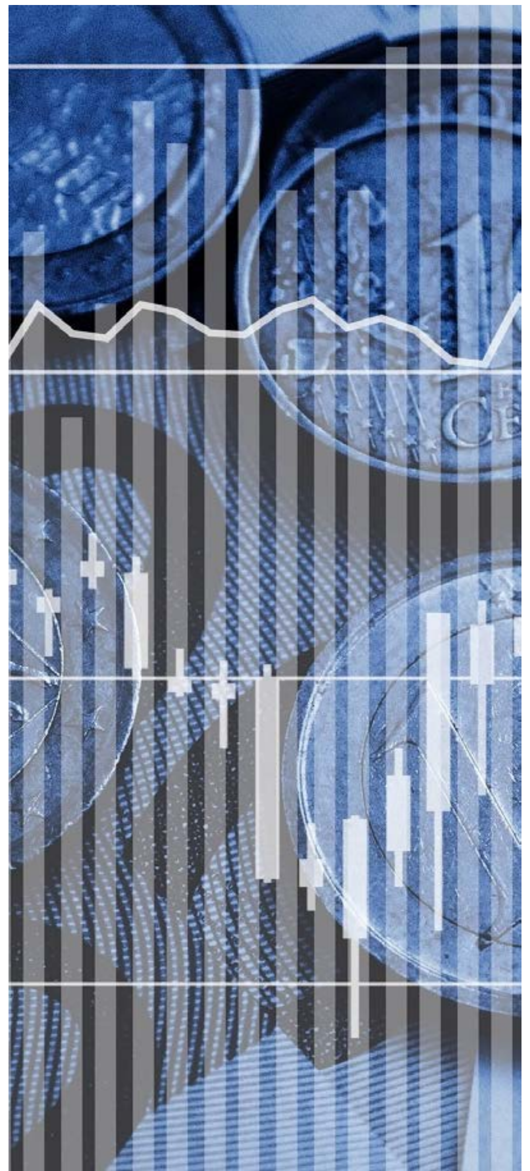
Deutsche Bank
Co-chair of the subgroup on cash and derivatives products

Anna Kozhevnikova

Generali
Co-chair of the subgroup on cash and derivatives products

Neil McLeod

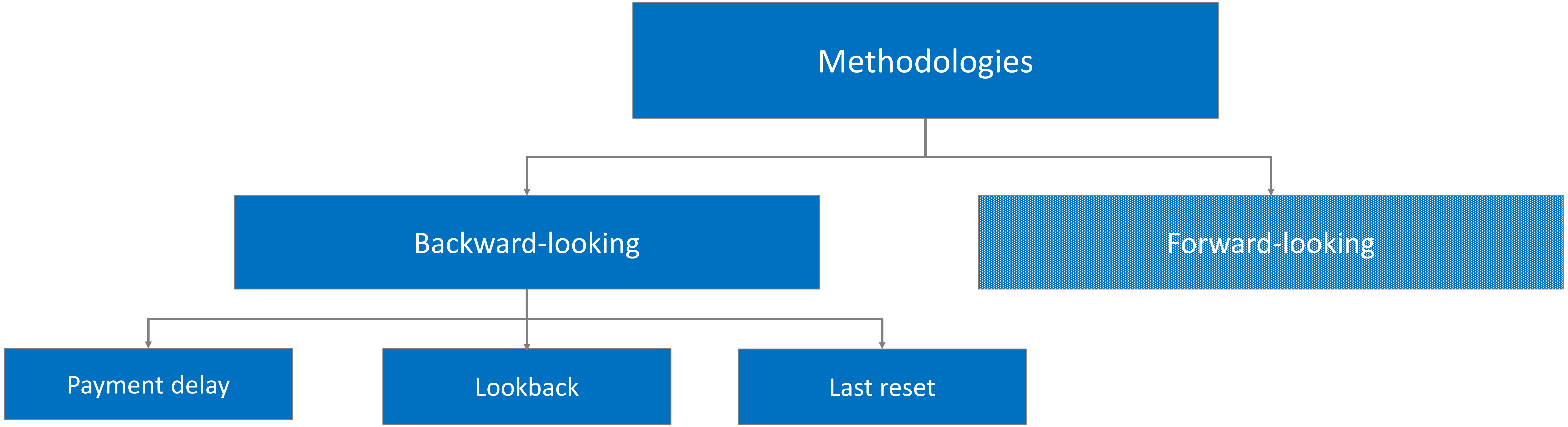
Erste Group
Chair of the use cases task force



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				
Professional market players	🟢	🟢	🟢	🟢
Corporates	🟢	🟠	🟠	🟢
SME/consumers	🟢	🔴	🟠	🟢
Hedging ease and hedge accounting impacts	🟡	🟢	🟢	🔴
Other accounting impacts	🟢	🟢	🟡	🔴
Risk management impacts	🟠	🟠	🟠	🔴
Consistency with other jurisdictions/asset classes	🟠	🟠	🟢	🟠

Colour code	
Feasible	🟢
Feasible with some minor changes/drawbacks	🟡
Feasible with some relevant changes/drawbacks	🟠
Questionable feasibility	🔴

€STR-based backward-looking term structure methodologies – proposals (1/2)

- 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**.

  - Although it is an in arrears methodology, it would **allow time for the calculation of payments, for billing**, and for borrowers/lenders to challenge any calculations in advance of payments
  - The lookback period methodology is helpful in the market where **there is a need to calculate interest accruing during an interest period** (e.g. for prepayments or calculations related to secondary trading), because it provides certainty for a given number of days at any point in the interest period
  - The **method is consistent with fallback arrangements in derivatives documentation based on ISDA** which would then **facilitate hedging ease** (although there may be a small mismatch in terms of the length of the lookback period)
  - It **may be easier to adopt from a systems perspective than other methods**, given that system providers have started working with this method for LIBOR transition
  - The **approach is consistent with cash products in most other jurisdictions in the absence of a forward-looking term rate** (e.g. SONIA syndicated loans, SONIA and SARON bilateral loans, SOFR FRN and SONIA FRNs)

€STR-based backward-looking term structure methodologies – proposals (2/2)

- The **backward-looking lookback period** term structure methodology is proposed for **corporate lending, debt securities** and **for transfer pricing models used by most financial institutions**.
- For **derivatives**, the working group acknowledges ISDA's EURIBOR fallback measures, i.e. **backward-looking lookback period** methodology for the term structure methodology, in combination with continued guidance on applicability to different product types – no need for further recommendations.
- The **payment delay** option would be a better fit for **current accounts** than the lookback period option as the balance on accounts can change every day and they do not have a predefined maturity. The lookback period option would be more difficult and complex to implement and handle from an operational point of view.

€STR-based forward-looking term structure use cases - proposals (1/2)

- **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 better suited. Conclusion of the working group was that this methodology would be necessary for the following use cases:

    - Mortgages, consumer and SME loans
    - Trade finance
    - Export and emerging markets finance products

- For those use cases, **the working group recommends introducing the forward-looking rate into contracts via a "waterfall structure".** This waterfall structure approach implies that any EURIBOR fallback relying on a forward-looking term structure methodology would also entail a backward-looking term structure methodology or another appropriate alternative as a second layer of fallback. The working group believes this would mitigate the risk of the forward-looking methodology not being available.

€STR-based forward-looking term structure use cases - proposals (2/2)

- **For mortgages, consumer and SME loans** the following issues were considered:
  - What is a **sufficient period of notice** for the end users of these products, considering this rate is a fallback to an existing forward-looking rate.
  - What is necessary when considering the **financing for SME groups** on a discounted basis.
  - Are there any fundamental concerns using a **compounded rate** for a retail loans.
  - Are there any significant differences in the **understanding of the rate** for the less sophisticated end users.
- **Trade finance, export and emerging markets finance**
  - Considerations for **factoring, discounting receivables,** etc. for the trade finance business
  - Complexity of the borrower, legal environment and the need for much longer payment notice periods for emerging markets finance

- The **last reset backward-looking** methodology calculates the interest at the beginning of the period. However, the Working Group concluded the methodology had the following challenges:
  - **Feasibility for tenors longer than 3 months** and the disconnection with the interest period it represents
  - **Accounting issues** specifically regarding the time value of money IFRS SPPI test
  - **System and model requirements** when implementing within retail banking systems
  - **Hedging costs and complexity** when using the derivative market to manage the interest rate risk

Other cases - proposals

- For **Securitisations**, due to their interrelationship with the underlying assets, the Working group suggest applying the following:

    - For those securitisations that will include **underlying assets** where the working group has identified **the backward-looking lookback period term structure methodology as a suitable EURIBOR fallback measure (e.g. syndicated loans, business loans and debt securities)**, the inclusion of a similar EURIBOR fallback measure is recommended

    - For those securitisations that will include **underlying assets** where the working group has **identified the forward-looking term structure methodology as the most suitable EURIBOR fallback measure (e.g. mortgages and SME loans),** the working group believes it would be appropriate to include the same waterfall structure as a EURIBOR fallback measure.

- For **investment funds** the Working Group does not make a concrete proposal and would like to gather feedback from interested parties taking into account possible interactions between asset classes and related instruments.

€STR-based term structure methodologies – Summary

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)
								For corporates and some financials:	**For most financials:**	
Fallback methodology recommended for the first level of the waterfall	BWL lookback	FWL	BWL payment delay	FWL	FWL	BWL lookback	*Depending on the underlying assets*	FWL	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	*Depending on the underlying assets*	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

- 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.

- Alternative methodologies suffered from:
  - requiring market **data** that might **not** be **sufficiently available** or not available close to the potential cessation date
  - triggering **data access and administration issues**, e.g. vendors have little appetite to publish spread adjustment data that is not used until a fallback scenario kicks in
  - vulnerability to undue impacts and **market distortions**

- The **historical mean/median** is the **spread adjustment methodology adopted by ISDA, the ARRC and the Sterling WG** and allows to:
  - reflect **current market conditions** whenever fallbacks take effect (no “cliff effect”)
  - consider tendency of interest rates to fluctuate around the long-term mean
  - benefit from long term average market conditions being **less impacted by temporary market distortions**
  - use **information** that´s readily **available**
  - The Working Group expects it to be broadly accepted by market participants as this methodology has been widely adopted in other jurisdictions and across asset classes

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.

Q&A session

Christian Gau
- Deutsche Bank
- Co-chair of the subgroup on cash and derivatives products

Kam Mahil
- Loan Market Association (LMA)
- Member of the working group

Anna Kozhevnikova
- Generali
- Co-chair of the subgroup on cash and derivatives products

Tilman Lueder
Alessandra Atripaldi
- European Commission

Neil McLeod
- Erste Group
- Chair of the use cases task force

Michele Mazzoni
- European Securities and Markets Authority (ESMA)

Jaap Kes
- ING Bank

Helmut Wacket
- European Central Bank

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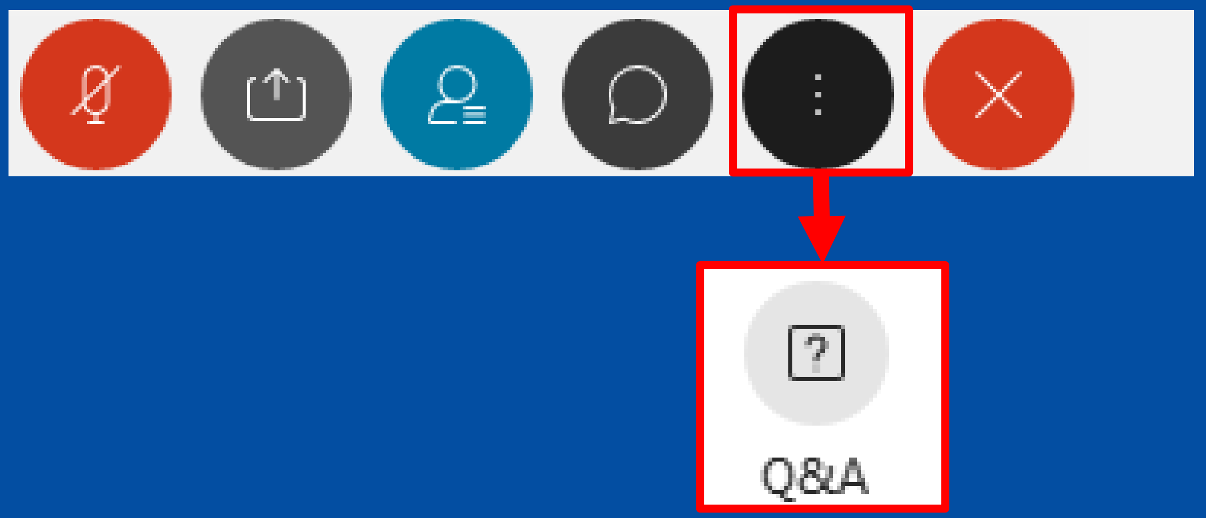

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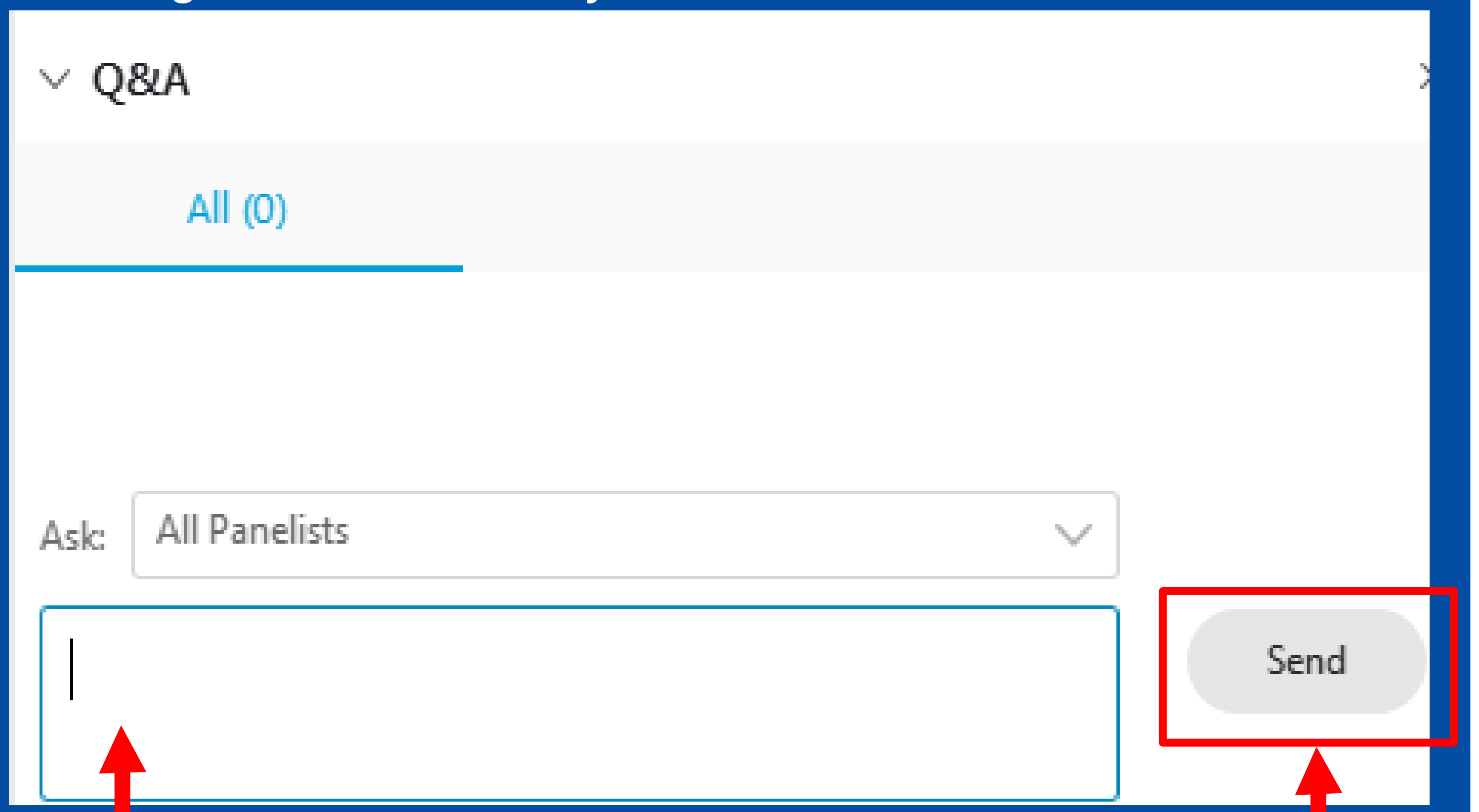

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