EUROPEAN CENTRAL BANK

EUROSYSTEM

Teleconference of the working group on euro risk-free rates

Thursday, 10 September 2020, 09:30-13:30 CET

SUMMARY

1. Introductory remarks, approval of the agenda and obligations of working group members under competition law

Tanate Phutrakul, the new Chair of the working group on euro risk-free rates, opened the call, pointing out that the main purpose of the meeting was to discuss the first drafts of the public consultation on euro interbank offered rate (EURIBOR) fallbacks for cash and derivatives products and the pubic consultation on EURIBOR fallback triggers scheduled for publication by the end of 2020.
Mr Phutrakul reminded the members of the working group of their obligations under EU competition law, as described in the guidelines on compliance with EU competition law published on the ECB's website.

2. Update by subgroup 3 on the EURIBOR legal action plan

2.1 Update by the European Commission on the BMR review

Tilman Lueder (European Commission) presented the legislative proposal for amending the EU Benchmark Regulation (BMR)[1] that is currently being discussed by Member States in the European Council. Discussions between Council and Parliament are expected to take place in October 2020.

Under the proposed legislation, the Commission would have the power to designate a statutory rate to replace references to a critical or otherwise systemically relevant benchmark that ceases to be published at a given moment in the future. In particular, the new Commission powers would ensure that statutory or mandated replacement rates published outside of the European Union could apply to all financial contracts, financial instruments and performance measurement tools based on EU law that are entered into or used by a supervised entity subject to the BMR if they do not contain fallbacks.

In response to questions from members of the working group, **Mr Lueder** clarified that, in exercising the proposed new powers, the European Commission would aim to align itself with the recommendations of the risk-free rate working groups convened by the public authorities of the relevant currency areas covered by the benchmark in cessation. As the designation powers are premised on the fact that the relevant working groups on risk-free rates recommend a replacement rate, the applicable spread adjustment to limit unwanted value transfer to the extent possible and the conforming contract changes, **Mr Lueder** invited the working group on euro risk-free rates to address all three aspects in its forthcoming EURIBOR fallback recommendations.

2.2 Public consultation on EURIBOR fallback triggers

José Carlos Pardo (BBVA) presented the draft public consultation on EURIBOR fallback trigger events.

The draft consultation paper has been updated in the light of the proposal published by the European Commission to amend the BMR, which recognises two cessation and one pre-cessation trigger events.[2] The list of events included in the consultation paper that would trigger the activation of the EURIBOR fallback provisions has been slightly amended to recommend the inclusion of a "pre-cessation trigger"[3] instead of asking respondents to state their preference about whether to include one or not (as presented in the working group meeting on 2 July 2020).

Working group members then discussed whether a material change to EURIBOR's methodology should be deemed a EURIBOR fallback trigger event and, if so, whether it should be presented in the public consultation separately from the other proposed trigger events as an optional trigger that counterparties can consider including in their contracts. This trigger would always require further negotiation between counterparties.

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1 Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 as regards the exemption of certain third country foreign exchange benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation, COM(2020) 337 final, 24 July 2020.

2 See the proposed Article 23a(1)(a).

3 The "pre-cessation trigger" would be a trigger event where a supervisor of the EURIBOR issues a public statement in which the benchmark is assessed as being no longer representative.

3. Update by subgroup 7 on the communication actions and the next steps to promote the public consultations

Maite Bermúdez (Santander) pointed out that the coronavirus (COVID-19) outbreak had had an adverse impact on communication-related activities, as it was difficult to reach out to and meet with stakeholders. However, the majority of the working group ambassadors had been able to maintain some contact with their local regulators and banking associations, updating them on the working group's progress through conference calls and video conferences.
Ms Bermúdez reported that the next steps would be to develop a communication plan for the two public consultations on EURIBOR fallbacks. Future newsletters and FAQs published on the ECB's website would be updated in line with the progress made by the working group.

4. Update by subgroup 5 on the consultation on EURIBOR fallbacks (cash products and derivatives)

4.1.a. Feedback from the IASB on hedge accounting and SPPI testing implications with regard to different EURIBOR fallback measures

As a follow-up to items 2.1(b) and (c) of the last working group meeting[4], on 8 July 2020 the working group sent a letter to the International Accounting Standards Board (IASB)[5] identifying International Financial Reporting Standard (IFRS) 9/IAS 39 hedge accounting issues and IFRS 9 solely payment of principal and interest (SPPI) testing issues related to the use of certain EURIBOR fallbacks. In that letter, working group members asked the IASB to provide guidance on (i) the possible use of basis swaps to maintain the hedge accounting relationship upon activation of the fallback and (ii) the use and form of regulated rates for SPPI testing.

On 14 July a call took place between IASB staff and representatives of the working group and of subgroup 5. Regarding **hedge accounting**, the IASB staff clarified the two conditions set out in the Interest Rate Benchmark Reform – Phase 2 amendments[6]:

1. changes introduced should be a direct consequence of the interbank offered rate (IBOR) reform, i.e. entities should substantiate whether the changes introduced are required by the reform;
2. the economic equivalence basis should be met, i.e. the contractual cash flows before and after the changes introduced by the reform should be economically equivalent.

As long as those preparing financial statements can demonstrate that the changes being made fulfil these two conditions, no impact should be expected. The IASB staff explained that circumstances will be different from jurisdiction to jurisdiction, but these principles should always be met. For that reason, the IASB did not consider it necessary to provide prescriptive or exhaustive examples.

The IASB staff also clarified that the explanations regarding basis swaps included in (1) IASB staff paper 14b (28-30) for the June 2020 IASB board meeting and (2) basis for conclusions BC309 in the final IBOR Reform – Phase 2 amendments (as published on 27 August 2020) were based on the responses to the IBOR Reform – Phase 2 exposure draft. Respondents referred to changes that entities may wish to introduce on an optional/voluntary basis in order to manage hedge ineffectiveness without differentiating on the basis of whether or not the changes were required by the IBOR reform. Therefore, it was the IASB's intention to clarify that changes that are not required by the IBOR reform are not covered by the relief set out in the amendments.

The IASB staff said that in principle any change needs to meet both conditions (i.e. required by the reform and economically equivalent) for it to be in scope of the relief in the amendments. In line with this principle, the IASB staff confirmed that if the working group determines that there are some use cases with a EURIBOR fallback in a hedged item that deviates from the EURIBOR fallback in hedging derivatives that would require the inclusion of a basis swap in a hedge relationship in order to meet both conditions, then the inclusion of a basis swap in a hedge relationship would be in scope of the amendments. In this case, an entity would not have to undesignate and redesignate the hedge relationship.

Taking into account the feedback received from the IASB, working group members concluded that they would continue the analysis of suitable EURIBOR fallback measures. If the working group considered it recommendable to include a EURIBOR fallback in a typically hedged cash product that may deviate from the EURIBOR fallback in hedging derivatives based on the language of the International Swaps and Derivatives Association (ISDA), this would need to be substantiated in a specific use cases analysis and subjected to broader public consultation. If a large majority of the market respondents agree with the use cases, pointing to a real market consensus, this could support the final recommendations from the working group on euro risk-free rates. For those use cases, in the event EURIBOR ceases to exist, the inclusion of a basis swap in a hedge relationship could then be seen as required by the reform without having to undesignate and redesignate the hedge relationship.

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4 See Minutes of the teleconference of the working group on euro risk-free rates on 2 July.

5 Letter from the working group on euro risk-free rates to the IASB, 8 July 2020.

6 Interest Rate Benchmark Reform – Phase 2 (Amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16), IFRS, August 2020.

Regarding **SPPI testing,** the IASB staff mentioned the IASB's guidance on this topic from 2009, 2013 and 2014 which already referred to "time value of money" mismatches on interest rates, average interest rates and lagging rates and in which the IASB clarified that, even in those cases, the SPPI test could still be met. IFRS 9 is not prescriptive in the analysis of the time value of money and acknowledges that it can be imperfect and still meet the SPPI test. IFRS 9 looks at whether the modified time value of money component could result in contractual cash flows that are significantly different from "perfect" cash flows.

Regulated rates are, however, something specific. They are not rates freely established by the market but rates that are set by the government or a regulatory authority as part of macroeconomic policy or, for instance, to encourage entities to invest in a particular sector of the economy.

Taking into account the IASB feedback, in the opinion of the working group, the nuance rests in testing how "significantly" different the contractual cash flows with a modified time value of money are from perfect cash flows. IFRS 9 does not provide a definition of or threshold for "significant", and instead leaves this to the discretion of entities in their own accounting policy, which can range from 5% up to 10%. Particularly when replacing longer EURIBOR tenors (6 or 12 months) and in volatile markets where rates can diverge more than significantly, it is likely that this could result in the failure of the SPPI test.

For that reason, the working group will further explore whether there is indeed a need for a backward-looking last reset term structure methodology for certain use cases and, if so, its advice would be to:

1. recommend its use only for shorter tenors;
2. inform market participants of potential risks;
3. offer an alternative to the last reset methodology for market participants to consider.

4.1.b. ECB public consultation on euro short-term rate (€STR) compounded rates

Pascal Nicoloso (ECB) presented the public consultation on the publication by the ECB of €STR compounded term rates[7] in which it asks the public to submit views on the main features of the compounded term rates (maturities, compounding formulae, day count convention, publication policy and number of decimal places for the rate and the index value).

The motivation for the ECB to publish such rates is to support the use of compounded rates as alternatives to risk-free rates and EURIBOR fallbacks. As these would need to be available even in adverse market circumstances, they will benefit from the robustness of the €STR, which underlies these rates.

4.2 Presentation of the draft consultation on EURIBOR fallbacks

Anna Kozhevnikova (Generali) presented the latest changes to the subgroup 5 consultation, taking into account the deliberations of the working group at its 2 July meeting.

During the working group meeting on 2 July, working group members agreed that backward-looking rates provide the most robust options as a EURIBOR fallback and, since, under the ISDA documentation, derivatives would fall back on backward-looking rates, using them would avoid market fragmentation. At the same time, feedback received during the working group's second public consultation on term rates pointed to a possible preference for forward-looking term rates, particularly for the products used by less sophisticated/non-professional market participants. Moreover, certain products may require the rate to be known in advance owing to business needs.

For these reasons, it was agreed to conduct a substantiated use cases analysis to identify the limited set of cash products for which forward-looking rates would be recommendable. In such cases, the working group would also recommend a waterfall structure in the fallback provision to cater for the possibility that forward-looking rates might not be available or robust enough at the time the fallback is triggered. The second level of this waterfall structure should therefore refer to a backward-looking fallback.

In order to conduct such use cases for forward-looking rates analysis, a Task Force was established under the leadership of **Neil McLeod (Erste)**.

During the subsequent discussion, **Cornelia Holthausen (ECB)** challenged the notion that less sophisticated users would not be able to adapt to the backward-looking *in arrears* methodologies, giving the example of the Swiss market where the transition to these rates had started and end users seem to accept them. Backward-looking rates are the most robust options; they are readily available and are also technically simple to understand. At the same time, judging from the latest €STR overnight index swap (OIS) data published by LCH,[8] liquidity in the €STR market remains low, thus creating uncertainty about the feasibility of robust and reliable forward-looking rates based on the €STR OIS market. In **Ms Holthausen's** view, the working group should consider adding questions to the public consultation to find out whether in arrears methodologies present any significant impediments for users and whether such potential impediments could be removed.

7 "ECB announces public consultation on the publication of compounded €STR rates", *press release*, ECB, 24 July 2020.

8 See "RFR Volumes" on the LCH website.

Finally, **Ms Holthausen** added that the ECB would be interested in having an estimate of the potential share of the euro market that could be linked to forward-looking rates should such rates be recommended by the working group. Other national working groups, e.g. the Sterling working group, had already conducted such a survey.

One member of the working group explained that the Swiss market cannot be compared to the EU market because (1) the Swiss market is relatively small and lacked the possibility of creating a forward-looking rate, given the absence of a Swiss Average Rate Overnight (SARON) OIS or futures market, and (2) the take-up of backward-looking in arrears methodologies is primarily seen in new mortgage products, but is not yet established for legacy mortgage products. In addition, several working group members highlighted that the EONIA-€STR transition is under way, with the expectation that liquidity in the €STR OIS market will increase during the remainder of 2020/2021 and reach the same level of liquidity observed in the current EONIA OIS market by the time EONIA ceases to exist on 3 January 2022, supporting the existence of the forward-looking rates in the future. A few members also pointed to the importance of forward-looking rates and the fact that other jurisdictions are still considering using them as part of waterfall structures and expressed the view that they should be considered for a broader range of use cases.

Tilman Lueder (EC) pointed out that different fallback recommendations by the working group, depending on asset classes or a waterfall structure, could work for the implementation of a statutory solution, but that the implementation would be very difficult if the working group recommendations are too granular in terms of the proposed EURIBOR fallbacks and include too many exceptions. The statutory rate would work better with a harmonised fallback landscape. Working group members were reminded that the replacement benchmark designated by the Commission would not apply in cases where market participants decide to renegotiate their contracts and opt for different rates.

4.3 Adoption of ISDA's 2006 definitions and protocol

Rick Sandilands (ISDA) informed working group members that on 22 July ISDA had sent a letter to the Chairs of all the risk-free rate working groups and to the Official Sector Steering Group (OSSG)[9] outlining its plans for the launch of the IBOR Fallback Protocol and the IBOR Fallback Supplement to implement the new fallbacks for legacy and new derivative contracts, respectively. These documents should ensure that robust fallbacks will be installed for derivative contracts under ISDA documentation to certify contractual robustness in the case of a cessation of IBOR benchmarks.

ISDA encourages broad-based adherence to the protocol. In order to facilitate this, ISDA will offer "adherence in escrow", whereby market participants can adhere to the IBOR Fallback Protocol prior to the launch date. This adherence will be binding and complete, but the adhering entity's name and information will not appear on ISDA's website until the official launch date of the protocol.

Wide take-up of this adherence in escrow process will result in a broad and comprehensive list of adherents at the time the IBOR Fallback Protocol launches and thereby indicate to the market an expectation of widespread use of the new fallbacks.

For more information, **Mr Sandilands** directed working group members to ISDA's website[10], where they can find educational material, webinars and frequently asked questions and answers. He also mentioned that ISDA is providing bilateral templates for EONIA amendment agreements which parties can use to amend legacy transactions or existing collateral agreements so that they reference the €STR instead of EONIA.

During the discussion that followed, **Cristian Weststeijn (ESMA)** expressed support for those documents and encouraged market participants to adhere to them. Subsequently, **Cornelia Holthausen (ECB)**, as OSSG member, reminded working group members that ISDA was tasked by the OSSG/Financial Stability Board (FSB) to amend the 2006 ISDA Definitions and provide protocols that introduce robust and workable IBOR fallbacks, and that the publication of the EURIBOR fallback protocol is a major step in the right direction to improve the robustness of derivative contracts. She thanked ISDA for the work it has done, expressing the hope that users of ISDA documentation would not hesitate to subscribe to these fallback protocols so that their contracts remain robust and functional and in order to ensure market stability and consistency across derivatives products.

5. AOB

5.1 Proposal to close subgroup 6 on risk management and hedge accounting

Jaap Kes (ING) noted that subgroup 6 had been "dormant" since the publication of its second report in November 2019. Since then it had been kept informed, and in the course of recent months it had been consulted on topics in its area of competence regarding hedge accounting and SPPI testing issues. However, with the finalisation of the EURIBOR fallback consultation, subgroup 6 will have completed the tasks under its terms of reference[11], in which it

9 Letter on the adherence to the ISDA IBOR Fallback Protocol, 22 July 2020.

10 ISDA's website

11 Terms of reference for subgroup 6 on risk management and accounting issues.

was tasked with “analysing the impact on financial accounting and risk management of (i) the transition from EONIA to the €STR and (ii) the inclusion of fallbacks to Euribor based on a €STR-based term structure methodology and the possible fallback triggers”.

For that reason, the Chair of the working group – in close agreement with subgroup 6 Chair **Markus Schmidtchen (KfW)** – proposed the closure of subgroup 6. The proposal was unopposed. The Chair and working group members expressed their gratitude to **Mr Schmidtchen** and the members of subgroup 6 for their timely and impeccable work in support of the working group deliverables.

List of participants

Participant's organisation	Name of participant
Chairperson	Mr Tanate Phutrakul
ING	Ms Marjolein de Jong-Knol
Voting members	
Bank of Ireland	Mr Barry Moran
Barclays	Mr Andreas Giannopoulos
Bayerische Landesbank	Mr Harald Endres
BBVA	Mr José Carlos Pardo
BBVA	Mr Adolfo Fraguas
BNP Paribas	Ms Dominique Le Masson
BNP Paribas	Mr David Gorans
BPCE/Natixis	Mr Olivier Hubert
CaixaBank, S.A.	Mr Francesc Xavier Combis Comas
Crédit Agricole	Ms Florence Mariotti
Crédit Agricole	Mr Laurent Cote
Deutsche Bank	Mr Juerguen Sklarczyk
DZ Bank	Mr Philipp Nordloh
Erste	Mr René Brunner
Erste	Mr Neil McLeod
Eurobank SA	Mr Theodoros Stamatiou
HSBC	Ms Nathalie Gay Guggenheim
ING Bank	Mr Jaap Kes
Intesa Sanpaolo	Ms Maria Cristina Lege
KfW Bankengruppe	Mr Markus Schmidtchen
KfW Bankengruppe	Mr Ingo Ostermann
LBBW	Mr Jan Misch
Nordea	Ms Jaana Sulin
Santander	Ms Maite Bermúdez Santander
Santander	Mr Javier Pareja
Société Générale	Mr Olivier Balpe
UniCredit Bank	Mr Umberto Crespi
Non-voting members	
European Money Markets Institute	Mr Jean-Louis Schirmann (recused of Item 4)
European Money Markets Institute	Ms Petra de Deyne (recused of Item 4)
EFAMA	Ms Agathi Pafili
International Capital Market Association	Ms Katie Kelly
International Swaps and Derivatives Association	Mr Rick Sandilands
International Swaps and Derivatives Association	Mr Jonathan Martin
Loan Market Association	Ms Kam Mahil

Invited institutions

European Investment Bank	Mr Thomas Schröder
Generali	Ms Anna Kozhevnikova

Observers

European Central Bank	Ms Cornelia Holthausen
European Commission	Mr Tilman Lueder
European Commission	Ms Alessandra Atripaldi
European Commission	Mr Rik Hansen
European Securities and Markets Authority	Ms Iliana Lani
European Securities and Markets Authority	Mr Michele Mazzoni
European Securities and Markets Authority	Mr Cristian Weststeijn
Financial Services and Markets Authority	Mr Randy Priem

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European Central Bank	Mr Vladimir Tsonchev