21 September 2020
ESMA80-187-627

2021: A Defining Moment for The Interest Rates Reform

City Week 2020 – London

Steven Maijoor
Chair
European Securities and Markets Authority

Introduction

Good morning Ladies and Gentlemen,

It is my great pleasure to participate today in the City Week 2020 forum.

The interest rates reform is one of the key challenges that the global financial system is currently facing. Therefore, I would like to thank City & Financial Global and the other institutions involved in the organisation of this forum for inviting me and for including in the agenda a panel discussion on this very important matter.

Today, before participating in the panel discussion, I would like to speak about recent and expected developments of the global interest rates reform and the crucial role that the cooperation between public authorities and the financial industry is playing in this process.

€STR: the new risk-free rate for the euro area

As Chair of a European Authority, please allow me to start with an overview of interest rates transition in the euro area and the challenges that lie ahead of us.

We are soon approaching the first-year anniversary of the Euro Short-Term Rate, or €STR[1], which has been published by the ECB since 2nd October 2019. This rate is arguably the core element of the interest rate reform in the euro area, and I will try to explain why this is the case.

€STR is an unsecured overnight rate, reflecting borrowing costs of banks located in the euro area. It is fully based on transactions and it has been recommended as the risk-free rate for the euro area by the Working Group on Euro Risk Free Rates[2], the reference industry group in which ESMA participates.

€STR will replace the previous euro overnight rate, EONIA, which will be discontinued on the 3rd of January 2022[3]. Until such replacement, EONIA is currently computed as "€STR plus a fix spread of 8.5 basis points". This change in the calculation of EONIA was recommended by the Working Group on Euro Risk Free Rates[4] and it has been widely recognised by international stakeholders as a successful strategy. This approach allowed the transition to €STR to start in a *fast-track* mode and avoided the frustration of EONIA contracts. As EONIA is now fully anchored to €STR, it incorporates the strengths of €STR, one of which being that it is fully based on transactions.

In the next months and in 2021 the transition efforts should focus on completing the switch from EONIA to €STR and thus providing deeper €STR liquidity.

To do so, the first step is for market participants to actively use €STR instead of EONIA in their new contracts. To incentivise the direct use of €STR, a key milestone was the switch of CCPs from the EONIA discounting curve to the €STR discounting curve. The most relevant European CCPs performed the switch at the end of July 2020[5].

[1] https://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/euro_short-term_rate/html/index.en.html
[2] https://www.ecb.europa.eu/press/pr/date/2018/html/ecb.pr180913.en.html
[3] https://www.emmi-benchmarks.eu/euribor-eonia-org/about-eonia.html
[4] https://www.ecb.europa.eu/pub/pdf/annex/ecb.sp190314_annex_recommendation.en.pdf
[5] https://www.eachccp.eu/wp-content/uploads/2020/04/EACH-statement-on-the-transition-from-EONIA-to-%E2%82%ACSTR-discounting-regime.pdf

Because of the crucial role CCPs play in interest rate derivative markets, over the course of the next months the CCPs discounting switch is expected to give a boost to €STR derivatives. As of today, the €STR swaps market activity remains fairly low comprising around 2% of the swaps market volume in August 2020, according to LCH public data[6]. The COVID-19 crisis also contributed to the slow development of the €STR-derivative markets so far, as during this period market participants preferred to use the most liquid EONIA products.

However, thanks to the CCPs switch and the fact that EONIA is anchored to €STR, at ESMA we expect the high liquidity of EONIA derivative markets to gradually move to the €STR derivative markets in the next months, ahead of the EONIA end-date in January 2022. The widespread use of €STR derivative contracts should therefore be a matter of time, following a pattern already seen in the UK and the US with reference to their overnight risk-free rates, SONIA and SOFR.

To further enhance the role of €STR in the European financial system, this summer the ECB launched a consultation[7] seeking feedback on the publication of compounded €STR by the ECB. This consultation ended in mid-September and its result should be published in the coming days. The publication of compounded €STR by the ECB would represent an important step forward, strengthening the interest rate landscape in the euro area. I fully support that step.

Compounded €STR will benefit from €STR robustness, as it is built on an active overnight borrowing market. This means that even in times of market uncertainty, when long-term market activity may be declining, compounded €STR will remain robust because the overnight markets remain by far the most liquid.

Moreover, the daily publication of compounded €STR by the ECB would ensure international consistency, as the Bank of England and the US FED already took the

[6] https://www.lch.com/services/swapclear/volumes/rfr-volumes
[7] https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200724~6aab0ffe50.en.html

decision to publish the compounded version of their overnight risk-free rates SONIA and SOFR.

Considering all this, it is clear that compounded €STR can represent a key factor to enhance the use of €STR, particularly in cash products. And there is more, as compounded €STR is also one of the main candidate fallback rates to be used in EURIBOR contracts.

So, €STR will not only fully replace EONIA, but will also play a crucial role in relation to EURIBOR, and that is why I consider €STR an important pillar of the interest rate reform in the euro area.

The state of play of EURIBOR

I would now like to say a few words about EURIBOR. I know that EURIBOR is followed with great interest in London, as market participants wonder whether it will suffer the same fate as LIBOR.

Let me start with the latest developments. During the recent outbreak of COVID-19, EURIBOR continued to be regularly published by its administrator. While the liquidity in the underlying market started to decrease between Q1 and Q2 this year, since May it has started to improve again, moving back to the levels seenbefore COVID-19. This is surely positive news.

Also, at the peak of the COVID-19 crisis, EURIBOR continued to react smoothly to monetary decisions by the ECB, playing its role in the monetary transmission mechanism for the euro area. All in all, we can say that EURIBOR navigated the difficult last months in an appropriate manner.

The hybrid methodology that is used to calculate EURIBOR allowed for this smooth navigation.

This methodology is based on a waterfall approach composed of several layers of input data. At ESMA we consider this hybrid methodology robust, resilient and transparent, as well as compliant with the applicable EU Benchmarks Regulation.

As you may be aware, in July 2019 EURIBOR was authorised under the EU Benchmarks Regulation by the Belgian FSMA and the relevant College of Supervisors, of which ESMA is a member. The authorisation of EURIBOR allows EU supervised entities to continue using EURIBOR for the foreseeable future.

ESMA will substitute the Belgian FSMA as supervisor of EURIBOR in January 2022 and I can clearly state that, as of today, the discontinuation of EURIBOR is not part of our plans. So, ahead of us there are diverging paths for LIBOR and EURIBOR.

However, there is an equally important message I would like to share with you today in relation to EURIBOR.

For ESMA, the robustness of contracts of the financial products that reference EURIBOR will be a supervisory priority. This can be achieved with the inclusion of effective fallback provisions in all EURIBOR contracts.

EURIBOR users and their clients should be able to know in advance what will happen to their contracts if EURIBOR is maybe discontinued one day. As a regulator, we are aware that the implementation of the fallback provisions in relation to EURIBOR has been somewhat slow to date. This is why I would like to reinforce the message about the importance of introducing fallbacks in EURIBOR contracts. They ensure the continuity of contracts in the unlikely scenario of discontinuation of EURIBOR, increasing legal certainty and minimising frustration risks.

We do not think that supervised entities can afford to take any risk of contract frustration vis-à-vis EURIBOR products. Moreover, under the EU Benchmarks Regulation (Article 28(2) for those who like precision), it is a regulatory requirement for EU supervised entities to incorporate fallback provisions in their EURIBOR contracts.

The good news is that market participants will very soon be equipped with new effective tools to meet the requirements of the EU Benchmarks Regulation regarding fallback provisions. Indeed, relevant protocols are currently being published by trade associations, while the Working Group on Euro Risk Free Rates is about to finalise key recommendations on EURIBOR fallback provisions. I hope to get the chance to speak about these recommendations in greater detail during the upcoming panel discussion.

The need to prepare for LIBOR discontinuation

I cannot conclude my speech at this City event without referring to LIBOR.

In the last months, the Bank of England and the FCA confirmed[8] that the COVID-19 pandemic did not change the central assumption that firms cannot rely on LIBOR being published after the end of 2021.

Similarly, the recent report of the Financial Stability Board to the G20 on the LIBOR transition supervisory issues[9] highlighted the clear risks to global financial stability posed by continued reliance on LIBOR. The same report argued that a significant negative impact may be felt by both financial and non-financial institutions unless adequate preparations are made.

Public authorities in the UK, the US and elsewhere agree that the LIBOR transition effort needs now to accelerate as the end of 2021 quickly approaches. Continued engagement from the private sector, in conjunction with a significant commitment by the public sector, is crucial in order to support this transformational effort.

In this respect, key progress has been made over the course of the last months thanks to the commitment of the industry groups in the UK and the US: the Working Group on Sterling Risk-Free Reference Rates in the UK and the Alternative Reference Rates Committee in the US.

The global use of US dollar LIBOR represents arguably the most challenging element of the LIBOR transition.

[8] https://www.fca.org.uk/news/statements/impact-coronavirus-firms-libor-transition-plans
[9] https://www.fsb.org/2020/07/supervisory-issues-associated-with-benchmark-transition-report-to-the-g20/

Hence, I am glad to see that the Chair of the Alternative Reference Rates Committee, Thomas Wipf, will participate in the panel discussion, so that we can hear from him about the latest developments in relation to US dollar LIBOR.

Legislative initiatives to strengthen the LIBOR transition

US dollar LIBOR exposures are particularly relevant among European market participants. The transition away from LIBOR represents therefore a significant priority also from a European perspective. The EU institutions are following this situation very closely.

The European Commission recently published a proposed law to amend the existing EU Benchmarks Regulation[10]. The aim of the proposed amendments is to ensure an orderly cessation of LIBOR in the EU and to increase legal certainty around the discontinuation of this rate in relation to contracts involving EU parties. The European Parliament and the European Council are now considering this proposal, which can become EU Law by the end of this year.

A similar legislative initiative has been taken by the UK Government, which in July announced that it intends to bring forward legislation to give the FCA[11] enhanced powers to cope with LIBOR discontinuation.

It is evident that the public sector is working intensively to foster the interest rates reform. It was thanks to the cooperation among central banks and market authorities that the risk-free rates industry groups were established in different jurisdictions. In parallel, central banks all over the world started to publish risk-free rates and actively supported their use by financial firms, while market authorities oversaw the change in the methodologies used to calculate -IBOR rates. Now the initiatives adopted by legislators in different jurisdictions confirm, once again, how the interest rates reform is considered a top priority by the different stakeholders within the public sector.

[10] https://ec.europa.eu/finance/docs/law/200724-benchmarks-review-proposal_en.pdf
[11] https://www.fca.org.uk/markets/transition-libor/benchmarks-regulation-proposed-new-powers

Conclusion

Let me now conclude with a short remark about the future.

As I previously mentioned, by the end of next year, under the EU Benchmarks Regulation, the supervision of so-called critical benchmarks, such as EURIBOR, will be ESMA's responsibility.

We are already preparing ourselves for this new supervisory task and we are committed to managing this new responsibility in a smooth and effective way. Because of this new supervisory duty, in the near future ESMA will play an even greater role in the interest rates transition, and we stand ready to fulfil our mission together with the public sector in the EU and in other jurisdictions.

The global interest rates reform is a multi-year international effort and is entering a defining moment. It is underpinned by a strong common interest between the private and public sectors.

What I would like to stress is that only coordinated efforts by both the public and the private sectors will make the interest rates reform a global success story. This coordination will become even more crucial over the course of 2021.

The extensive work already delivered in many jurisdictions across the globe has laid foundations for a successful interest rates reform. Enormous energy and insight have been provided by banks, market infrastructures, trade associations, and countless individuals in private firms and in public authorities.

I strongly believe that during the course of the next months we will be able to effectively move forward in the transition thanks to a renewed, joint effort by the public and private sectors, and a common goal: sounder and resilient interest rate benchmarks.

Thank you.