

## A supervisory perspective on the interest rate benchmarks reform

Third roundtable on euro risk-free rates – online edition

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### Introduction

Good afternoon Ladies and Gentlemen,

It is a great pleasure for me to participate in this year's roundtable on euro risk-free rates.

These roundtables, organised by the ECB, have become an annual appointment to discuss the state of play of the interest rate reform in the euro area. They bring together stakeholders from both the public and the private sectors. I fully support their aim, which is sharing the wealth of knowledge that the Working Group on Euro Risk-Free Rates has built over the last three years with a broad audience.

I would, therefore, like to thank the ECB for organising the roundtables on euro risk-free rates also this year, in digital format, and for inviting me.

Today, before listening to the presentations of the two Consultation Papers recently issued by the Working Group on Euro Risk-Free Rates, I would like to speak about ESMA's outlook on the interest rates reform in the euro area.

### EURIBOR fallback provision: a supervisory priority

In one year from now, ESMA will substitute the Belgian FSMA as supervisor of EURIBOR administrator, EMMI. We, at ESMA, are preparing ourselves for this new supervisory task and we are committed to managing this new responsibility in a smooth and effective way. As part of this preparation, we are cooperating with the FSMA to ensure continuity in the supervision of EURIBOR.

The FSMA has already authorised EMMI as administrator of EURIBOR under the Benchmarks Regulation. EU supervised entities can therefore continue using EURIBOR for the foreseeable future.

The EMMI developed and implemented the so-called hybrid methodology, used to calculate EURIBOR. At ESMA, we consider this hybrid methodology robust, resilient and transparent, as well as compliant with the Benchmarks Regulation.

Thanks to the hybrid methodology, EURIBOR was able to properly navigate the turbulent waters of 2020. During this challenging period, EURIBOR has been reacting smoothly to monetary decisions by the ECB, playing its role in the monetary transmission mechanism for the euro area.

Also, between the first and second quarter of this year the underlying market of EURIBOR experienced a temporary liquidity reduction, but the hybrid methodology was able to cope with these adverse circumstances. Then, starting in May 2020, the liquidity of the market underlying EURIBOR improved again, moving back to the level experienced before COVID-19.

As you are aware, there is no EURIBOR discontinuation in sight. Still, I would like to share with you an important message in relation to EURIBOR: market participants must include fallback provisions in their EURIBOR contracts.

Fallback provisions are recognised as the most effective way to increase contractual robustness and they are increasingly becoming an industry standard across different jurisdictions.

Besides, Article 28(2) of the Benchmarks Regulation requires supervised entities to include fallback provisions in their contracts referencing benchmarks, such as EURIBOR. So, there is a regulatory requirement that must be fulfilled.

We know that EURIBOR is widely used not only in derivatives, but also in mortgages and other types of loans. This means that millions of European households have direct exposure to EURIBOR.

ESMA's mission is to enhance investor protection and promote stable and orderly financial markets. As EURIBOR plays such a central role in EU financial markets, any issue related to the continuity of EURIBOR can become a risk to investor protection, market integrity and financial stability at once.

For this reason, we do not think that financial firms can afford to take any risk of contract frustration vis-à-vis EURIBOR products. The implementation of fallback provisions in all EURIBOR contracts, including legacy contracts, is therefore a regulatory and supervisory priority for ESMA.

In the course of 2021, ESMA will work together with the National Competent Authorities to monitor the implementation of the final recommendations on EURIBOR fallback provisions by the Working Group on Euro Risk-Free Rates. ESMA and National Competent Authorities will use all the tools at their disposal to ensure that supervised entities across the EU adopt on a timely basis viable EURIBOR fallback provisions which are compliant with the Benchmarks Regulation.

After my speech, we will hear about the EURIBOR fallback provisions proposed in the two consultation papers by the Working Group on Euro Risk-Free Rates. One of the two consultation papers focuses on the EURIBOR fallback rates<sup>1</sup>, which will be based on €STR.

As we will hear later today, for some asset classes, such as mortgages or other types of loans, the consultation paper proposes to base the EURIBOR fallback rate on a forward-looking term-structure. And this brings me to the second topic I would like to discuss today.

### **Finalising the transition from EONIA to €STR**

A liquid €STR derivatives market, providing reliable and transparent price information, is a prerequisite for producing a forward-looking term structure. However, the current liquidity of the €STR derivatives market remains modest.

Since October 2019, EONIA has been calculated as €STR + 8.5 bps, so EONIA derivatives market and €STR derivatives market are now equivalent from a risk point of view. But this is not sufficient. Many traders are still using EONIA in new contracts out of habit and inertia, despite the fact that EONIA will be discontinued in January 2022.

Therefore, my second key message today is a call on all market participants to take every necessary action to ensure the full and timely transition from EONIA to €STR. Financial firms should now actively use €STR instead of EONIA in all their new contracts, as well as in their internal systems and calculations.

An increased use of €STR in derivative contracts will have a twofold beneficial effect. First, it will ensure a smooth discontinuation of EONIA in one year's time. Secondly, it will allow the calculation of a solid EURIBOR fallback rate based on the €STR forward-looking term-structure.

In the UK, the use of the local risk-free rate, SONIA, is more widespread compared with the use of €STR in the euro area. The SONIA derivatives market is already well-established, and since the second half of 2019, the average daily volume of new SONIA swaps traded has exceeded that average daily volume of GBP LIBOR swaps<sup>2</sup>.

Thanks to this existing liquidity in the SONIA derivatives market, some British administrators have been publishing a SONIA forward-looking term-structure since June this year<sup>3</sup>. It is fundamental that in the very next months benchmark administrators in the EU will be able to regularly publish an €STR forward-looking term-structure, so that it can be used as a EURIBOR fallback rate.

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<sup>1</sup> [https://www.ecb.europa.eu/pub/pdf/other/ecb\\_pubcon\\_EURIBORfallbacktriggerevents.202011~e3e84e2b02.en.pdf](https://www.ecb.europa.eu/pub/pdf/other/ecb_pubcon_EURIBORfallbacktriggerevents.202011~e3e84e2b02.en.pdf)

<sup>2</sup> <https://www.lch.com/services/swapclear/volumes>

<sup>3</sup> <https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor>

Market participants should therefore no longer wait and fully rely on €STR instead of EONIA. The end of EONIA is approaching fast and €STR must be adopted as the sole risk-free rate for the euro area.

## **Conclusion**

Let me now conclude with a short remark.

In February 2018, almost three years ago, I gave a speech<sup>4</sup> at the first meeting of the Working Group on the Euro Risk-Free Rates.

At the time, the EURIBOR hybrid methodology was not defined, EMMI was not authorised under the Benchmarks Regulation and the production of €STR was not yet considered by the ECB.

The interest rates landscape in the euro area has changed dramatically since the establishment of the Working Group on the Euro Risk-Free Rates. It is important to recognise that the Working Group was at the very centre of this progression.

Back in 2018, the definition of precise and viable EURIBOR fallback provisions almost felt like a mission impossible because too many pieces of the puzzle were still missing. Today, we know that EU supervised entities will soon be able to implement accurate fallback language for all their EURIBOR products, thanks to the finalisation of the Working Group recommendations.

The implementation of EURIBOR fallback provisions is not the end of the story, though. EURIBOR will remain in the spotlight. The liquidity of the market that EURIBOR seeks to measure, the unsecured euro money market, remains a source of concern. In addition, the representativeness of the EURIBOR panel of banks is also an issue that ESMA will monitor very closely.

As future supervisor of EURIBOR, we are fully aware that we have a great responsibility ahead of us. ESMA is ready to continue its work with the ECB, the European Commission and with the stakeholders of the private sector, to ensure that the EU financial system can rely upon sound and resilient interest rate benchmarks.

Thank you.

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<sup>4</sup>[https://www.esma.europa.eu/sites/default/files/library/steven\\_maijoor\\_concluding\\_remarks\\_1st\\_euro\\_rfr\\_wg\\_meeting\\_26\\_02\\_2018.pdf](https://www.esma.europa.eu/sites/default/files/library/steven_maijoor_concluding_remarks_1st_euro_rfr_wg_meeting_26_02_2018.pdf)