

Teleconference of the working group on euro risk-free rates

Thursday, 2 July 2020, 09:00-13:00 CET

SUMMARY

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

Mr Van Rijswijk (Chair) announced that he would be leaving his position as Chair of the working group on euro risk-free rates following his appointment as ING's Chief Executive Officer as of 1 July 2020. He would be handing over to ING's Chief Finance Officer, **Mr Tanate Phutrakul**, after today's meeting.

On behalf of the working group and of the public sector, **Cornelia Holthausen (ECB)** thanked **Mr Van Rijswijk** for his achievements as Chair of the working group, taking note of the considerable progress made with the deliverables under his chairmanship. She warmly welcomed **Mr Phutrakul** and expressed her confidence that cooperation would continue to be as fruitful as it had always been within the working group.

Mr Van Rijswijk reminded the members of the working group of their obligations under EU competition law, as described under the guidelines on compliance with EU competition law published on the ECB's website.

2. Update by Sub-group 5 on the consultation on Euribor fallbacks (cash products and derivatives)

Mr Van Rijswijk explained that Sub-group 5 had identified five critical issues that the working group needed to clarify before it could make its recommendations as to the most suitable Euribor fallbacks, as follows:

1. whether the €STR-based forward-looking term rates¹ were feasible and constituted robust fallbacks that could be recommended for use in the near future;
2. what the IFRS9/IAS39 hedge accounting implications would be if the forward-looking and backward-looking last reset methodologies were to be used as Euribor fallbacks;
3. what the IFRS9 solely payments of principal and interest (SPPI) implications would be if the backward-looking last reset methodology were to be used as Euribor fallbacks;
4. which market conventions should be used for the various asset classes; and
5. whether certain backward-looking methodologies² might not be able to comply with the national laws of certain countries. This issue would be further addressed under Item 3.2 below.

2.1 Issues for debate

a. Summary of the feedback received from the potential administrators for €STR-based forward-looking term rates

The working group intends to assess whether the €STR-based forward-looking term rates constitute feasible and robust fallbacks which can be recommended for use in the near future. To this end, it requested a status update to the five administrators that had already expressed an interest in providing an €STR-based forward-looking term rate that could function as a possible fallback for the Euribor.³ A summary of their standard replies was [presented](#) by the ECB, as secretariat of the working group, and [published](#) on the working group's website page.

Four projects were presented, including EMMI-ICE Benchmark Administration (joint proposal), FTSE Russell, IHS Markit and Refinitiv. Detailed explanations were given of the envisaged methodologies to compute these rates: data scope, data access, governance, contingency policies and the timing of the envisaged rate. Some respondents were planning to use €STR OIS committed quotes and €STR futures, either using: (i) interdealer or client-to-dealer platforms; or (ii) exchanges platforms. Another respondent proposed using actual €STR OIS and futures trades.

The main differences between the proposals are: (i) the number of different levels of "waterfalls" that the administrators plan to use if the data proves to be insufficient (from three to six); and (ii) the information content to be included in the waterfall, and whether to use €STR-based compounded rates for the last level of the waterfall if the other levels have failed to provide adequate data.

¹ "Forward-looking" term rates are based on the RFR derivative markets; more specifically, these rates would be based on the €STR derivatives market in the euro area.

² "Backward-looking" term rates are based on the RFR compounded rate, i.e. €STR-based compounded rate for the euro area.

³ See the Minutes and related documentation of the meeting of the working group on euro risk-free rates on 16 October 2019.

In the absence of a developed €STR OIS market, the potential providers remained prudent/cautious as regards the quantitative information concerning the waterfalls trigger mechanisms, the number of expected active dealers and the representativeness of the rate.

Mr Van Rijswijk concluded that all administrators seemed, at this stage, to be rather positive about the possibility of developing an €STR-based forward-looking term rate that would be able to meet both the EU Benchmark Regulation (BMR) requirements and the IOSCO principles. However, they all mentioned a caveat, which was that the final methodology for and publication of such a rate would crucially depend on developments in the €STR OIS market, which was still in its early stages. Since this €STR OIS market was expected to develop further once the central counterparties (CCP) had switched the discounting regime from the EONIA to the €STR at the end of July 2020, the working group would be requesting another status update from these administrators by the end of 2020.

In the subsequent discussion, a few working group members raised some concerns related to the robustness of the forward-looking rates during market stress episodes. The latest market developments during the COVID-19 crisis had shown that potential providers of these “forward-looking” rates were facing significant issues producing rates based on these methodologies in other jurisdictions.

Helmut Wacket (ECB) confirmed that there was still some uncertainty surrounding the future feasibility of the forward-looking rates at this stage. He recalled that the OIS market in the euro area did not point to very high levels of liquidity, and on the contrary, pointed to very high level of concentrations, as constantly observed by the ECB over the past few years. In this respect, he shared the concerns expressed about the robustness of the possible forward-looking rates.

b. IFRS 9 hedge accounting implications with regard to different Euribor fallback measures

Subgroup 5 had analysed the potential hedge accounting implications of the different Euribor fallback measures currently under consideration for the various cash products. This subgroup had noted that there could be some accounting issues surrounding the specific methodologies, referred to as “in advance” methodologies, where the interest rate due is known at the beginning of the interest period, as opposed to “in arrears” methodologies, i.e. the backward-looking last reset methodology and the forward-looking methodology. This is because these methodologies differ more substantially as compared to the International Swaps and Derivatives Association’s (ISDA) proposals for derivatives.⁴

The introduction of differing fallback rates for the hedged item (backward-looking last reset or forward-looking) and the hedging instrument (backward-looking lookback) would imply an imperfect hedge. This could create potential profit and loss (P&L) impacts and volatility in accordance with the hedge accounting rules. Various solutions had been explored by Subgroup 5 to address this difference. Only one of these solutions was regarded as feasible, which consisted of including a basis swap⁵ to offset the unintended difference resulting from using different types of Euribor fallbacks.

The inclusion of a basis swap (to offset the unintended difference in Euribor fallbacks) was discussed both from a market perspective and from an accounting perspective, with the following conclusions being made:

From the market perspective, most of the members thought that a basis swap market might develop in the future, if there were enough demand for it, while pointing out that such a single-sided market would also come at a cost. Most of the members noted, however, that the last reset methodology would introduce convexity into the potential basis swaps (due to the fact that the observation periods between fallbacks did not overlap). The working group therefore concluded that the last reset methodology should be viewed with caution as a fallback for Euribor cash products due to the hedge accounting reasons explained above.

From an accounting perspective, the “basis swap” solution would require the following changes for those market participants that wished to use in advance fallbacks and minimise the consequences for their hedge accounting: (i) for new hedging relationships, market participants could mention in their hedging documentation that a basis swap would be added to the hedging relationship as soon as Euribor ceased to exist, i.e. when the fallback rate became effective; (ii) for existing hedging relationships, the working group members agreed to approach the International Accounting Standards Board (IASB) once again in order to request IFRS 9 relief measures⁶ for market participants

⁴ ISDA’s proposal for derivatives for the euro LIBOR and Euribor are: (a) a backward-looking lookback methodology with a two-day backward shift adjustment for the compounded rate, similar to the lookback period methodology; and (b) a five-year historical median approach for the spread adjustment.

⁵ These two proposals were discarded, because: (i) they deviated from ISDA’s solutions for derivatives products; and (ii) they were considered not to be feasible (i.e. reopening of the hedging relationships).

⁶ Similar to those provided for by the Financial Accounting Standards Board (FASB) for the US GAAP on the same topic, see [Reference Rate Reform \(Topic 848 – BC52/BC53\)](#).

who wanted to introduce these basis swaps as part of their hedging documentation. Owing to the very tight schedule of the IASB, it was agreed that this letter should be sent as soon as possible prior to publication on the ECB's website.

Finally, some working group members indicated that the introduction of basis swaps could have some non-negligible regulatory capital implications which market participants should take into consideration. It was also agreed that subgroup 5 should continue exploring alternative solutions to address these hedge accounting issues should the basis swap market prove not to be a feasible option in the end.

Cornelia Holthausen (ECB) welcomed the fact that any solution requiring a deviation from the current ISDA IBOR fallback methodologies had been discarded by the working group so as to address these hedge accounting issues. The ECB did not see any reason for deviating from the ISDA arrangements for derivatives, particularly given the extensive work undertaken by ISDA over the past few years under the guidance of the Official Sector Steering Group. Besides that, she asked that working group members better substantiate why, in their opinion, European retail customers might prefer forward-looking rates or last reset methodologies. Customers' acceptance of the backward-looking fallback rates had not yet been explored and it was not so clear that forward-looking rates would actually be a more transparent and robust arrangement for retail customers, as compared to the direct use of the €STR. Examples such as the recent mortgage loans in Switzerland granted using in arrears methodologies showed that backward-looking rates could easily be used in retail contracts. The ECB would, therefore, encourage the working group to analyse the examples provided by other jurisdictions in this regard.

c. IFRS 9 SPPI testing implications with regard to different Euribor fallback measures

Marjolein de Jong (ING) provided some insight into the possible IFRS 9 SPPI testing implications of the different Euribor fallback methodologies, in particular for the backward-looking last reset methodology.

The most critical element needed to pass this accounting test is to determine whether the financial asset recognised by a given company reflects consideration for the time value of money. This is something likely to be achieved when using fallbacks for which the observation period and the interest period used to calculate them do not differ significantly, which is not the case for the last reset methodology. In the last reset methodology, there is a disconnection between the observation period and the interest period that could lead to a modified time value of money. This disconnection is more significant for longer maturities, for example if it is used as a fallback rate for the 6 or 12-month Euribor and could likely mean it would fail the SPPI test, particularly during periods of market volatility.

In terms of a potential solution to ensure that IFRS 9 SPPI requirements are complied with, the working group had wondered whether in cases where the €STR-based compounded rates were published by a public authority this could be considered to be a regulated rate, as recognised under IFRS 9. If this were to be the case, the €STR-based compounded rate could be considered to be an accepted proxy for the time value of money. The working group agreed to approach the IASB to obtain further guidance on the use and eligibility of regulated rates in the context of SPPI testing so as to decide whether this solution could potentially be used.

In the subsequent discussion, some working group members questioned the viability of a rate calculated using the last reset methodology as a potential fallback for Euribor (particularly for longer tenors), because, in their view, it did not meet some of the relevant criteria⁷ in terms of: (i) being representative of a bank's borrowing costs, because it did not consider the time value of money; and (ii) being sensitive and responsive to changes in the policy rate and other market factors, because it involved a delay. Other members, however, referred to the EU consumer directive and the EU mortgages directive⁸, saying that the last reset methodology would allow customers to know their payments in advance, while these directives did not provide conclusive arguments about whether an in arrears backward looking methodology would be compliant with their provisions.

d. Market conventions

Anna Kozhevnikova (Generali) updated the working group members on Subgroup 5's proposals for different market conventions that would form part of the public consultation, distinguishing between: (i) market conventions for which international consistency would be relevant; (ii) those proposals for which the working group was planning to provide recommendations; and finally (iii) those proposals for which the ultimate decision should be taken by the future administrator of the compounded €STR. The working group approved this approach.

⁷ As defined by the working group in its [first public consultation on the assessment of the new risk-free rate](#).

⁸ Article 27 (1) of the Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 requires that the "creditor informs the consumer of any change in the borrowing rate, on paper or another durable medium, before the change takes effect".

2.2 Update on the consultation on Euribor fallbacks

Anna Kozhevnikova (Generali) and **Christian Gau (Deutsche Bank)** presented the current status of the subgroup 5 consultation on Euribor fallbacks⁹ for cash and non-ISDA derivatives for which the subgroup 5 is expected to deliver a final version in autumn 2020.

a. Cash products

For this public consultation, both backward-looking methodologies (the payment delay, the lookback and the last reset methodology) and forward-looking methodologies are being considered as potential fallbacks for Euribor-linked cash products.

For the purpose of analysing which fallback methodology(ies) would be the most appropriate for the identified asset classes, subgroup 5 identified a set of criteria to support the selection process: (i) robustness/availability; (ii) operational ease; (iii) client acceptance; (iv) hedging ease; (v) consistency with other jurisdictions across asset classes; (vi) financial accounting impacts; and (vii) risk management impacts. The list of criteria was validated by the working group.

Backward-looking rates provide the most robust alternatives as a Euribor fallback and since the derivatives under the ISDA documentation would fall back on backward-looking rates, using them would avoid market fragmentation. At the same time, feedback received on the second public consultation by the working group on term rates pointed towards a possible preference for forward-looking term rates, particularly for the less sophisticated/non-professional market participants. Moreover, certain products may require knowing the rate in advance owing to business needs. With this in mind, the working group discussed how to balance the needs of certain market participants whilst striving for a consistent, non-fragmented and robust benchmark landscape.

In the subsequent debate, some working group members highlighted the work carried out in other jurisdictions, whereby a detailed use case analysis was conducted to better justify the potential use of forward-looking rates for a limited set of cash products. It was agreed that, where forward-looking rates are recommended for a limited set of cash products, they should be introduced using a waterfall structure to cater for the fact that these rates are not yet available and also for the uncertainties surrounding their future feasibility and robustness. Therefore, a general caveat was also introduced regarding future developments in the €STR derivatives market, its liquidity and representativeness (see Item 2.1.a).

As part of the debate, **Cornelia Holthausen (ECB)** recalled the Financial Stability Board's (FSB) guidance on the matter requesting careful consideration by the working group before recommending fallbacks. She highlighted that fallback provisions only made sense if they directed the user to an existing and robust rate. Given that overnight risk-free rates were more strongly rooted in transactions and reflected more active and liquid markets as compared to any other alternative measure – both in terms of data sufficiency and representativeness of the rate – backward-looking rates represented the most robust, and certainly the only available rates, at the current juncture for the Euribor fallback planning. The FSB also recognised that there could be a role for forward-looking rates for certain cash products. However, the working group should consider keeping forward-looking use cases to the minimum and should substantiate the motivations behind such a choice. The ECB would encourage the working group to analyse the examples provided by other jurisdictions in this respect. Using forward-looking rates as fallbacks would introduce some divergences from other IBOR fallbacks, as well as the Euribor fallbacks in the derivatives markets, and thus introduce additional complexities. Finally, and in addition to this FSB guidance, the ECB was of the opinion that any use of forward-looking methodologies for Euribor fallbacks should be limited and agreed that it should be done using a waterfall approach, i.e. with a second level of backward-looking fallbacks.

b. Derivatives

In terms of derivatives products, **Christian Gau (DB)** clarified that the working group would use the [ISDA's results](#) as a starting point. These results would not become subject to the working group public consultation, because, as shown by the ISDA results, there is broad market support for the proposed fallbacks to be applied to Euribor and euro LIBOR ISDA derivatives. However, a small set of products had been identified¹⁰ for which additional amendments to ISDA's proposals could be required and for those products the working group would work in close cooperation with ISDA to ensure a unified approach.

⁹ All the fallback options are analysed based on the assumption of a permanent cessation of all Euribor tenors.

¹⁰ Coupons that reference a Euribor tenor which is longer than the accrual period (for example, 1 million Euribor paid weekly); coupons with so-called "Asian" features, i.e. the payment with respect to a given interest period is a function of several Euribor fixings; coupons containing a range accrual feature; coupons for which the Euribor reset is at the end of the calculation period (for example, Euribor fixed in arrears); and forward rate agreements (FRAs).

c. Spread adjustment

David Gorans (BNP) presented the analysis conducted by subgroup 5 of the spread adjustment to be introduced in addition to the term rates in the Euribor fallbacks. The working group would leverage on the work already carried out by ISDA for the derivatives and by the Alternative Reference Rates Committee (ARRC) and UK working group on sterling risk-free rates for cash products, while taking into consideration the euro specificities.

The working group would include its analysis of both the dynamic and the fixed spread adjustments in subgroup 5's contribution to the public consultation.

(i) In the opinion of the working group, it was not clear that a “dynamic spread” could be created, as it could face similar challenges with the underlying transaction data as that of the Euribor, in particular in the event of its discontinuation. This solution also appeared to be overly complex.

(ii) The working group would include an analysis of the modified “forward approach methodology”¹¹, so as to only take into account the most liquid points available for calculating the spread. This method could not be recommended, as it could create inconsistencies between the cash and the derivatives markets.

The working group members also confirmed that the “dynamic credit spread” would be disregarded, primarily due to the complexity issues mentioned and due to the fact that at the time of the potential activation of the “forward-approach methodology”, the market would be so distorted that it would not be representative.

The working group concluded that it should avoid deviating from ISDA's proposals for the spread adjustment, i.e. a five-year historical median approach, as such a deviation would create inconsistencies between the markets.

3. Update by subgroup 3 on the Euribor legal action plan

3.1 Public consultation on Euribor fallback triggers

Adolfo Fraguas (BBVA) presented the consultation on Euribor fallback triggers. He recalled the seven trigger events identified by his sub-group and listed those being considered for the future public consultation paper.

Recent discussions within the sub-group focused on the “pre-cessation trigger”, i.e. a trigger event for the case in which a supervisor of the Euribor issues a public statement in which the benchmark is assessed as being no longer representative. Views were very divided in subgroup 3 as to whether or not to recommend the inclusion of such a trigger event for Euribor fallbacks. The public consultation should request that respondents state their preference in an open manner. It was noted that such a pre-cessation trigger had been included for the LIBOR cessation, as well as in the ISDA derivatives, but not for the Euribor.

He also clarified that the future consultation paper would only deal with a permanent Euribor cessation scenario, i.e. a full discontinuation of the Euribor, i.e. it would not deal with the discontinuation of specific tenors. In this specific case, some working group members recalled that in past cases, parties had frequently agreed on the interpolation from other remaining tenors.

In response to a question, **Tilman Lueder (European Commission)** indicated to the working group that the review of the BMR was ongoing and that the initial proposal was expected to be published in the summer of 2020. He clarified that the BMR review would be aimed at avoiding financial instability in the Union in case a widely used interest rate benchmark were no longer in published format without there being a replacement rate in place at the time of cessation. Moreover, he confirmed that market consensus on Euribor replacement would be extremely useful in guiding market participants to amend their contracts and introduce a contractual fallback rate.

Mr Lueder reiterated his statements made previously regarding the cessation triggers, namely that a trigger of “non-representativeness” should only exist if the competent regulator definitively determined that the benchmark was no longer representative of an underlying market and could not be reformed. A potential assessment as to a future event that could trigger “non-representativeness” should not trigger a fallback provision.

The subsequent discussion also confirmed that one of the triggers related to an event which established a benchmark as being unlawful, and its consequences, depended on an event affecting the applicable law of the contract and/or the parties thereof.

3.2 Update on the compounded €STR and civil law

The working group on euro risk-free rates had agreed to explore additional issues relating to the possible non-compliance of some backward-looking methodologies with the civil law of some countries. This is because: i) certain consumer protection provisions make it mandatory for the retail party to know in advance its interest rate payment (i.e. “in arrears” methodologies can be problematic unless sufficient payment delay applies); ii) backward-looking methodologies may sometimes be interpreted as charging interest on overdue interest payments, a practice that is

¹¹ The “forward approach” for the spread adjustment is calculated using observed market prices for the forward spread between the relevant IBOR and the adjusted RFR in the relevant tenor at the time the fallback is triggered.

restricted or even banned in some European jurisdictions (“anatocism”). This issue is also relevant for all compounded risk-free rates (notably the SOFR and the SONIA).

It could be argued that a compounded €STR does not impose “interest on interest”, but rather that it is a mathematical formula for the calculation of the actual rate or coupon applicable to an interest period before the relevant interest actually becomes due. Also, compounded rates are widely used in financial products, for instance in the calculation of OIS rates. However, there is not yet any case law in place to confirm this interpretation, therefore potential legal risk may not be completely disregarded in these countries.

The working group took note of the fact that it is not an issue that affects all EU Member States and hence potential solutions should be sought within each of the affected countries and addressed at the local level. For example, national authorities in the affected countries could provide legal certainty by means of clarifications relating to the application of national legislation or, if necessary, make amendments to provisions in the existing national legislation. One member also noted that in the context of the syndicated loan market, this issue was not purely a domestic one in the sense that if the applicable law of the loan contract chosen by the parties does not recognise and enforce compounding (due to public order rules against anatocism), this could have an impact beyond the jurisdiction of the applicable law given that syndicated loans are often international in nature with counterparties from multiple jurisdictions. Given this wider impact, it could be helpful for European authorities to conduct education and outreach with local authorities on the transition.

These issues should also be reported in the Subgroup 5-related public consultation, so as to inform market participants and encourage them to start a dialogue with national authorities to obtain such clarifications, if deemed necessary.

4. Update by Subgroup 7 on communications-related activities

Maite Bermúdez (Santander) mentioned that the COVID-19 outbreak had had an adverse impact on communications-related activities, as the current situation had made it difficult to conduct proper meetings with all the necessary parties involved. However, the majority of the working group ambassadors had been able to maintain contacts with their local regulators and banking associations, distributing the relevant documentation and spreading messages from the working group through conference calls and video conferences.

Furthermore, **Ms Bermúdez** reported that since the last working group meeting, a newsletter had been published on the working group’s ECB webpage and a new edition was about to be released in the course of July. Moreover, the FAQ and check list would be updated and aligned with the new working group planning and with the progress made by the working group overall.

5. AOB

5.1 Update on the ISDA Euribor fallback protocol

This point was not addressed due to a lack of time.

List of participants

Participant's organisation

Name of participant

Chairperson

ING

Mr Steven van Rijswijk

Ms Marjolein de Jong-Knol

Voting members

Bank of Ireland

Mr Barry Moran

Barclays

Mr Joseph McQuade

Barclays

Mr Andreas Giannopoulos

Bayerische Landesbank

Mr Harald Endres

BBVA

Mr José Carlos Pardo

BBVA

Mr Ignacio Ollero

BBVA

Mr Adolfo Fraguas

BNP Paribas

Ms Dominique Le Masson (recused of Item 2.1.a)

BNP Paribas

Mr Patrick Chauvet

BNP Paribas

Mr David Gorans

BPCE/Natixis

Mr Olivier Hubert

CaixaBank, S.A.

Mr Francesc Xavier Combis Comas

Crédit Agricole

Mr Carlos Molinas

Deutsche Bank

Mr Christian Gau

DZ Bank

Mr Philipp Nordloh

DZ Bank

Mr Michael Schneider

Erste

Mr René Brunner

Erste

Mr Neil McLeod

Eurobank SA

Mr Theodoros Stamatiou

HSBC

Mr Pierre Jenft

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

Santander

Ms Mónica López-Monís

Société Générale

Mr Olivier Balpe

Société Générale

Mr Stephane Cuny

UniCredit Bank

Mr Umberto Crespi

Non-voting members

European Money Markets Institute

Mr Jean-Louis Schirmann (recused of Item 2)

European Money Markets Institute
EFAMA
International Capital Market Association
International Swaps and Derivatives Association
International Swaps and Derivatives Association
International Swaps and Derivatives Association
Loan Market Association

Invited institutions

European Investment Bank
European Investment Bank
Generali
Generali

Observers

European Central Bank
European Central Bank
European Commission
European Commission
European Commission
European Commission
European Securities and Markets Authority
European Securities and Markets Authority
Financial Services and Markets Authority

Secretariat

European Central Bank
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European Central Bank
European Central Bank
European Central Bank

Ms Petra de Deyne (recused of Item 2)
Ms Agathi Pafili
Ms Katie Kelly
Mr Rick Sandilands
Mr Jonathan Martin
Mr Graham Bryant
Ms Kam Mahil

Mr Thomas Schröder
Mr Nikolaos Tzoldos
Ms Anna Kozhevnikova
Mr Fabio Mandirola

Ms Cornelia Holthausen
Mr Helmut Wacket
Mr Tilman Lueder
Ms Alessandra Atripaldi
Mr Ivan Keller
Mr Rik Hansen
Ms Iliana Cristian
Mr Michele Mazzoni
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Ms Anne-Lise Nguyen
Mr Pascal Nicoloso
Mr Armin Greif
Ms Yasmina Santalla Pérez
Mr Vladimir Tsonchev