€STR v. EURIBOR: the battle of the euro benchmark

October 2019

Authors: **Jeremy Duffy**, **Denise Diallo**, **Julia Smithers Excell**, **Amitaben Patel**, **Emmanuelle Leroy**

Tomorrow heralds an important milestone in the evolving saga of LIBOR's discontinuation, seeing the launch of the fifth and final rate, €STR, as the proposed successor to euro LIBOR. However, although in our other articles (available here and here) we have encouraged market participants to keep abreast of market developments and make the transition over to the relevant risk-free rate when appropriate, this article tells a slightly different story. Here we note that while LIBOR's demise is scheduled for the end of 2021, taking with it its euro rate, the market already had (and is likely to continue to have) a viable alternative to euro LIBOR in the form of EURIBOR. To date, there has been no suggestion that EURIBOR will be discontinued, instead efforts have been made to fortify the rate. In this article, therefore, we not only examine €STR, but also EURIBOR and look at the factors that loan market participants may need to consider when documenting euro loans going forward.

Background

€STR (and the move away from EONIA)

Following the announcement by the UK Financial Conduct Authority (FCA) that LIBOR was to be discontinued, the working group on Euro Risk-Free Rates (the "*Euro Working Group*") quickly looked at publicising its euro risk-free rate alternative. Whilst most other working groups looked to existing risk-free rates, where available, the Euro Working Group excluded the possibility of using EONIA (the Euro OverNight Index Average), the effective overnight reference rate for euro, on the basis of its non-compliance with the EU Benchmarks Regulation 2016/1011 ("*BMR*"). The BMR broadly applied from 1 January 2018 (with the transition period for critical and third country benchmarks to be extended to 31 December 2021 via provisions in the EU Low Carbon Benchmarks Regulation), introducing a code of conduct for contributors that involves the use of robust methodologies and sufficient and reliable data. In particular, it calls for the use of actual transactional data, where possible. As early as 2018, however, the European Money Markets Institute (EMMI), the current administrator of EONIA, had made public its conclusion that compliance with the BMR was unlikely on the basis that the volume of transactions underpinning EONIA had fallen significantly over time.

Instead, we saw the announcement of a new rate known as €STR (the Euro Short-Term Rate), to be administered by the European Central Bank. According to a press release from the European Central Bank on 11 July 2019, €STR will be published for the first time at 8:00 a.m. CET tomorrow (2 October 2019) reflecting the trading activities of today (1 October 2019), with a revised rate to be republished at 9.00 a.m. CET should errors be detected (it should be noted that Guideline (EU) 2019/1265 of the European Central Bank of 10 July 2019 requires publication no later than 9:00 a.m. CET, with any revisions and republication to take place by 11:00 a.m. CET, if errors are detected following publication). With the launch of a new overnight rate, EONIA will become surplus to requirements and be discontinued from 3 January 2022. In the meantime, however, EONIA will continue to exist under a new methodology that makes direct reference to €STR (calculated as €STR, plus a spread of 8.5 basis points). By contrast to EONIA, which requires voluntary data submissions from its 28 panel banks, €STR is a rate based exclusively on transactional data from unsecured overnight borrowing transactions, reported daily by banks in accordance with the Money Market Statistical Reporting Regulation (which currently amounts to roughly 50 of the largest banks in the euro area in terms of balance sheet size) and is therefore in line with the BMR (and IOSCO Principles).

EURIBOR

EURIBOR (or the Euro Interbank Offered Rate) is a daily reference rate published by EMMI, representing the rate at which credit institutions in the EU can borrow wholesale funds in euros in the unsecured money markets. EURIBOR is calculated for 1-week, 1-month, 3-month, 6-month and 12-month tenors, and published at or shortly after 11:00 a.m. CET on each TARGET 2 business day. EURIBOR, like LIBOR therefore, is a forward-looking term rate.

In October 2018, EMMI noted that, without reform, it could not be guaranteed that EURIBOR would be compliant with the BMR. In February 2019, it published a blueprint, whereby it proposed to transition its panel banks (19 at that time) across from its current quote-based methodology to a new hybrid methodology, anchored in transactions, to the extent possible. The hybrid methodology uses a hierarchical approach consisting of three levels, applied progressively. Under level 1, panel bank contributions are based solely on eligible transactions for that particular tenor. Level 2 looks at contributions based on transactions across the maturity spectrum using a formulaic calculation technique provided by EMMI. Finally, under level 3, contributions are based on transactions and/or data from a range of markets closely related to the unsecured euro money market, using a combination of modelling techniques and/or panel bank judgment. With its proposal to move across to this methodology, EMMI was successful in receiving authorisation under the BMR in July 2019 and will start to transition panel banks to the hybrid methodology by the end of this year.

Critical assessment factors?

With BMR authorisation given, the euro continues to benefit from two rates. Yet, the critical question for market participants is which option to use – whilst there is encouragement from regulators to move across to risk-free rates (and therefore use €STR), there is the option for continuity and certainty offered by the newly reformed EURIBOR. Below we consider some of the factors that parties may want to take into account when making this important decision.

Forward-looking term rate?

In February of this year, the Euro Working Group stated (based on a summary of responses from an earlier consultation) that a large majority of market participants viewed forward-looking term rates to be essential or desirable. In March, it therefore recommended a methodology for a forward-looking term rate based on the €STR derivatives market, shortly followed by a call for potential benchmark administrators to express an interest in producing such forward-looking rates. However, whilst this would only be feasible once there was sufficient liquidity in the €STR derivatives market, their recommendation was not discussed in the context of a forward-looking €STR term rate for use in the loan market as is being considered for other LIBOR replacement rates. Instead, it was suggested as a fallback for EURIBOR-linked contracts, should EURIBOR be unavailable. It appears therefore that rather than the creation of an alternative benchmark based on €STR for use in the cash markets in its own right, the Euro Working Group is focusing its attention on reforming and strengthening EURIBOR, perhaps with the intention that it continues to be used in the cash markets.

Methodologies and multicurrency loans

As an alternative to a forward-looking rate, it is possible to use a so-called 'backward-looking term-rate,' such as compounding or averaging the overnight rates to create a risk-free rate capable of use in the loan market. Such rates are currently being considered for the SONIA and SOFR loan market; and have been successfully utilised in the bond market for both of those rates. The adoption of such a rate would therefore ensure consistency across the markets (which may prove useful for multicurrency loans), with the additional benefit of a lower rate compared to LIBOR and EURIBOR (given the lack of credit and term rate premiums when using risk-free rates). It should be noted however, that while this option could be feasible for new contracts being entered into, amending legacy contracts to reflect such a rate could prove difficult, as currently there is no agreed spread adjustment (or proposal to consult on one) to bridge the gap between €STR and EURIBOR (or LIBOR, as applicable) to aid the amendment process. Without more focus (and guidance) on this from the Euro Working Group, an €STR backward-looking term rate may not be an option for market participants.

A possible later withdrawal?

A final factor to take into account during any decision-making process is a possible withdrawal of EURIBOR at a later stage. While regulators have been supportive of the reforms to EURIBOR, prior attempts to move to a methodology based entirely on transactional data had proven unsuccessful and we have therefore defaulted to a hybrid methodology. It may be that overtime, there are deficient levels of transactional data, therefore prompting reliance on level 3 of the hybrid methodology more frequently. Should that be the case, it may be desirable for the market to reconsider its options for EURIBOR and look to other alternatives (such as a forward or backward-looking term rate for €STR). As further evidence of this, it would be remiss not to note that prior to the FCA's decision to discontinue LIBOR, a hybrid methodology had also been discussed for LIBOR and yet the FCA determined that such an option was not sustainable based on transaction volumes and therefore proposed the discontinuation. A similar prognosis for EURIBOR cannot therefore be excluded.

Conclusion

While other rates have been faced with the threat of impending doom, the euro has had the benefit of a double-edged sword in its war against LIBOR's discontinuation with two possible alternatives for the market to use. Now we are faced with the question of whether market participants will cling to EURIBOR or heed to the advice of regulators and move across to risk-free rates. With certain other jurisdictions (such as Australia and Hong Kong) also independently considering a transition to risk-free rates, parties may be incentivised to make the transition now. However, with attention focused on strengthening EURIBOR and little emphasis on developing an €STR rate fit for use in the cash markets, this may be difficult to do.

White & Case LLP
5 Old Broad Street
London
EC2N 1DW
United Kingdom

T +44 20 7532 1000

White & Case LLP
19, Place Vendôme
75001 Paris
France

T +33 1 55 04 15 15