Feedback on the report on the transition from EONIA to ESTER by the working group on euro risk-free rates

Summary of responses

February 2019

1 Executive summary

The call for feedback on the report by the working group on euro risk-free rates concerning the transition from the euro overnight index average (EONIA) to the euro short-term rate (ESTER) closed on Friday, 1 February 2019. The report drew considerable interest from the financial sector and other interested parties. 63 market participants – 37 of which were from the banking sector –provided responses or comments. The response sample ensures appropriate geographic coverage and adequately reflects relevant (sub) sector views. The main messages may be summarised as follows:

1. *Respondents broadly agreed with the working group's recommendation that the preferred transition path would be the time-limited recalibration approach with a spread and clean discounting. 61 respondents or 97% of the responses considered this path as being the most appropriate for ensuring a smooth and orderly transition from EONIA to ESTER, predominantly on the grounds of its effectiveness for transferring current EONIA liquidity to the emergent ESTER market, and for mitigating potential risks of value transfers between market participants on the recalibration date, as well as the fact that it would provide an adequate time frame to renegotiate EONIA legacy contracts. However, some respondents requested that more clarity be provided with regard to the applicable discounting regime and the methodology to be used for closing out or transitioning any legacy exposure on the succession date.*

2. *Respondents generally concurred with the working group's conclusion that an end-date for the publication of the recalibrated EONIA by end-2021 was sufficient for a smooth transition under the recalibration approach with a spread and clean discounting, albeit around 10% of respondents considered it preferable to postpone this deadline or to introduce some flexibility with regard to the end-date.*

3. *Although most of the respondents considered a time limit the most effective incentive for supporting the transition of the derivatives market to ESTER, many*

respondents proposed other alternative ideas for accelerating the transition process.

4. *The vast majority of respondents regarded the authorisation and supervision of the recalibrated EONIA as positive, because it would provide greater legal certainty to the transition process and would highlight that the recalibrated EONIA was in line with best practices and international recommendations.*

5. *Respondents mainly agreed with the working group's proposal for the spread methodology based on a one-year pre-ESTER historical data period, calculated as an average with a 15% trimming.*

6. *A wide range of responses were given as to the minimum time required to make systems ready for ESTER T+1 publication, ranging from 1 to 24 months. The most common response was 6 months, followed by 9 and 12 months.*

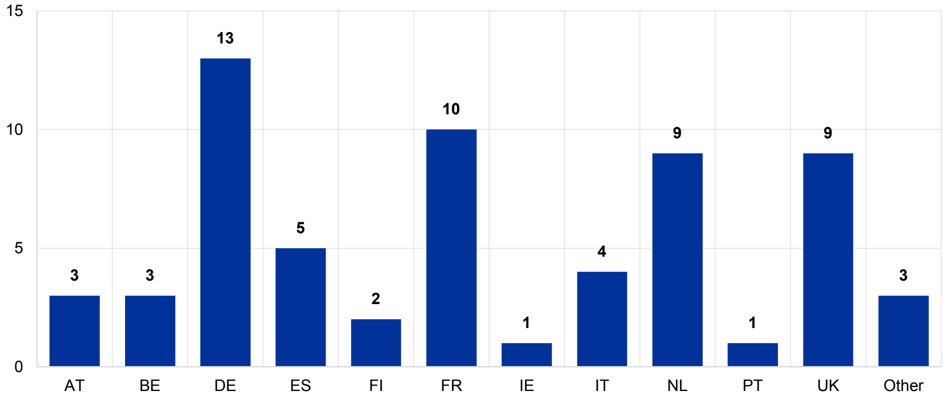
The working group on euro risk-free rates will keep market participants informed on the progress of its work so as to support their own preparations for the introduction of the new benchmark. The working group may also seek further input from market participants through additional public consultations.

Chart 1

Geographic coverage of the response sample

February 2019

(number of respondents by geographic area)



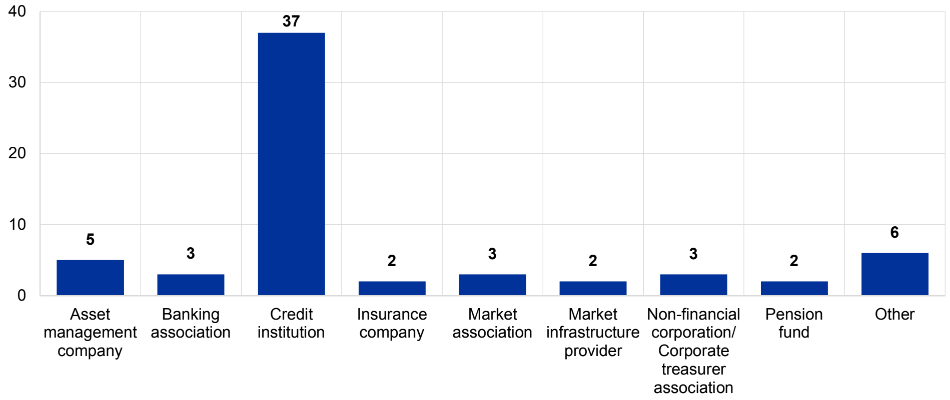
Source: ECB Secretariat to the working group on euro risk-free rates.

Chart 2

Representation of stakeholder groups in the response sample

February 2019

(number of respondents by sector)



Source: ECB Secretariat to the working group on euro risk-free rates.

2 Assessing the transitions paths from EONIA to ESTER

Do you agree with the working group's recommendation that the preferred transition path is the time-limited recalibration approach with a spread and clean discounting?

Respondents broadly agreed with the working group's proposed transition path, as it avoids dual markets, contributes to the rapid and orderly development of ESTER derivatives markets, mitigates potential risks of value transfers between market participants and provides an adequate time frame for renegotiating legacy contracts referencing EONIA.

Respondents largely shared the conclusion of the working group that its proposed transition path seems a good approach for the euro area, as it would address the risk of the bifurcation of liquidity from the parallel existence of ESTER and EONIA markets.

Additionally, some respondents pointed out that the use of a single discounting regime would encourage the transfer of liquidity from EONIA to ESTER, while reducing technical complexity — by avoiding the parallel run of several methodologies in daily business — and market fragmentation.

Adding a spread was also deemed positive, as it would reduce potential value transfers between market participants. Moreover, other respondents pointed out that the existence of a fixed EONIA-ESTER relationship allows the recalibrated EONIA to continue representing the euro overnight unsecured market, i.e. the same underlying interest.

Another argumentation in favour of the working group's recommended transition path was that it would allow EONIA legacy books to lapse or offer an adequate time frame to renegotiate, thereby providing legal certainty and stability for contracts referencing EONIA.

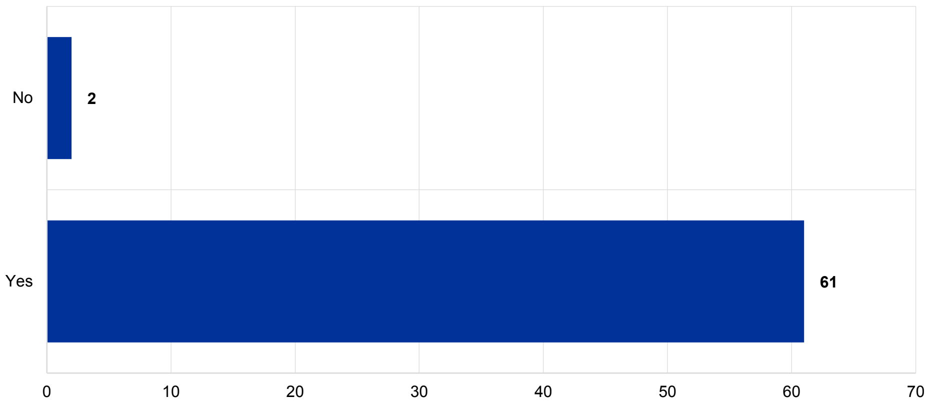
Finally, respondents also mentioned that other approaches were neither achievable within the relevant time frame nor feasible due to uncertainty regarding the sustainability of the panel-dependent EONIA. The simplicity of the preferred option and the fact that it allows for clear communication to clients, was also favoured by some respondents.

Chart 3

Extent of agreement with the working group's recommended transition path from EONIA to ESTER

February 2019

(number of responses)



Source: ECB Secretariat to the working group on euro risk-free rates.

If not, what would be your preferred option and why?

Although only two respondents replied negatively to the previous question, four respondents proposed alternative paths for transitioning from EONIA to ESTER. Three of those respondents pointed to the applicable discounting regime, proposing a dual discounting regime instead of a single one, however.

Both supporters and critics of the proposed transition path noted that the report did not provide sufficient details on the mechanics of discounting for legacy EONIA transactions or whether the applicable rate would be ESTER or ESTER plus a spread, thus requiring more guidance on how discounting and collateral remuneration would be performed until the end of 2021, and beyond.

By the same token, it was noted that a standard approach for closing out or transitioning legacy EONIA exposure on the succession date would be very helpful. This standard approach would require alignment across central counterparties (CCPs) and could entail a standard compensation mechanism and standard documentation on legacy trades, for example, for credit support annexes. Such an approach would help in managing the implications in hedge accounting and tax treatment.

Chart 4

Alternative preferred options to transition from EONIA to ESTER

February 2019

(number of responses)

Source: ECB Secretariat to the working group on euro risk-free rates.

3 Assessing the publication deadline for the recalibrated EONIA

Do you agree that a publication deadline for the recalibrated EONIA of end-2021 is sufficient for a smooth transition under the recalibration approach with a spread and clean discounting?

Respondents generally concurred with the working group's conclusion that the last day for the publication of the recalibrated EONIA at end-2021 was sufficient for a smooth transition under the recalibration approach with a spread and clean discounting, while emphasising however that it was an ambitious deadline, taking into account the need for extensive preparations and repapering of contractual documentation.

On the one hand, the majority of respondents emphasised that the existence of a firm deadline to transition away from EONIA created a strong incentive for a voluntary transition, whilst recognising that different market participants can move at different speeds. Anything longer would run the risk of the market deprioritising the required preparation. However, some respondents warned that it is vital that CCPs switch their price alignment interest (PAI) from EONIA to ESTER early enough and well before the end of 2021 and that there is a transparent and aligned compensation process to this end.

Many respondents mentioned that the envisaged time period until the end of 2021 would also be in line with the requested extension of the transition period in the EU Benchmarks Regulation, as well as with transition periods in other jurisdictions. The latter would facilitate the transition with regard to multi-currency contracts. However, some respondents urged further examination of the possible negative outcomes by aligning key milestones.

Another argumentation in favour of establishing an end-date for the recalibrated EONIA publication was the issue of the legacy book referencing EONIA. As many outstanding contracts will have matured by the end of 2021, this would reduce the burden for contract amendments and changes.

Additionally, it was also suggested that a fixed spread would be more difficult to defend with a longer transition period.

On the other hand, some respondents pointed out that it may be necessary to consider a longer transition period. Although the end-2021 deadline would be preferable, it seemed an optimistic and ambitious timeline for the phasing out of EONIA from financial markets. End-2022 or end-2023 were regarded as more realistic alternative deadlines in the opinion of these respondents.

Some respondents also suggested that it would be safe to introduce flexibility with regard to the deadline depending on how quickly the ESTER derivatives market developed and left some leeway, including the possibility of assessing, prior to the deadline, the state of play on the repapering side and the preparations to move to ESTER, with the capacity for authorities to decide an extension of the deadline. These respondents therefore suggested that the announcement of the EONIA recalibration deadline be seen as a preliminary cut-off date that could be reassessed at a later date, if necessary.

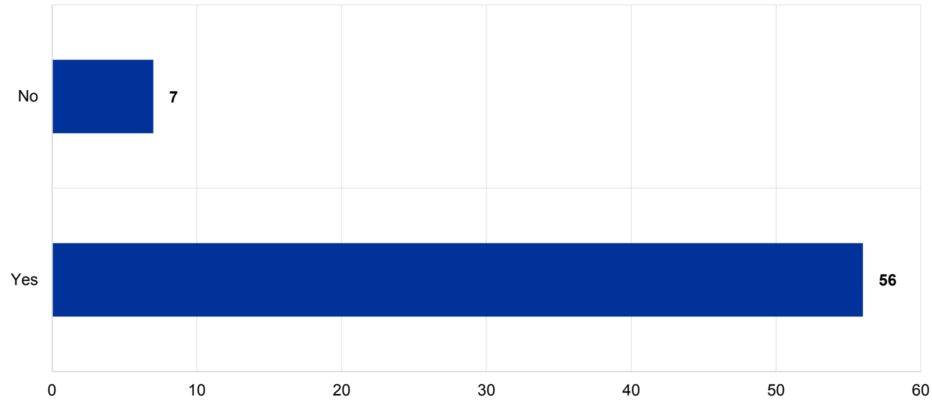
Other proposals were to continue with the recalibrated EONIA publication after January 2022 and allow its use exclusively for legacy transactions, whilst ensuring that there was no incentive to continue adding EONIA exposure as of that date, for example, by withdrawing the authorisation of EONIA from January 2022.

Chart 5

Extent of agreement with the recalibrated EONIA deadline of end-2021

February 2019

(number of responses)



Source: ECB Secretariat to the working group on euro risk-free rates.

4 Assessing the ideas for accelerating the transition

Do you have any other ideas for accelerating the transition of the derivatives market to ESTER?

Although most of the respondents found a time limit to be the most effective incentive for the transition of the derivatives market to ESTER, many respondents proposed alternative ideas:

- Promoting ESTER-linked issuance.
- Including in the transition plan a recommendation whereby new transactions use exclusively ESTER from an earlier date than January 2022, even for transactions which expire before that date.
- Setting up an infrastructure subgroup that could review operational issues and offer guidance to market participants.
- Ensuring CCPs can clear ESTER swaps as soon as the fixing is published and ensuring CCPs early adoption of ESTER as PAI would be seen as positive measures; another suggestion would be to announce an accompanying compensation mechanism in CCPs to facilitate the switch from EONIA to ESTER.
- Promoting the use of ESTER as a discounting curve for pension funds and insurance liabilities.

- Organising the publication of a specific EONIA-ESTER ISDA protocol to tackle the EONIA to ESTER transition and to avoid the burden of bilateral renegotiation. The proposed protocol should likely cover not only ISDA Master Agreements but also other Master Agreements (e.g.: local Master Agreements), credit support annexes and other collateral agreements.

- Developing ESTER-based futures.

- Increasing communication in order to make the market aware of the upcoming and necessary changes.

- Providing direction to the market through a clear milestone-based transition plan.

- Providing clarity to the market that with the EONIA recalibration the underlying interest of EONIA remains unchanged.

- Enacting a legislative framework to enforce a transition.

- Introducing heavier capital charges for assets referencing EONIA.

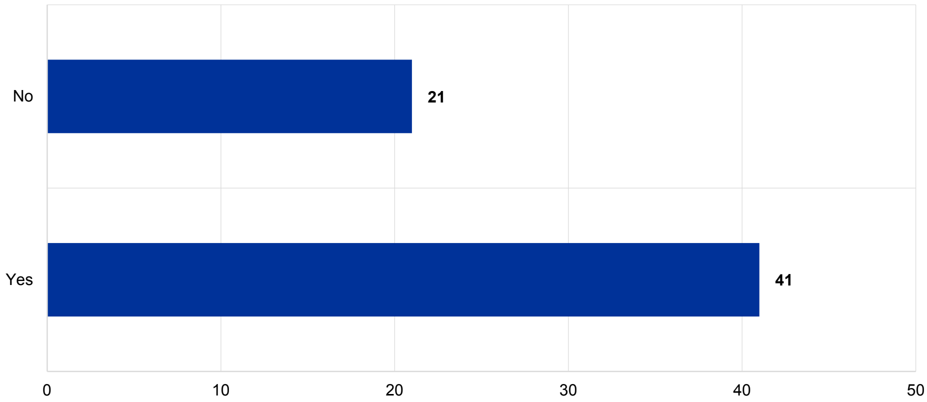
- Regulators requiring financial firms to start preparations for the transition.

Chart 6

Extent of proposals to accelerate the transition of the derivatives market to ESTER

February 2019

(number of responses)



Source: ECB Secretariat to the working group on euro risk-free rates.
Notes: The sum of the number of responses does not equal the total number of responses received as some respondents did not reply to this question.

5 Assessing the authorisation and supervision of the recalibrated EONIA

Do you see any benefit in the new recalibrated EONIA being authorised and supervised until its publication deadline?

The majority of respondents regarded the authorisation and supervision of the recalibrated EONIA until its publication end-date as positive, because it would add legal certainty to the transition process and it would illustrate that the recalibrated EONIA was also in line with best practices and international recommendations.

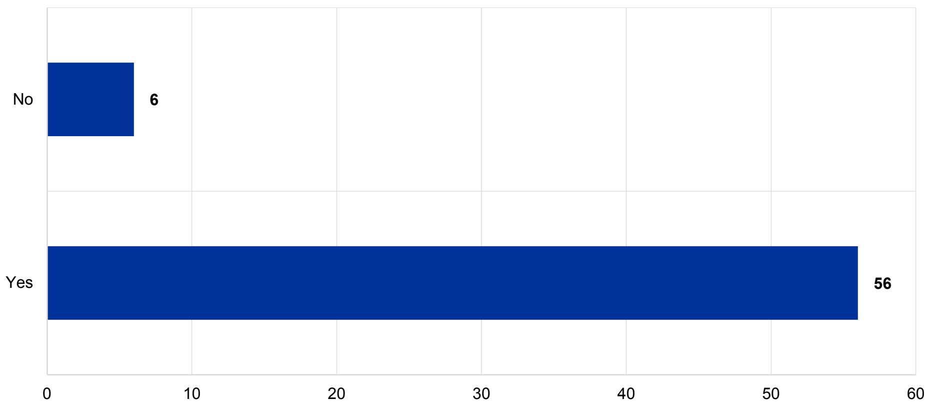
The increase in confidence of the appropriateness of the methodology and its governance through the authorisation and supervision of the recalibrated EONIA was considered a positive development.

Any clarification by EONIA's administrator or the European authorities to illustrate that developments in the methodology do not alter the underlying interest was seen as contributing to a smooth transition. It was also mentioned that such supportive actions by the administrator and competent authorities would also underpin the operational and legal framework during the migration process.

Other respondents pointed out that the authorisation and supervision of the recalibrated EONIA was a nice-to-have, but that it did not bring any tangible benefits in their view, arguing that, if the recalibrated EONIA were to be based on ESTER that should be sufficient.

Chart 7
Extent of support for the authorisation and supervision of the recalibrated EONIA

February 2019
(number of responses)



Source: ECB Secretariat to the working group on euro risk-free rates.
Notes: The sum of the number of responses does not equal the total number of responses received as some respondents did not reply to this question.

6 Assessing the spread methodologies

Do you agree with a spread methodology based on a one-year pre-ESTER historical data period, calculated as an average with a 15% trimming?

Respondents mainly agreed with the working group's proposal with regard to the spread methodology based on a one-year pre-ESTER historical data period, calculated as an average trimmed at 15%.

Respondents highlighted that the working group's proposed spread calculation methodology provided a good compromise between the benefits of a longer period (e.g. transparency and robustness) and a shorter period (e.g. a better capture of the most recent EONIA-ESTER spread), thereby reducing potential value transfers.

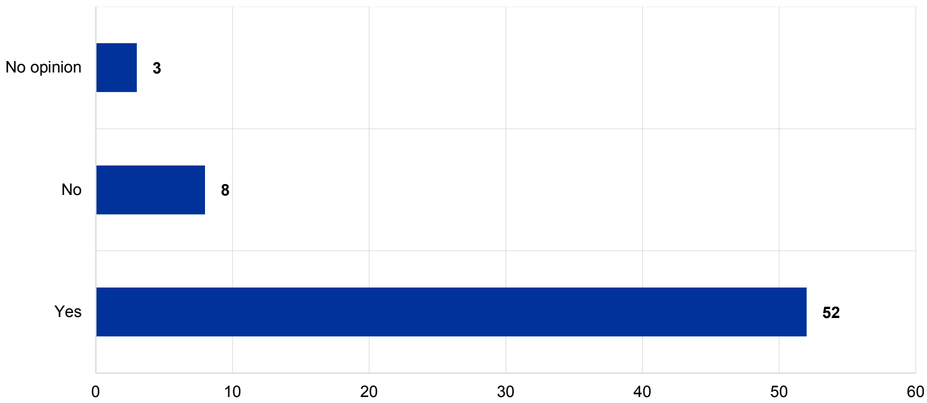
Furthermore, some respondents emphasised that even if more sophisticated approaches could be used, an easy-to-understand and easy-to-adopt approach which, at the same time as being reliable and transparent, outweighed more theoretical approaches.

Chart 8

Extent of agreement with the working group's proposal of a spread methodology based on a trimmed mean (15% 1Y)

February 2019

(number of responses)



Source: ECB Secretariat to the working group on euro risk-free rates.

If not, what would be your preferred option and why?

Alternative proposals mostly emphasised the use of a longer data period for the calculation of the spread between EONIA and ESTER, as well as assigning more weight to most recent data, while some respondents questioned the use of a 15% trimming mechanism.

Those respondents who opposed the working group's conclusion mainly favoured the spread being calculated on the basis of a longer look-back period, taking into account all available Pre-ESTER data in order to avoid the influence of short-term volatility patterns or idiosyncratic movements.

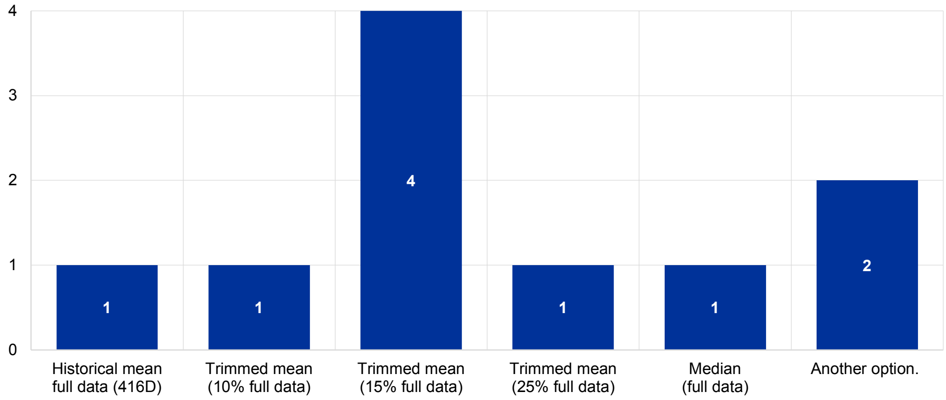
Some respondents thought that the trimming could reduce the representativeness of the spread, as it could eliminate some recurring market fluctuations.

Additionally, some respondents recommended the use of a time-weighted average with a view to assigning more weight to the most recent data and less to distant data; an exponential weighting average was also mentioned as an alternative option by those respondents.

Moreover, both supporters and critics of the spread methodology mentioned that good communication on the chosen parameters was important and some recommended that the disclosure of the spread and detailed methodology should occur on the same day as the disclosure of the one-year reference period.

Chart 9
Alternative proposed spread methodologies

February 2019
(number of responses)



Source: ECB Secretariat to the working group on euro risk-free rates.

7 Assessing the timeframe needed for systems readiness for ESTER T+1 publication

How much time do you think would be the minimum required to make your systems ready for ESTER T+1 publication?

A wide range of responses were given with regard to the minimum time required to make systems ready for ESTER T+1 publication, ranging from 1 to 24 months. The most common response was 6 months, followed by 9 and 12 months. Many of the respondents only provided qualitative feedback. Some of the respondents mentioned that they were currently investigating the impact of the transition at the internal level.

It was highlighted that readiness across market participants was essential for a well-functioning ESTER market to develop. Some respondents cited the experience in the development of SOFR and related markets, indicating that it showed that the timing for systems' readiness varied across organisations; some market participants would likely require considerably more time to be operationally ready to trade products using ESTER than others.

It was acknowledged that EONIA was used in a wide variety of derivatives, credit support annexes and cash products and for valuation purposes for euro denominated products — not only EONIA-linked, but also EURIBOR-linked — and, therefore, many systems and processes would be affected by the transition from EONIA to ESTER:

- While some respondents signalled that it would require around 12 or 15 months to develop the systems and applications and to run tests to avoid operational errors and disclosure issues, others pointed to at least 20 months. Yet some other respondents stated that the related IT developments would have to be prioritised in order to achieve correct delivery before the first publication of ESTER.
- Some market participants referred to their experience in the transition from GBP LIBOR to SONIA and mentioned that the change from T to T+1 would require at least 4 to 6 months. Among other aspects, the preparations would require analysing the inventory as well as the exposures, along with updates to pricing systems and other internal systems with dependencies on the given rate.
- The USD LIBOR to SOFR transition was also cited as an example of the work that would be required for the adoption of ESTER as a new rate, which includes internal governance processes for the approval of the usage of new products or services, operational applications (pre-post trade) and related testing from front to back.

- It was noted that the change of the publication of the reference rate from T to T+1 would have a profound impact on the valuation processes of many products and that it was difficult to assess and to develop the exact implementation process, as substantial elements were still missing, such as market conventions, switchover date and the final spread.

- It was also noted that the time required for the critical work of setting up new curves was estimated to be significant due to the number of curves to be reviewed, for example, benchmark yield curves, discounting curves, intraday curves, tenor curves, etc. Respondents also agreed with the assessment that MMFs would be highly impacted by the change from same day settlement to T+1.

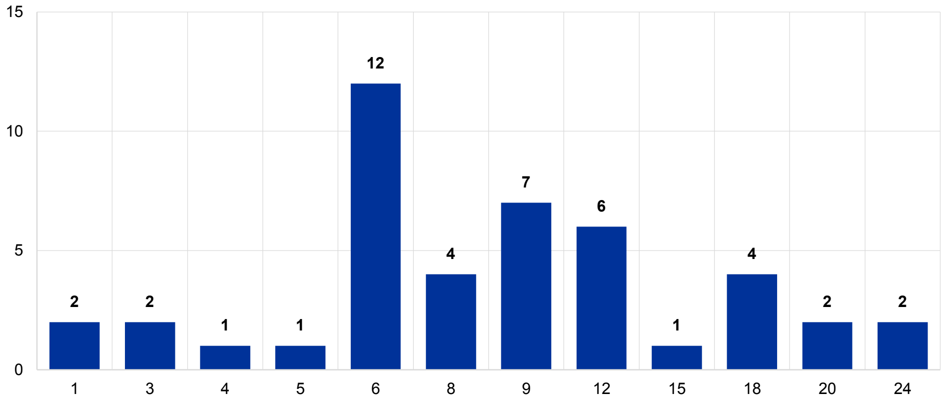
Finally, some respondents saw scope for the working group on euro risk-free to address the issue that there would be one day without EONIA fixing. Coordination would be required to find an industry-wide compromise and the working group on euro risk-free rates was regarded as an appropriate forum to facilitate such discussions.

Chart 10

Number of months required to make systems ready for ESTER T+1 publication

February 2019

(number of responses)



Source: ECB Secretariat to the working group on euro risk-free rates.
Notes: The sum of the number of responses does not equal the total number of responses received as some respondents did not reply to this question.

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