

Indexes crisis: The uncertain future of Eonia and Euribor.

Eonia and Euribor, the leading reference rates on financial markets of the euro zone, are involved in the valuation of almost all derivatives contracts denominated in euro - i.e. a market of over 100 trillion euros¹, and Euribor is the most common type of floating rate on floating rate loans in the euro area.

Yet **their survival is at stake**.

Two main reasons explain this situation:

- Euro area money market flows were affected by the financial crisis in 2008 and the liquidity crisis in 2011. It is now the ECB that is at the core of the money market to the detriment of day-to-day interbank transactions. At the same time, there was a sharp increase in interbank repo volumes but they are excluded from the calculation of the Eonia.
- The Libor scandal and the heavy fines imposed on several banks for manipulation have contributed to the willingness of some actors to leave the Euribor panel.

Thus, the **number of contributors to Euribor dropped from 49 in January 2007 to only 20 at the end of 2017** after JP Morgan's noticeable decision to withdraw from the panel in September 2017. The EMMI2 has raised alarm about the scarcity of contributors and estimates that at least 40 banks would be needed to keep the index safe from disappearing.

At the same time, **contributors to the Eonia fell from 44 in 2013 to 28 at the end of 2017** and around 80% of the transactions that constitute the Eonia rate are carried out by only five banks. This situation is so worrying that on 29 June 2017 the European Commission raised the status of Eonia to "critical" : a level forcing banks to remain on the panel for a period of two years.

In September 2017 the ECB, FSMA, ESMA and the European Commission issued a joint statement announcing the creation of a working group to oversee the identification and **adoption of a Risk Free Rate (RFR) for the euro zone** that could provide an alternative to Euribor.

Within the same month, the ECB announced that it would create a new day-to-day index that could co-exist with Eonia or replace Eonia. The ECB has announced that **this index will be created before 2020**.

It will be essential that a swap market is developed on this new benchmark if this new index is to truly replace Eonia, which may take time and fuels fears of a tense transition period..

¹ https://www.bis.org/publ/otc_hy1711.pdf, page 9

² EMMI stands for European Money Market Institute. EMMI officially publishes Euribor and Eonia. It is a non-profit organisation based in Brussels.

³ This working group includes banks and public and private market actors across Europe. The work of this working group has just begun.

What will happen to Euribor?

It's still too early to tell.

According to the new Benchmark Regulation⁴ which came into force on 1 January 2018, an index will be operational from 2020 onwards if it meets a number of criteria⁵. Among these criteria, the index should be based as much as possible on real transactions. And if there are not enough transactions, the index should be based on other data that can be used as soon as they represent either the market fairly and accurately or the economic reality that the benchmark intends to measure.

In contrast, the current Euribor definition is not based on actual transactions since its definition refers to the rate at which the contributor estimates that a leading bank would quote a deposit of this maturity to another leading bank within the euro area. Euribor is, as its name suggests, an offered rate (upper range) and is based on an estimation that increases the bank's legal risk in the event of an outlier contribution.

Proposals for adapting the index have been formulated by EMMI, but it will be necessary to wait until the last quarter of 2018 to find out whether these proposals comply with the regulations and satisfy market participants. In addition to that, the new working group announced in September 2017 will also make proposals. The clock is ticking.

What will happen to Eonia?

The future of Eonia seems even darker.

The ECB intends to use the MMSR which is a statistical tool introduced in April 2016 to analyze the smooth transmission of its monetary policy decisions into market rates as an information basis for determining a more representative day-to-day rate than EONIA.

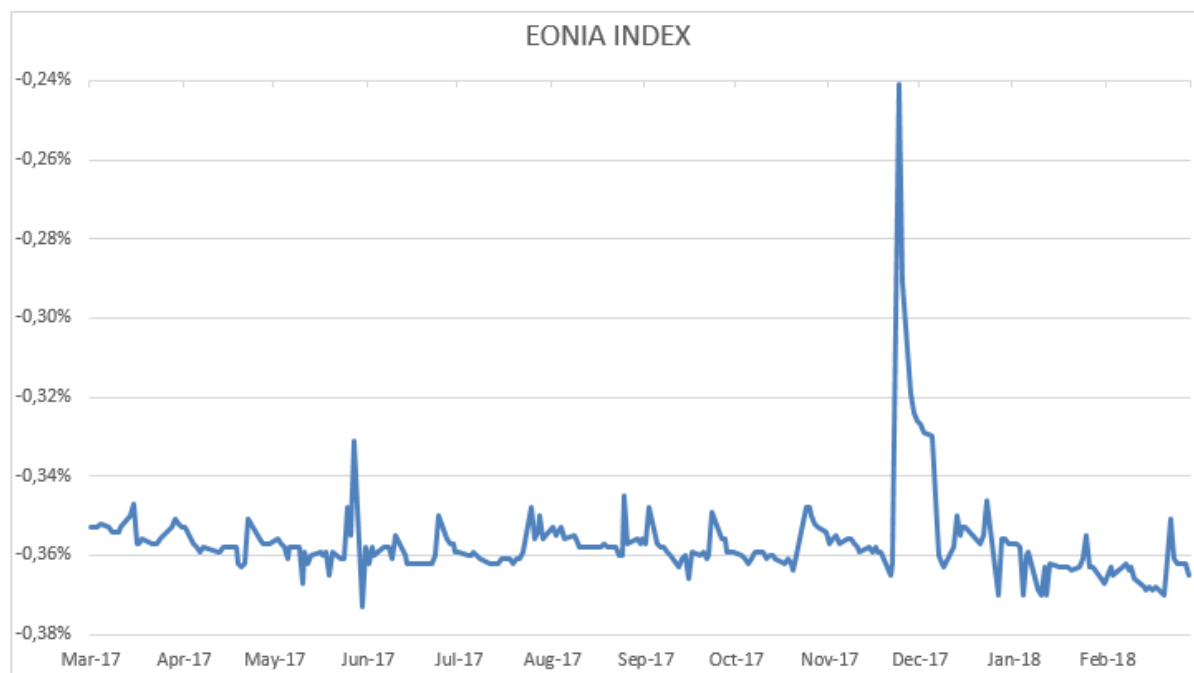
Based on this tool, the ECB intends to create a new index, independent from the Eonia, which will be placed under its responsibility following the example of the Federal Reserve in the United States, the Bank of England or the Swiss National Bank, which have already overhauled their index for overnight rates.

The new index will have to represent a much larger trading volume and not be disrupted by anecdotal transactions, as in the end of September 2017 when exceptionally more active Greek banks raised the Eonia's level by 12 basis points from one day to the next. It was a dramatic scenario that ended up undermining the credibility of the index and disrupting the Eonia swap market.

⁴ <https://www.esma.europa.eu/policy-rules/benchmarks>

⁵ Where an existing reference index does not meet the requirements of the present Regulation, but the ending or modification of that reference index in order to bring it into line with the requirements of the present Regulation would result in force majeure, would compromise or otherwise would contravene the terms of a financial contract or instrument, or the rules of an investment fund, referring to that reference index, the use of the reference index is authorized by the competent authority of the Member State in which the index provider is situated. No financial instrument, financial contract or performance measure of an investment fund adds a reference to such a reference index existing after 1 January 2020.

The fixing of Eonia is now based on daily volumes that ranges from 4 to 8 billion euros while day-to-day liquidity is traded for more than 250 billion euros daily. Such a gap must be filled.



Fixing of the Eonia index over the past year with the fixing disturbed at the end of November 2017. Source: Bloomberg

It is quite likely that this new reference will quickly replace Eonia and that the problem of substitution rates will have to be dealt with. Moreover, since EONIA is now clearly above the rate at which intra-day liquidity currently quotes⁶, it is quite likely that the new index will be lower in rate than EONIA.

Historically, it was also the observation of Danske Bank's interest rate trading manager, Eske Traberg Smidt, who recently stated in an article published in Risk Magazine that there was a widening gap between the level of the Eonia fixing (around -0.36%) and the rate of -0.47%, which reflected more adequately the level at which the market treats cash for a period of 1 day.

⁶The euronia currently sets around 11 basis points below the Eonia.

What should be done today to hedge the risks associated with the announced evolution of these indexes?

Market participants will have to be vigilant about the consequences of these announced changes in the valuation of derivatives, particularly if a new day-to-day index coexists for a while with Eonia. This situation might introduce new complexities into the valuation of derivatives, particularly for everything that is not centrally cleared.

1. Assessing the risk:

Starting today, it is important to check to what extent index substitution clauses could have a financial cost. This is also the case when direct exposure at index level is limited, for instance if swaps are backed by mirror swaps or because a floating rate loan is swapped for instance.

In some cases, exposure to index changes remains significant when rate substitution clauses are activated:

- Because they are written differently.
- Because they are governed by different rights.
- Because the substitution does not occur at the same time.

And if the portfolio is directly exposed to indexes, the risk must be measured and the available options assessed. For example, is it preferable in this context to have a variable rate exposure on Eonia or Euribor?

2. If possible, make contracts consistent:

The risks of mismatches can be limited if these issues are addressed today, for example by using similar languages for index replacements in back to back contracts.

3. Remain vigilant:

You must be vigilant if you are approached by counterparties to carry out certain transactions that modify the structure of your portfolio.

Indeed, we remember the 2008/2010 period when some banks were better informed than others and actively offered derivatives recouponings just before the collateralized derivatives market migrated from a Euribor basis to an Eonia basis.

The evolution of an index is inherently risky and the analysis of these risks is not simple. ESTER stands by your side to further discuss this subject with you.

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