

Consulting on new benchmark rates: ECB launches first consultation on EUOIR's high level principles

Consultation on developing an Euro unsecured overnight interest rate (EUOIR) to run to 12 January 2018

On 21 September 2017, the European Central Bank (ECB) announced¹ that it was launching a new overnight benchmark rate. This central bank led alternative would complement existing private sector rates and also serve as a "backstop to private sector benchmark rates". The ECB also announced the creation of a new working group tasked with developing the new risk-free overnight reference rates for the Eurozone (the **RFOR Working Group**)². On 29 November 2017³ it launched a call for participants to join that group following the launch of the ECB's 'first' public consultation⁴ on EUOIR's design a day before. Both the ECB's consultation process and the submission date to join the RFOR Working Group will close on 12 January 2018.

The RFOR Working Group is influential as it is the body that will decide whether to adopt EUOIR or an alternative to EUOIR as an appropriate (nearly) risk-free reference rate. Similar activity, spurred by recommendations of the Financial Stability Board, is being undertaken by global peers, notably the Bank of England and U.S. counterparts across the Atlantic including the Alternative Reference Rates Committee which has stated that its relevant replacement rate(s) could start as early as mid-2018. In summary, the ECB's proposals on a new rate joins the global race to find new benchmark replacement rate whilst the private sector in the EU is moving to meet compliance with new wide-reaching rules in the form of the EU's Benchmarks Regulation (EU 2016/1011) (the **BMR**), which enters into force on 1 January 2018.

The ECB's new benchmark rate is currently referred to as the "Euro unsecured overnight interest rate". At present this rate is officially unnamed, however, for purposes herein referred to as **EUOIR**. Whilst this working title and its pronunciation ('Eeyore?')⁵ are yet to be finalised, the ECB Governing Council's decision to develop a rate based on data available to the Eurosystem is promising and quite welcome and preserves the principle and place of an unsecured rate as a benchmark. A key question is whether waiting to get EUOIR up and running by 2020 will be too long in the event that alternatives from the private and the public sector have begun operations in the interim?

¹ See our coverage here: http://www.bakermckenzie.com/-/media/files/insight/publications/al_germany_ecbworkinggroup_sep17.pdf?la=en

² Comprised of the ECB, the European Commission, the European Securities and Markets Authority and the Belgian Financial Services and Markets Authority.

³ See: https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/shared/pdf/call.pdf

⁴ See: http://www.ecb.europa.eu/paym/pdf/cons/euoir/consultation_details_201711.pdf

⁵ Which many may know as a central character from works by A.A. Milne including the copious animated adaptations of works and appearances in standalone specials aired for the festive season. Chapter 4 of the consultation and footnote 11 states that the name of EUOIR is yet to be decided.



Putting the EUOIR in context

The ECB's commitment to EUOIR aims to restore faith in benchmark rates, submitters and administrators and thus assist in reviving liquidity of unsecured money markets. It will also likely be far reaching in terms of its use in financial market transaction documents and products including those used not just by financial firms, but by the "real economy".

Even if the ECB, as a central bank, is not subject to the scope of BMR it will nevertheless be important for users of EUOIR. It should also be noted that the ECB has a history of self-applying EU regulatory standards that it is otherwise exempt from. Where this leads to convergence and a more level playing field then this is desirable, but market participants, whether they lobby or participate in the RFOR Working Group, will have an interest in ensuring EUOIR in its final form is workable including private sector participants' relevant BMR compliance obligations.

The ECB's very well written and structured⁶ consultation document focuses on establishing the "high-level features of a new unsecured overnight interest rate". The expectation is that a further consultation will follow during the second or third quarter of 2018. The ECB will publish⁷ a high-level summary of the comments to the first consultation. In terms of overall timing, this fits in with the original plan to release further operating details during 2018 with a view to finalising and having EUOIR implemented by 2020.

The ECB proposes that EUOIR be calculated using data collected entirely from transactions in Euro that are reported by relevant banks as part of the ECB's money market statistical reporting (**MMSR**) exercise. That exercise started mid-2016 and is conducted in accordance with the MMSR Regulation⁸. Collected data is supplemented by longer-term values collated from the Euro Money Market Survey and TARGET-2 data.

Following the consultation phase on EUOIR and very much as part of the design phase, the ECB will finalise the definition and the parameters of "which economic reality the new rate intends to measure, develop the calculation methodology and test the robustness of the rate" ahead of implementation of the rate by 2020. This definition and the parameters, also referred in the consultation document as the "underlying interest" (see below) are in keeping with requirements and the spirit of the BMR. As the BMR does not apply to the ECB, the first consultation document has clarified that EUOIR's design is set to follow benchmark standards set by the International Organization of Securities Commissions (**IOSCO**). Those standards were taken into account and expanded upon by the BMR's provisions.

Key takeaways from the points out for consultation

The ECB's first consultation document is split into two parts. Part A summarises the size of the unsecured market and levels of liquidity across the Eurozone. It does this by using TARGET-2 data as well as the broad uses of unsecured overnight benchmark rates by stakeholders. In its analysis the ECB notes that at present, the MMSR data is not a complete dataset, even if supplemented by TARGET-2 data. As the amount of MMSR data increases this may improve the quality of input data for purposes of calculating and determining EUOIR. Chapter 3 of Part A reviews these issues in greater detail and weighs up the data sufficiency considerations as well as the breadth of representation of those submitting.

⁶ Certainly Part A of the two part consultation.

⁷ See: http://www.ecb.europa.eu/paym/cons/html/euro_unsecured_overnight_interest_rate.en.html

⁸ Regulation (EU) No 1333/2014 of the European Central Bank of 26 November 2014 concerning statistics on the money markets (ECB/2014/48), see: https://www.ecb.europa.eu/ecb/legal/pdf/oj_jol_2014_359_r_0006_en_txt.pdf

This scene setting is complemented by the contents of Part B and the concrete consultation and six specific questions. The first consultation document confirms the announcement made in September 2017 that EUOIR will be calculated on the basis of the current 52 MMSR reporting banks. Each of these are a reporting agent⁹ for purposes of the MMSR Regulation.

That being said, the first consultation document states that the bulk of firms forming the "MMSR reporting scope" could be expanded to a wider group when the ECB decides upon this during and at the latest before the end of 2018. This might include expanding the scope to non-banks as reporting agents. By ensuring that EUOIR also covers transactions beyond the interbank market i.e., with financial sector counterparties both the depth and distribution of data that would flow into the rate calculation would more accurately reflect the broader economic factors prevalent across the market in respect of the given time period.

EUOIR what's its "underlying interest"?

Part B of the consultation and its Chapter 4 sets out that the IOSCO principles require a benchmark to have an "underlying interest" in terms of what the benchmark measures and how it does this. These IOSCO principles are also echoed in the BMR. The definition and parameters of the "underlying interest" are subject to periodic review and potential adjustments. The consultation document describes this *raison d'être* for the rate as:

"The new [ECB unsecured overnight rate] is a rate which reflects the euro overnight funding costs of euro area banks. The rate is published daily on the basis of transactions deemed to be executed at arm's length."

In many ways this is straight, sweet and succinct... save that there may be some grounds to amend that definition given that the word "deemed" might be interpreted as limiting if the ethos behind the rate requires all in-scope transactions for data collection purposes to be actually executed at "arm's length". If the pool is expanded beyond banks, then this description may require amending in any event. Question 3.2 in Chapter 5 asks quite directly whether the pool should or should not be expanded.

Chapter 5 of Part B of the consultation discusses what constitutes "Borrowing Costs" as well as what, in light of the IOSCO principles, constitutes an arm's length transaction in the context of EUOIR's design. Chapter 5's discussion focuses on data quality and specific attention should be given to Question 4, which considers and asks whether EUOIR should be based on transactions in financial instruments other than money market deposits. A move to other such transactions would broaden the dataset even if the breadth of submitters remained concentrated around the original group of "reporting agents".

Part B concludes the consultation document with a technical discussion on some of the procedural attributes related to EUOIR and notably the timing of when the rate is to be published. The ECB proposes that the rate be published at 9 am CET in the morning of the next TARGET2 business day with, depending on responses to the consultation and its specific questions, the possibility of an earlier or later publication date as well as time. Question 6 rounds things off with a catch-all

⁹ The MMSR Regulation requires that reporting agents report to the ECB or the relevant national central bank: (a) all borrowing using the instruments defined in the MMSR Regulation, which are denominated in euro with a maturity of up to and including one year (defined as transactions with a maturity date of not more than 397 days after the trade date), of the reporting agent from other monetary financial institutions (MFIs), other financial intermediaries (OFIs), insurance corporations, pension funds, general government or central banks for investment purposes as well as from nonfinancial corporations classified as "wholesale" according to the Basel III LCR framework; and (b) all lending to other credit institutions with a maturity of up to and including one year (defined as transactions with a maturity date of not more than 397 days after the trade date) via unsecured deposits or via the purchase from the issuing credit institutions of commercial paper, certificates of deposit, floating rate notes and other debt securities with a maturity of up to one year.

question of what other high-level features or issues should be taken into account when developing EUOIR.

Next steps and outlook to 2020

In addition to the considerations in terms of documentation, models and lobbying that we mapped out in our earlier contribution¹⁰ on the development of EUOIR, market participants may want to consider:

1. the merits of becoming a MMSR reporting agent and what impact that may have generally or specifically in relation to compliance obligations pursuant to the BMR;
2. whether to join the RFOR Working Group. The deadline for joining is 12 January 2018;
3. modelling and scenario-planning how such rate would affect their own use of rates that EUOIR would complement or replace;
4. what transaction, product and control process policies, processes and documentation (including client-facing terms) might need amending to account for EUOIR as well as BMR-compliant 'back-up plans' that reflect EUOIR as a fallback rate or what the agreed process is should EUOIR cease to be an available fallback rate to another rate; and
5. assess what governance workstreams would need to be put in place as a user or provider of data related to EUOIR and how these might differ to similar measures required pursuant to the BMR.

So will it work? The first consultation is a step in the direction, but it is the first step. With 2018 set to be exceptionally busy across the Banking Union in terms of reforms coming into place, including the BMR which will have a transformative effect across "change the business" as well as "run the business" workstreams EUOIR will be one of many workstreams requiring attention and resourcing by market participants.

The move to replacement rates is continuing and doing so at different speeds across different jurisdictions. Importantly the European Money Markets Institute (**EMMI**), which manages European interbank benchmarks such as EURIBOR/EONIA, is launching its own reference rate for the Euro repo market in 2018. This new rate from EMMI will like EURIBOR and EONIA be in scope for purposes of BMR. EMMI's consultation on its new rate closed on 14 July 2017 and EMMI confirmed¹¹ on 29 November 2017 that it will be participating in the RFOR Working Group.

The road to 2020 is set to be busy and full of marked change. This includes finalisation and entry into circulation of replacement rates, continued embedding of compliance with BMR ahead of its review in 2020 as well as BREXIT and rates determined in the UK, suddenly needing to be permissioned in the EU so that EU supervised entities can use these. Consequently, private sector stakeholders will need to be ready to respond and amend models, documentation, governance and a wealth of other documentation and product specific workstreams that are affected by BMR and reliant on specific rates. EUOIR is certainly important, but one of multiple replacement rates.

¹⁰ See: http://www.bakermckenzie.com/-/media/files/insight/publications/al_germany_ecbworkinggroup_sep17.pdf?la=en

¹¹ See: https://www.emmi-benchmarks.eu/assets/files/D0572-2017-%20EMMI%20to%20participate%20in%20euro%20risk%20free%20rates%20Working%20Group_State%20ment.pdf

If you would like to receive more analysis from our wider Eurozone Group or in relation to the topics discussed above, including how replacement benchmark rates including EUOIR might affect documentation of financial transactions as well a host of related processes or how to respond to this and future consultations, then please do get in touch with any of our Eurozone Hub key contacts below.

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