EUROPEAN CENTRAL BANK
BANKING SUPERVISION

Horizontal assessment of SSM banks' preparedness for benchmark rate reforms

1 The horizontal assessment in summary

In July 2019 the ECB conducted a horizontal stocktake of the impact of the reforms under the EU Benchmark Regulation (BMR)[1] on banks supervised under the Single Supervisory Mechanism (SSM) and assessed their preparedness for it.

As a general conclusion, it was found that banks have focused more on the transition phase from the euro overnight index average (EONIA) to the euro short-term rate (€STR) than on the reform of the euro interbank offered rate (EURIBOR) and its associated risks. However, EURIBOR is the main benchmark rate in the euro area in terms of the number of contracts that reference it and is widely used in retail loans and hedging products.

Another key finding is that, while banks are aware of the potential risks entailed by the BMR reform, their action plans and, more concretely, the development and implementation of mitigation actions,[2] are generally behind schedule.

[1] Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 (OJ L 171, 29.6.2016, p. 1).

[2] E.g. fallbacks, concrete communication strategy, detailed implementation timeline, etc.

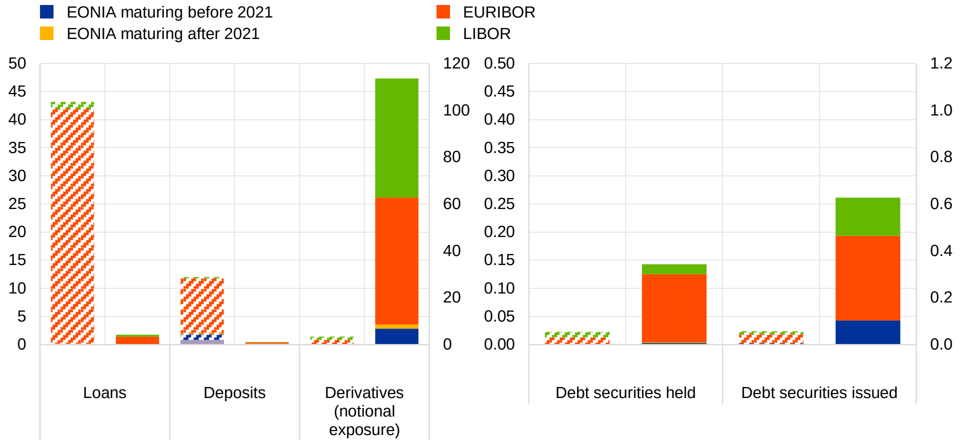
2 Measuring the impact

There are two main aspects to the importance of benchmark rates for euro area significant institutions (SIs) (see Chart 1): the exposures that are affected by the reforms (measured as notional exposure or carrying amount) and the number of contracts referencing rates that are subject to reform. The former gives an indication of the relative sensitivity of euro area SIs' profit and loss to a transition-induced change in reference rates (e.g. through activation of a fallback rate or other contractual provision or complete renegotiation of contracts). The latter captures the process-based challenges for banks, giving an indication of the number of counterparties whom banks need to inform or with whom banks may need to negotiate contractual changes.

Chart 1

Carrying amounts and number of contracts

(left-hand scale: number of contracts (millions); right-hand scale: carrying amounts (trillions))



Source: Dedicated data collection with euro area Sis.
Note: Number of contracts is shown with a patterned fill and carrying amounts are shown with a solid fill.

Data show that benchmark rate reforms have an impact on banks in terms of both of these measures: in total, euro area SIs have more than 50 million contracts outstanding that reference the benchmark rates under reform. Loan contracts account for more than 40 million of these outstanding contracts, but there are also more than ten million deposit contracts and more than one million derivatives contracts. Overall, notional exposure exceeds €110 trillion – predominantly through derivatives contracts.

The key rate for most euro area SIs is EURIBOR, which the great majority of reported outstanding contracts reference. EONIA is a significant reference rate for discounting purposes, but has far fewer contracts directly linked to it. Nevertheless, there are more than one million deposit contracts referencing EONIA and more than €5 trillion of notional exposures through derivatives contracts. Only relatively few contracts reference the London interbank offered rate (LIBOR), but euro area SIs on aggregate hold more than €40 trillion of notional LIBOR exposures through derivatives contracts, mostly linked to the USD LIBOR.

While the exposure through derivatives might overstate banks' sensitivity to changes in the rates, as the direction of the exposure is not taken into account and banks hold offsetting contracts in the context of market-making, overall exposure remains significant. The exposure through loan contracts alone exceeds € 4.5 trillions.

Direct exposures do not give the full picture of a bank's exposure to reference rate changes. Benchmark rates are often used for discounting purposes for a much wider range of instruments than those contractually referencing the rate in question. The total population of contracts affected by benchmark rates is difficult to capture, but is not limited to the types shown in the chart above.

3 Banks’ assessment of the risks related to the benchmark reforms

As part of the ECB’s data collection exercise, SIs submitted a qualitative ranking of risks related to the benchmark reforms. They see communication with counterparties to EURIBOR contracts as the greatest challenge. This is crucial in avoiding legal risks in the context of the large number of retail contracts that are affected. Banks will need to agree with counterparties how to incorporate fallback language into contracts in the event of EURIBOR being unavailable in the future.

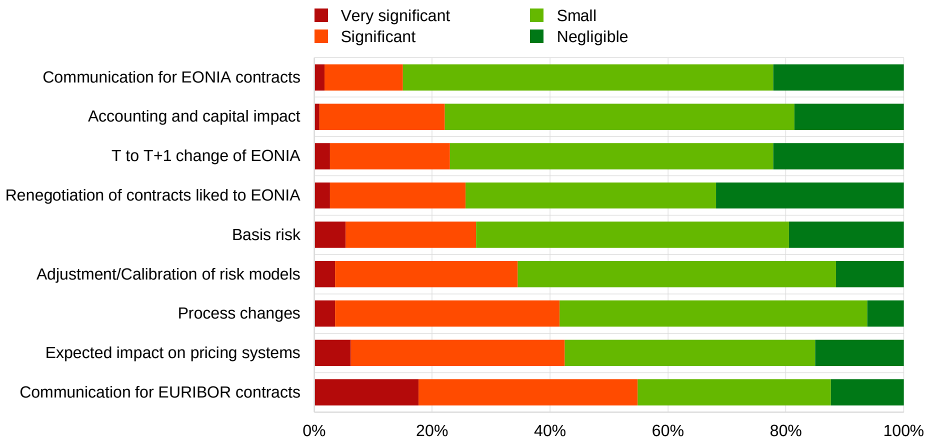
Banks cite the expected impact on pricing systems as the second most significant challenge and process changes as the third, as the reforms have an impact on, among other things, banks’ reporting and risk systems. The fourth item on the list, adjustment and recalibration of risk models, could in fact be regarded as a sub-item of the third (process changes) that is significant enough to cite separately.

Chart 2

SIs’ qualitative assessment of risks related to the benchmark reforms

For the nine risk types shown along the x-axis, euro area SIs were asked to indicate whether they assess this risk as negligible, small, significant or very significant. The chart depicts the share of SIs giving the respective risk assessment

(percentages)



Source: Dedicated data collection with euro area Sis.

4 Risk and challenges for banks

Below is a non-exhaustive list of risks and challenges; the interaction between them also warrants careful attention.

General business risks:

- knowledge gap risk (i.e. banks are unaware of an aspect of the reforms or their implementation, resulting in a lack of preparedness);
- relevant rates or related financial instruments are unavailable owing to market illiquidity;
- business risk stemming from new products and/or a delay in operational readiness and potential loss of market share;
- implications for internal core processes, such as controlling (e.g. budgeting and margin calculation) and steering of interest rate and foreign exchange exposures and related risks;
- reputational risks arising during the transition phase (e.g. as a result of a delay in operational readiness or a gradual deviation from acknowledged good practices or market standards).

Risks relating to counterparties:

- legal risks (particularly with regard to contract law in different jurisdictions, and including consideration of contract continuity);
- communication challenges with counterparties;
- consumer protection considerations (e.g. in relation to conduct during the renegotiation of existing contracts, or to any fund or issue-related prospectus or similar publication);
- changes in customer demand for different products or specific contractual terms.

Risks relating to third parties:

- discontinuation of reformed benchmark rates owing to a lack of contributors;
- risks arising from third-party service providers (especially in relation to outsourcing) or vendors.

Operational risks:

- operational challenges associated with repapering of contracts and the introduction of fallback provisions, which can entail a large operational burden and demand for personnel resources owing to customer enquiries;
- impact on booking infrastructure;

- changes to master data for contracts and accounts;
- adjustments to settlement and payment infrastructures;
- IT-related restrictions with regard to the valuation and booking of new products based on the reformed reference rates and corresponding valuation methodologies (e.g. continuous compounding);
- file transfer protocol (FTP) systems that depend on legacy rates that are going to be discontinued.

Financial risk management:

- risks relating to product adjustment strategies;
- impact on hedging strategies and management of basis risk, including back-to-back hedges;
- impact on internal decision-making (e.g. funds transfer pricing);
- risks from cross-currency products, where the reform path differs for the relevant reference rates;
- changes to the cost of hedging owing to lack a of liquidity in relevant products;
- impact of the renegotiation of contracts on pricing and margins.

In addition to risks, banks consider regulatory and accounting implications:

- valuation (including potential cliff effects);
- impact on additional value adjustments (AVA);
- other accounting implications;
- tax implications;
- impacts on discounting in internal calculations;
- impacts on internal models and (historical) input data;
- implications for processes and governance, including documentation on regulatory risk management and modelling;
- impact on other regulatory requirements, as well as regulatory reporting.

5 Are euro area Sis well prepared for the reforms?

ECB Banking Supervision has analysed the assessment of risks and banks' action plans and found that SIs are generally well aware of the complexity and broad range of challenges entailed by the reforms. However, their action plans lack concrete work streams and timelines in many cases and leave room for improvement. A memorandum on best practices for banks to prepare for benchmark rate reform is published as a separate document on the SSM website[3].

[3] See the Report on preparations for benchmark rate reforms.