Note: This publication is discontinued.

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EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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Chair of the Supervisory Board

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Banks' preparation with regard to interest rate benchmark reforms and the use of risk-free rates

Dear CEO,

ECB Banking Supervision is writing to the CEOs of significant institutions regarding the ongoing global benchmark reforms mandated by the Financial Stability Board (FSB), notably the imminent transition from the euro overnight index average (EONIA) to the new euro short-term rate (€STR) and the developments regarding the euro interbank offered rate (EURIBOR), but also more generally regarding the changes introduced for any relevant benchmark rates, in any currency, for contracts that significant institutions may be holding.

The purpose of this letter is to seek assurance that institutions' senior managers and boards understand the risks associated with these global benchmark reforms and are taking appropriate action now to ensure a smooth transition to alternative or reformed benchmark rates ahead of the deadline of the end of 2021[1] specified in the revised EU Benchmarks Regulation (BMR), taking into account that certain changes in the methodology for relevant benchmark rates as outlined below will be introduced as soon as October 2019.

The ECB is committed to launching the €STR on 2 October 2019. The €STR will reflect the wholesale euro unsecured overnight borrowing costs of euro area banks. In addition, since 2018 the ECB has hosted, and provided the secretariat for, the private sector-led working group on euro risk-free rates to pursue the practical implementation of certain requirements of the BMR for euro-linked benchmark rates. In September 2018 the working group recommended the €STR as the alternative euro risk-free rate and, in particular, recommended that it replace the EONIA.

This has resulted in the recommendation of a clearly defined transition path for EONIA. EONIA's methodology will be changed: from 2 October 2019 onwards, EONIA will be calculated as the €STR plus a fixed spread. Please note that with this change EONIA will be published in the morning of the day following the day it references (T+1), rather than in the evening of the same day (T) as under its current methodology. At the very beginning of 2022, EONIA will be discontinued, as announced by its administrator, the European Money Markets Institute (EMMI). Please note that financial contracts linked to EONIA will need to be reviewed, with a particular

[1] Please note that the current wording of the BMR specifies 1 January 2020 as the end of the transitional period, but political agreement was reached to extend this period by two years for all critical benchmarks and third country benchmarks, to 31 December 2021. This amendment, once formally adopted by the European Parliament and the Council, should be effective before the end of this year.

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focus on contracts that expire after 2021, and may require changes, for example via bilateral agreements or via master agreements. In this regard, the working group has recently published a public consultation on its recommendations to implement such changes to contracts referencing EONIA. Moreover, the working group is planning to provide concrete recommendations on the transition from EONIA to the €STR from an operational point of view before the publication of the €STR. The impact of European benchmark reforms on financial accounting and risk management issues also falls within the scope of the working group's analyses.

In addition, we would like to draw your attention to the reform of EURIBOR towards a hybrid methodology: the published rate should be supported by transactions from panel banks whenever available, and should rely on other related market pricing sources when necessary. EURIBOR's administrator has applied to its national regulator for authorisation under the BMR, and the final assessment is expected by the end of this year. In the meantime, taking into account Article 28 of the BMR, the working group is in the process of identifying and recommending potential fallback rates for EURIBOR in the event of a material change or cessation. The long-term future of this benchmark rate, beyond the decision by the regulator on compliance with the BMR, also depends on the availability of panel banks to support it.

Furthermore, interest rate benchmarks concerning other currencies are being reformed by the relevant administrators or replaced by new alternative benchmarks.

Given the widespread use of benchmark rates in financial contracts, and also as reference rates in discounting, valuation and risk models (including internal models for capital requirements), such rates are deeply embedded in current business practices, which underlines the significance of benchmark reform and related changes to the current environment for benchmark rates.

The fact that different benchmark rates will take different transition routes adds to the complexity of addressing the impact of these changes from an operational standpoint, in particular when dealing with different currencies.

In response to this letter, we ask you kindly to provide by close of business on 31 July:

- a board-approved summary of your institution's assessment of key risks relating to the benchmark reform and a detailed action plan to:
    - mitigate such risks;
    - address pricing issues, e.g. the alignment of front office and risk-management systems and parallel pricing in both EONIA and the €STR for the transition phase;
    - implement process changes, e.g. changes in the modelling setup or potential unavailability of historical data for back-testing, validation or calibration in pricing engines;
- contact points at management level who are in charge of overseeing the implementation of these action plans.

In addition, please submit by 15 September a reply to the attached questionnaire containing certain quantitative and qualitative fields to help us assess the significance of benchmark reform and transition for your institution.

Yours sincerely

Andrea Enria