lpa_

Defy. Deploy. Run.

Is the future EURIBOR?

Evaluation of the current developments around EURIBOR

November 2023

l-p-a.com

Is the future EURIBOR?

Evaluation of the current developments around EURIBOR

"MMCG members felt that the robustness of EURIBOR as a benchmark index has been suffering in general […]"[1]

"The Future is EURIBOR" – that is what Satu Huber, Chair of The Board of Directors of EMMI stated in an interview in September 2022.[2]

In December 2022, however, for the first time, an official institution questioned the robustness of EURIBOR: The ECB Money Market Contact Group (MMCG) has officially released a protocol of its meeting with the statement that "the robustness of EURIBOR […] has been suffering in general." This is particularly striking given that 15 of the 19 EURIBOR panel banks are part of the MMCG. The statement triggered several discussions about the future of interest rates in the euro area. However, until today there was no final decision in one way or another. A recently published consultation fuels the discussions and signifies a fundamental step linking EURIBOR to the new risk-free rates. Below, a short analysis on the current stand of EURIBOR.

Based on the developments, banks should put the following topics on their agenda for 2023/24:

1. Implementation of €STR / EFTERM® readiness for new business[3]
2. Switch the bank steering from EURIBOR to €STR
3. Set up an EURIBOR inventory as preparation for a potential legacy transition

– So, what is the real status of EURIBOR? A short analysis.

For this, let's have a look at some relevant aspects:

Reform efforts: EURIBOR was methodically reformed after the LIBOR scandal and is confirmed as EU BMR compliant. The underlying hybrid methodology largely corresponds to the adjustments undertaken for LIBOR. The contribution made by the panel banks follow a three-level

[1] ECB Money Market Contact Group (MMCG), 12 December 2022
[2] "The Future is EURIBOR", 07 September 2022
[3] Market adoption of recently launched Refinitiv Term €STR should be observed. For further information about the difference to EFTERM®: Comparative Table of Available Term €STR Rates

waterfall approach including transactions from the observation period (Level 1 and 2.2), derived or historical transactions (Level 2.1 and 2.3) or "expert judgment" grounded on transactions from nearby markets (Level 3). Although the figures have improved significantly in the big picture, as of August 2023 still only 20% of the contributions underlying the 6M EURIBOR tenor (standard tenor in EUR derivatives markets) were based on Level 1 and Level 2.2 quotations, as can be seen in chart 1[4]. For LIBOR, however, it was concluded that due to similar numbers, the rate could no longer be determined in a representative manner and thus, it has been and will be discontinued accordingly. EMMI apparently sees the danger as well. Therefore, they published the consultation mentioned earlier in October 2023 with the goal to reduce the cost of compliance for the EURIBOR quotation and thus to incentivize banks to join the panel.[5] For this, Level 3 quotation is to be discontinued and Level 2.3 gets linked to the Term €STR-rate EFTERM® which is conducted in the aftermath by EMMI in case there is an insufficient number of valid transactions reported by the panel banks. This link would ultimately have the effect that a large part of the EURIBOR quotations will be based on Term €STR and brings the risk profile of EURIBOR closer to that of €STR – particularly during times of crisis with low level of liquidity in the market.

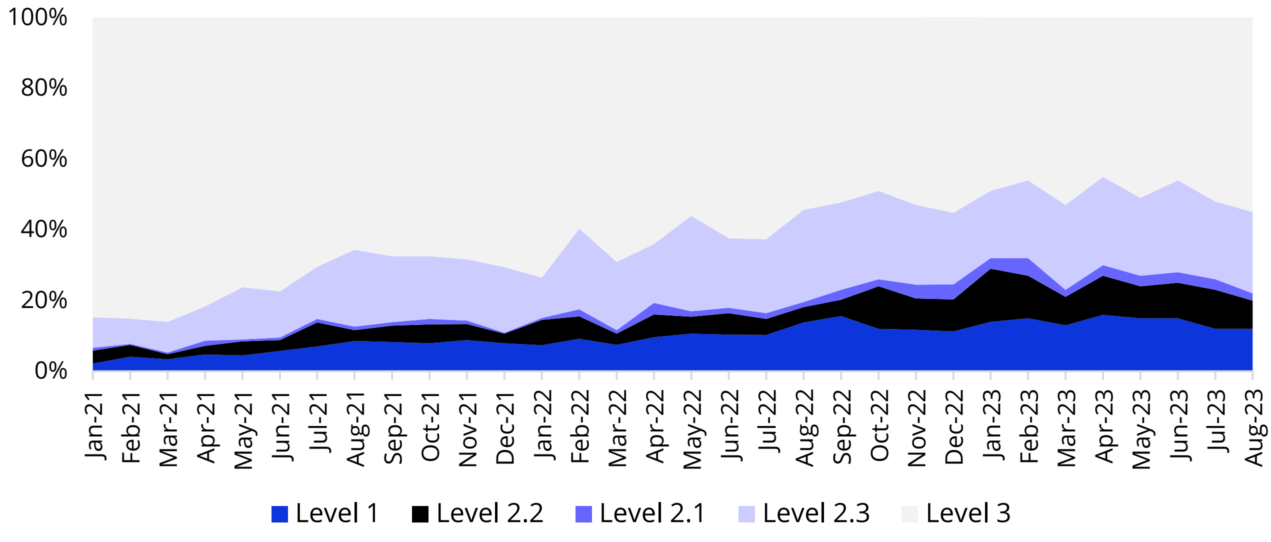

Chart 1: Timeline of the EMMI transparency indicators for 6M EURIBOR

Representativeness in question? The MMCG is questioning the robustness of the methodology: A main point of criticism is the slow reaction of EURIBOR to (strong) interest rate changes for tenors up to 3 months. As can be seen in chart 2, the 3M EURIBOR reacts in line with the rate hikes in H2 2022, but the

[4] Data source: EURIBOR Transparency Indicators Report
[5] Consultation Paper on Enhancements to EURIBOR's Hybrid Methodology

reactions in other forward-looking rates such as €STR swaps were much more intensive, leading to a massive reduction of the EURIBOR - €STR basis to well into negative territory. This has raised concerns about the ability of EURIBOR when reflecting changes in the general interest rates in the market. The current consultation might fix this but leads to a lagging spread incorporated by the panel banks into EURIBOR. This is particularly true in times of market turmoil where liquidity is plummeting, and published quotes are not representing the panel anymore because of the link to historical quotes.

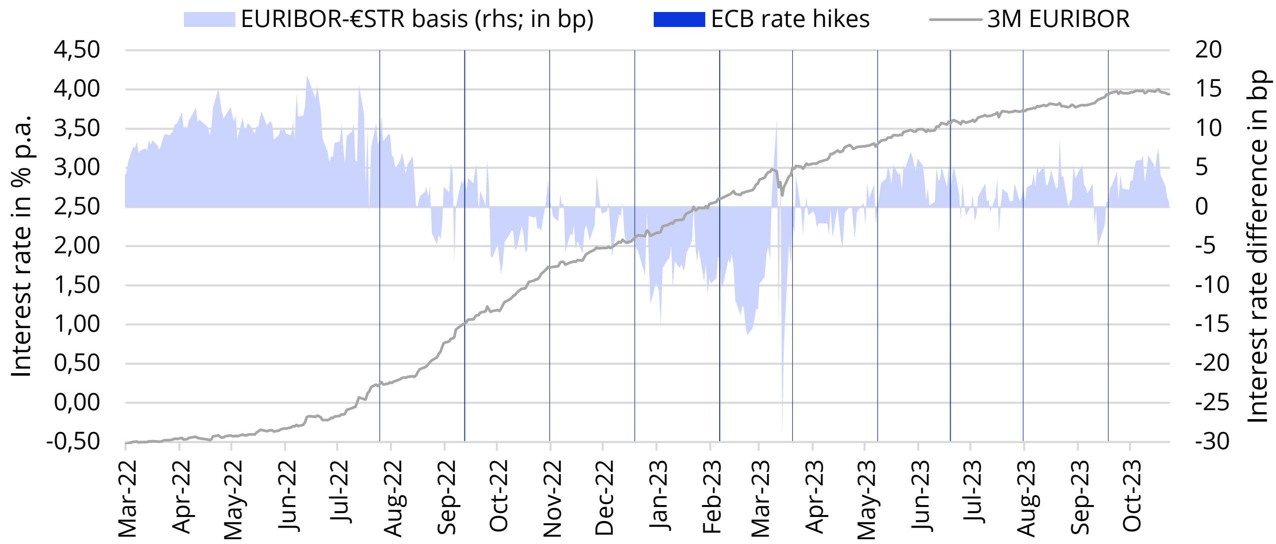

Chart 2: Comparison of 3M EURIBOR with €STR swap rates

Market structure: The old LIBOR market (USD, GBP, CHF and JPY) has been fully transferred to the new Risk-Free Rates. EUR markets, on the other hand, continue to reference EURIBOR.

Although EURIBOR is still the major EUR reference rate, cross-currency markets have already switched to €STR instead. Overall, the share of €STR in the EUR derivatives market is robust with a market share between 30% and 40%[6, 7]. Short-term €STR Swap liquidity is also sufficient to generate a robust €STR term rate. As a consequence, EMMI and Refinitiv are publishing forward-looking €STR term rates, EFTERM® and Refinitiv Term €STR. The rates, primarily described as the EURIBOR fallback, have no legal usage restrictions for the use in financial products. Whether they will also be used as a primary rate in contracts is yet to be seen. The market infrastructure, thus, seems so far ready for a potential EURIBOR transition.

[6] Working Group on Euro Risk-Free Rates, 13 July 2023: Annex II by ISDA
[7] ISDA-Clarus: RFR-Adoption Indicator September 2024

Underlying transactions: Following the adjustment of the methodology and the associated expansion of the definition of underlying transactions, the transaction volumes of EURIBOR could increase slightly, but they are still significantly below EUR 10 billion per month. Chart 3 shows the volume for 6M EURIBOR.

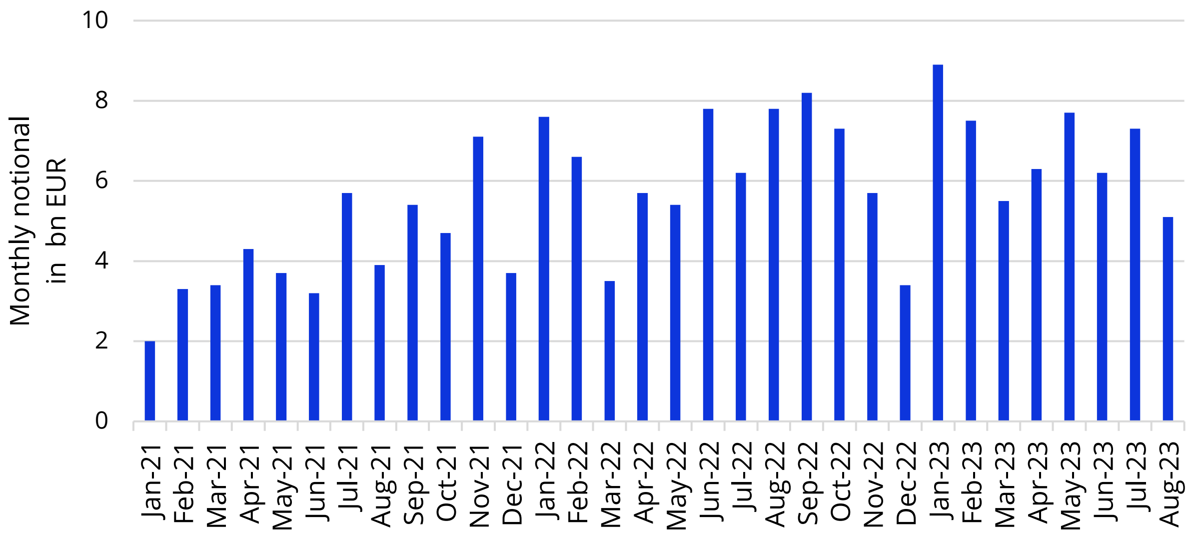

Chart 3: 6M EURIBOR monthly notional of underlying market transactions[8]

This corresponds to underlying average volume per business day of less than EUR 500 million. On the other hand, the underlying derivatives volume referencing these EURIBOR-fixings is significantly above such figure. LCH, the largest derivatives CCP is clearing a daily volume in EURIBOR-linked derivatives above EUR 1 trillion per trading day[9] - and this does not even take into account other trading sources or cash markets. The "Inverted Pyramid" shown in chart 4 is still in place.

[8] Volume of Level 1 and Level 2.2 submissions
[9] Data source: Trading volume LCH Swap Clear, numbers based on October 2023 data

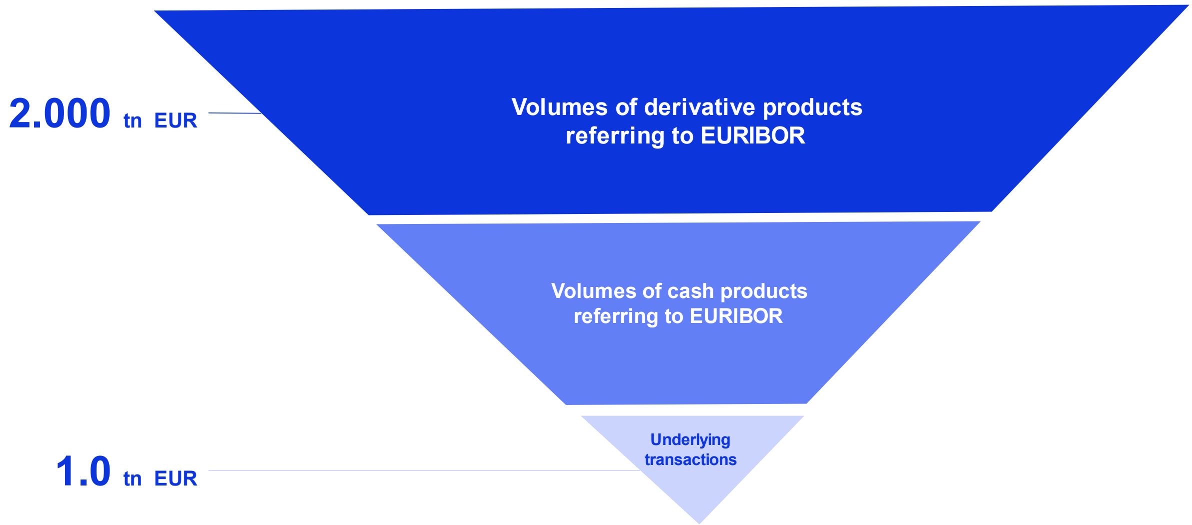

Chart 4: Schematic representation of the "Inverted Pyramid" of EURIBOR

An interesting feature of the EUIBOR is that it is a wholesale funding benchmark. Put simply, non-banking entities create transactions used to determine EURIBOR via their placement of funds with the panel banks. Given the low average volume of 500 Mn per day this could make the benchmark sensitive to manipulation.

– Conclusion: Market view on the EURIBOR outlook

The mentioned aspects are not new and are openly discussed topics in the market. Nevertheless, there are two camps regarding the future of EURIBOR[10]:

1. **EURIBOR will also be discontinued in the short to medium term.**
   This group supports the above-mentioned arguments and therefore reaches the fundamental conclusion that an end to EURIBOR analogous to LIBOR will take place.

2. **EURIBOR will continue in the long term.**
   Although this group does not contradict the above-mentioned arguments, they underline the significant **costs** and **complexity** of a EURIBOR transition. They conclude that this is not in line with the political will and, therefore, will not happen. This is in line with the previous communication of the relevant stakeholders (EMMI, ECB, ESMA, EUR WG).

That the robustness of EURIBOR has been questioned by a relevant industry group for the first time and EURIBOR should be linked to €STR in the last step of the waterfall, might be a sign that political support for EURIBOR is starting to crumble. Discussions in the industry have already started again (see Risk.net

[10] LinkedIn Survey(s) "How long will EURIBOR be available as reference rate for new contracts?" showed when performed at two different points in time, that slightly above 50% of the participants think that EURIBOR is only allowed for new business by the end of 2024 the latest.

articles – ECB group sounds alarm on 'sluggish' EURIBOR, Is Euribor on borrowed time, or here for the duration?, Emmi consults on axing 'expert judgement' for Euribor). One may ask: "Is the future EURIOR?"

Authors

Peter Woeste Christensen
Director

Tel.: +49 69 971 485-450
peter.woeste.christensen@l-p-a.com

Stefan Wingenbach
Senior Manager

Tel.: +49 69 971 485-441
stefan.wingenbach@l-p-a.com

Girolamo Viciglione
Senior Consultant

Tel.: +49 69 971 485-232
girolamo.viciglione@l-p-a.com

Get in touch with us!

Germany
contact@l-p-a.com

Switzerland
contact.ch@l-p-a.com

Founded in 1999 by Stefan Lucht & Roland Probst as a way to offer solutions as the finance industry evolved, LPA was built on the needs of its clients. And as those needs have grown, so has LPA, becoming one of the world's leading creators of award-winning software and consulting for the capital markets. Today the company has over 400 employees in 12 cities worldwide, delivering cutting-edge consulting through its specialist teams and technology through Capmatix, a software framework to automate workflows and documentation for OTC derivatives, structured products, complex contracts and asset management. Motive Partners, a leading specialist financial technology investment firm, has been partnered with and invested in LPA since November 2018.

Defy the processes of the past. Deploy innovation in a way that suits you.
Run to the forefront of global innovation.