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Is the future EURIBOR?

Evaluation of the current developments around EURIBOR

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"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]

Now, however, for the first time, an official institution is questioning the robustness of EURIBOR: The ECB Money Market Contact Group (MMCG) has officially released a protocol of its meeting in December 2022 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. At this stage, it is not possible to know what implications this might have for the future of EURIBOR. However, due to the ongoing discussions in the market about the survivability of EURIBOR in the mid-term, this might get the ball rolling. 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
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 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,

[1] ECB Money Market Contact Group (MMCG), 12 December 2022
[2] "The Future is EURIBOR", 07 September 2022

as of December 2022 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[3]. 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.

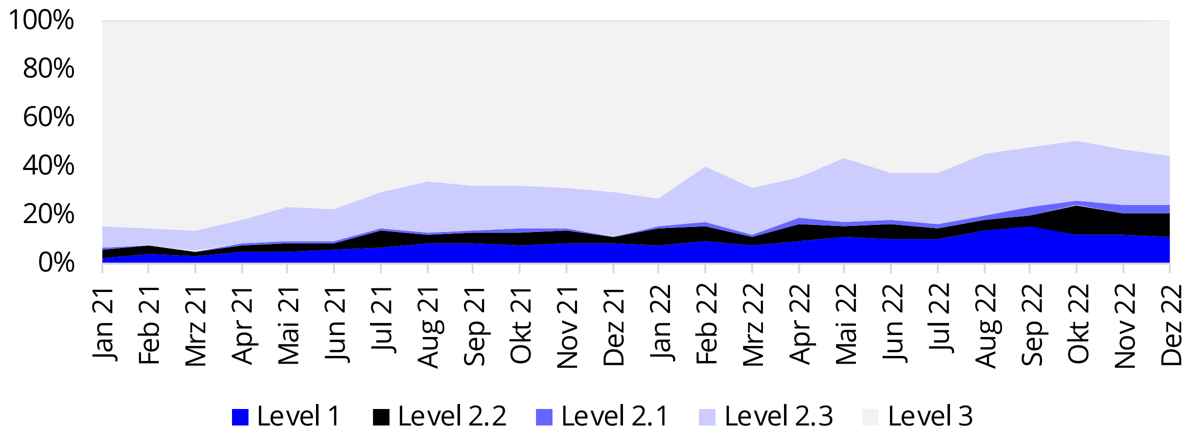

Chart 1: Timeline of the EMMI transparency indicators for 6M EURIBOR

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 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.

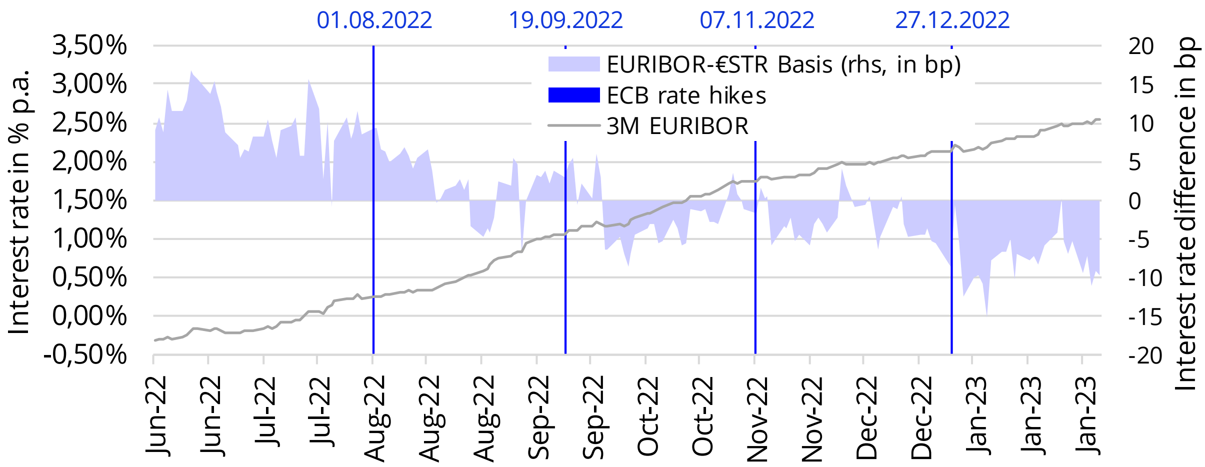

Chart 2: Comparison of 3M EURIBOR with €STR swap rates

[3] Data source: EURIBOR Transparency Indicators Report

Market structure: The old LIBOR market (USD, GBP, CHF and JPY) has been fully transferred to the new Risk-Free Rates[4]. EUR markets, on the other hand, continue to reference EURIBOR.

Interestingly the cross-currency markets have switched to €STR instead of EURIBOR. Overall, the share of €STR in the EUR derivatives market is robust with a market share between 30% and 40%[5]. Short-term €STR Swap liquidity is also sufficient to generate a robust €STR term rate. As a consequence, EMMI is now publishing a forward-looking €STR term rate called EFTERM®. This rate primarily described as the EURIBOR fallback, has no legal usage restrictions for the use in financial products. Whether EFTERM® 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.

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 below EUR 10 billion per month. Chart 3 shows the volume for 6M EURIBOR.

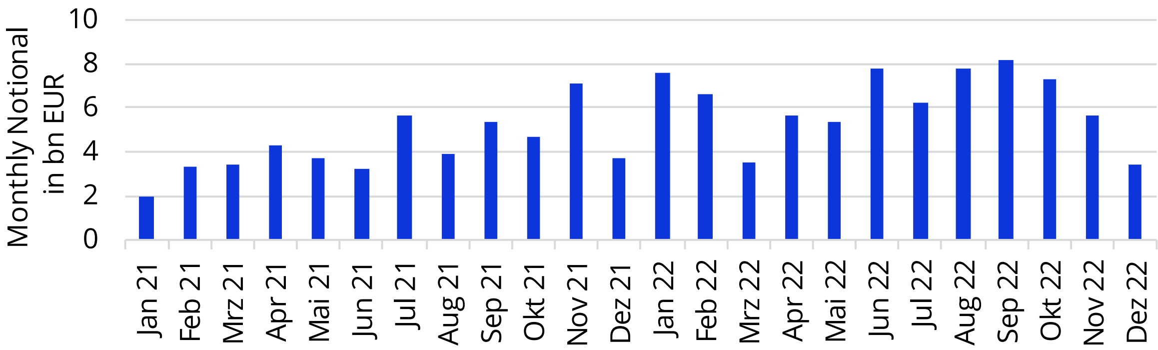

Chart 3: 6M EURIBOR monthly notional of underlying market transactions[6]

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[7] - 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.

[4] Switch of legacy USD-market to follow by 30th June 2023
[5] Working Group on Euro Risk-Free Rates, 15 September 2022: Annex I by ISDA
[6] Volume of Level 1 and Level 2.2 submissions
[7] Data source: Trading volume LCH Swap Clear, numbers based on January 2023 data

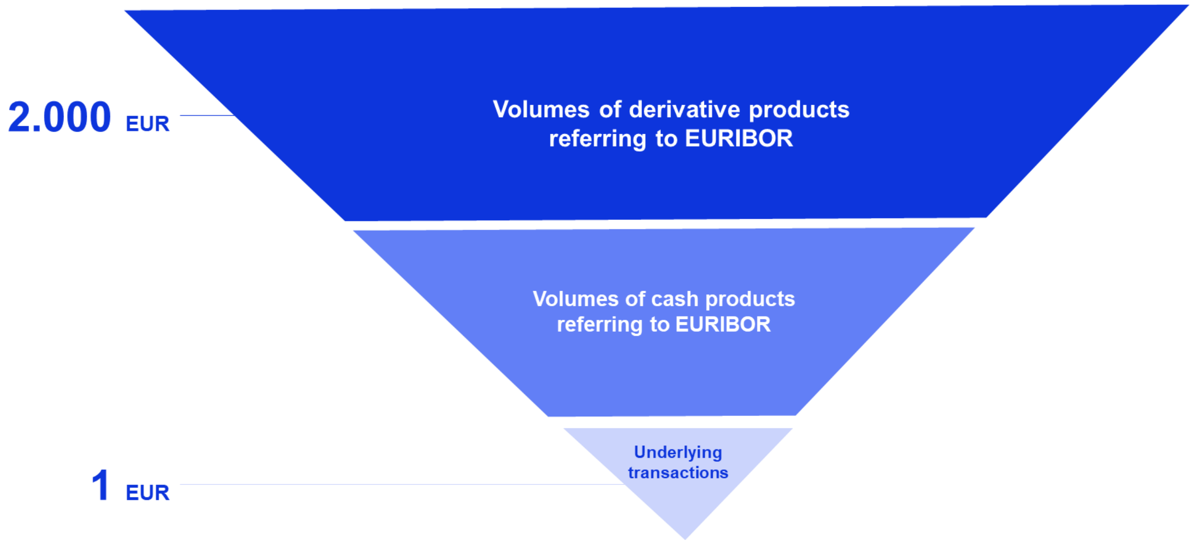

Chart 4: Schematic representation of the “Inverted Pyramid” of EURIBOR

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[8]:

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.**
   This group underlines 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).

Now that the robustness of EURIBOR has for the first time been questioned by a relevant industry group, this might be a sign that political support for EURIBOR is starting to crumble. Discussions in the industry have already started again (see Risk.net article – ECB group sounds alarm on ‘sluggish’ EURIBOR). One may ask: “Is the future EURIBOR?”

[8] 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.

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