Benoît Cœuré: The importance of euro interest rate benchmark reforms

Welcome address by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the first meeting of the Working Group on Euro Risk-Free Rates, at the ECB, Frankfurt am Main, 26 February 2018.

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On behalf of colleagues from the European Commission, the European Securities and Markets Authority, Belgium's Financial Services and Markets Authority and the European Central Bank (ECB), welcome to this first meeting of the Working Group on Euro Risk-Free Rates. Thank you for dedicating your time and resources to supporting the working group in successfully delivering on its mandate.

I would particularly like to thank Koos Timmermans, Chief Financial Officer of ING Group and Vice-Chairman of ING Bank, for agreeing to chair the working group. I am convinced that the group will benefit from his extensive experience in European banking and financial markets.

The task at hand is of utmost importance. First and foremost, the working group has a mandate to identify and develop an adoption plan for a risk-free overnight rate that can serve as a basis for an alternative to the benchmarks currently used in the euro area. As a second step, the working group should explore ways to ensure a smooth transition to the preferred new rate.

Both the financial and public sectors have a keen interest in a smooth and successful reform of the reference interest rate.

For the financial sector, reference rates play a pivotal role because they are widely used in a broad range of financial products and contracts. In the past, we have seen banks become increasingly reluctant to participate voluntarily in benchmark panels, mainly due to potential litigation and compliance risks as well as increasing contribution costs. Together with the declining activity in the underlying market, this has undermined confidence in the reliability and robustness of existing benchmarks.

For the public sector, a smooth and successful reform is needed to underpin the good functioning of euro area money markets and trust in the related products. For the ECB in particular it is vital as monetary policy is initially transmitted through financial markets.

A more reliable and robust reference interest rate may also enhance financial stability, for three main reasons:

- First, without robust fallback arrangements, a loss of confidence in reference rates may lead to market functioning being disrupted.
- Second, poorly designed reference rates, given their underlying role in many financial contracts, may transfer risks and pricing errors across financial markets, or create greater and unnecessary basis risk. Ultimately, this might also affect the financing conditions of households and firms.
- And third, unreliable reference rates – for example, reference rates that become highly volatile due to idiosyncratic factors – may make it difficult for the central bank to assess general money market conditions and prevent it from responding to potential sources of tension in interbank markets.[1]

With this in mind, it is easy to see that planning for contingencies, including considering alternative rates, is essential to safeguard the sound functioning of our financial markets.

This is also reflected in two general recommendations of the Financial Stability Board (FSB) that aim to guide the reform of the reference rate and the transition to alternative benchmarks.[2]

The first recommendation is to strengthen existing benchmarks by underpinning them with transaction data to the greatest extent possible. Attempts to reform existing benchmarks have shown, however, that the number of transactions involved is often limited, making the search for robust fallbacks even more difficult. The second recommendation is to develop alternative, nearly risk-free rates. We anticipate the recommendations of the working group to comply with the recommendations of the FSB and the guidance issued by the International Organization of Securities Commissions (IOSCO).

The EU Benchmarks Regulation sets a demanding timeframe for the reform.[3]

It has set 1 January 2020 as a deadline for benchmarks designated as critical to comply with its provisions. These provisions are also relevant for contracts based on the EONIA benchmark. While users of such contracts are compelled to provide for a fallback solution, there is currently no alternative benchmark rate that is suitable for both new and outstanding contracts.

In early February 2018 the EONIA administrator – the European Money Markets Institute (EMMI) – announced that it would no longer pursue a thorough review of the EONIA.[4]

The future use of the EONIA will hence depend on the willingness of both the panel banks and EMMI to support the continuity of the benchmark, as well as on the existence of viable alternatives.

In the absence of a solution for legacy transactions – i.e. transactions based on the EONIA initiated before 1 January 2018 and maturing after 1 January 2020 – market participants are exposed to legal and operational risks. The issue of the legal transition must be addressed.

In parallel, the ECB has launched an initiative to produce an overnight interest rate based on data already available to the Eurosystem under the Money Market Statistical Reporting Regulation.

Let me elaborate. The ECB rate is designed to provide a backstop to the existing overnight benchmark, but the working group can also consider it as a candidate for a fallback rate. The ECB aims to start releasing a daily rate before 2020.

A summary of responses to the ECB's first public consultation on developing a euro unsecured overnight interest rate was published on the ECB's website in mid-February 2018.[5] A second public consultation document building on the analysis presented in the first consultation document, and the feedback received from market participants, is currently being prepared. It will explore the methodology to be used for the new rate as well as key operational and technical parameters. The document is scheduled to be published towards the end of March 2018.

Let me conclude by saying that, for the reform to be successful and conducted in a non-disruptive manner, it is essential that this working group reaches a broad-based consensus on alternative risk-free rates and on the best approaches for incorporating their use in financial contracts. This consensus should extend beyond this working group and include the wider financial sector community. One way to achieve this is by involving institutions, or financial sub-sectors, that are not represented in the working group discussions.

Coordination, cooperation and transparency across market segments, products and users is therefore essential for the success of the benchmark reform and the possible transition to alternative rates. Many users and other involved parties may not yet be aware of the changes to come, and all of us need to make an effort to reach out to them too.

Thank you.

[1] BIS Economic Consultative Committee (ECC) report entitled "Towards better reference rate practices: a central bank perspective" (March 2013).

[2] FSB report "Reforming Major Interest Rate Benchmarks" (July 2014).

[3] 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.

[4] EMMI announcement "State of play of the EONIA Review" (February 2018)

[5] Summary of responses to the ECB's first public consultation on developing a euro unsecured overnight interest rate (February 2018)