SLAUGHTER AND MAY

Transforming Interest Rate Benchmarks

September 2019

Developments in euro land

The UK's Financial Conduct Authority (**FCA**) continues to emphasise that LIBOR users should assume that the rate will not be available after the end of 2021. As outlined in our July briefing, the LIBOR market is working hard to transition affected products to risk free rates (**RFRs**) ahead of this deadline.

There are many similarities between LIBOR and EURIBOR. Initial expectations were that EURIBOR exposures would most likely need to be transitioned in the same way as LIBOR exposures. However, the euro-area supervisors eventually decided to take a different path to the FCA. The European Central Bank (**ECB**) appears keen to support the continuation of EURIBOR based on a reformed methodology alongside €STR, the new RFR for euro.

Does this mean that the topic of transitioning to RFRs can be ignored in relation to euro exposures? Sadly not, for a number of reasons:

- EONIA, the current overnight rate for euro, is used as a reference rate for certain products and for various purposes within EURIBOR deals (eg as the basis of interpolation calculations). EONIA is being phased out along the same timeline as LIBOR. Products referencing EONIA will need to be transitioned to €STR.

- As LIBOR products shift to RFRs and market participants become familiar with the new conventions, it seems reasonable to anticipate market demand for products referencing €STR as an alternative to EURIBOR, even while EURIBOR continues to be available.

- The long-term future of EURIBOR remains unclear and ensuring contractual robustness has been a key area of focus in the context of benchmark reform. Contractual fallback rates for EURIBOR deals are therefore anticipated to evolve to accommodate RFRs in the same way as those applicable to LIBOR deals.

- Reformed EURIBOR and €STR are to be published at different times and on different bases to current EURIBOR and EONIA. This may require changes to operational practices and certain documentation terms applicable to products referencing those rates.

This briefing explains these issues and outlines some near-term action points for euro market participants.

What is happening to EONIA?

EONIA is being phased out as it is not compliant with the EU Benchmarks Regulation (**BMR**). The BMR was enacted to promote the quality and integrity of benchmarks, establishing a "preventative regulatory framework" for the administration, use and compilation of benchmarks. While the BMR applies to benchmarks relating to a variety of currencies, the future of the major benchmarks used in the euro-currency area is particularly driven by and dependent on this regime.

EONIA will cease to be published at the beginning of 2022, when its "grandfathering" protection under the BMR (ie the period during which it can continue to be used notwithstanding its lack of approval under the BMR), expires. EONIA users must therefore adapt to a RFR such as €STR, and are being urged by euro-area supervisors to do so sooner rather than later.

How does €STR differ from EONIA and what is "€STR+"?

In summary, EONIA measures the cost of overnight inter-bank lending in euro along LIBOR-like lines. €STR is also an overnight borrowing rate, but like other RFRs is based on a defined pool of transactions from the previous day. The key difference between EONIA and €STR in the context of transitioning from one to the other is therefore economic.

In part to facilitate the transition of legacy EONIA products to €STR when EONIA ceases, from 2 October 2019 (when €STR becomes available), EONIA will be published as €STR plus a spread. In other words, from 2 October 2019 until 3 January 2022, EONIA will be based on €STR, but adjusted so that EONIA remains (economically) broadly the same.

Following consultation, the ECB decided that the spread would be determined on a historic average. From 2 October 2019, EONIA will be published as €STR plus a fixed spread of 8.5bps. This approach is similar to the 'adjustment spread' idea being debated in the context of the transition from LIBOR to RFRs. This adjusted rate "is" EONIA after 2 October 2019, although it is being referred to by many as "**€STR+**".

Will €STR+ impact documentation referencing EONIA?

The publication of EONIA as €STR+ for an interim period appears to have been designed to minimise contractual disruption. Generally, contracts referencing EONIA should automatically (in the absence of more specific contractual provisions eg those that catch a change in basis calculation) be read to reference €STR+, as that "is" EONIA after 2 October 2019. Users will need to assess that analysis against applicable contractual terms with their advisers.

The Working Group on euro RFRs (the **euro Working Group**) recommends that, prior to 2 October 2019, parties to new contracts should consider acknowledging specifically that EONIA methodology will be changing. In their view, specific contractual acknowledgement should not generally be necessary, but would improve transparency in line with certain provisions of the BMR.

What about contracts referencing EONIA that extend beyond 3 January 2022?

After 2 October 2019, users of euro overnight rates have a choice of using EONIA (ie €STR+) or €STR itself for new transactions. Where €STR is used, pricing is likely to be different to EONIA (ie to accommodate the 8.5bp adjustment built into €STR+). If EONIA (ie €STR+) continues to be used, appropriate fallback rates will need to be developed to apply when EONIA is finally discontinued in favour of €STR.

Whether those fallbacks will be specified in the agreement or left to be agreed and the nature of applicable fallbacks will need to be considered. Syndicated loans referencing EONIA (eg euro swinglines) are likely to follow the LMA's general approach of providing for a streamlined amendment process in the event a benchmark needs to be replaced. If made available by ISDA, derivatives are likely to follow an EONIA-specific protocol which, if adhered to by both parties to the relevant transaction, will automatically incorporate new (€STR-based) fallbacks into legacy transactions. Alternatively, contracts may be amended on a bilateral basis. The euro Working Group has released some draft fallback language for cash products (excluding syndicated loans) which makes alternative suggestions.

Which euro overnight rate will be used after 2 October?

The euro Working Group's view, which is consistent with the approach being taken by the supervisors of LIBOR, is that, after 2 October 2019, new contracts referencing a euro overnight rate should use €STR rather than EONIA. Nonetheless, in practice, both options will be available until 3 January 2022.

The major trade associations are working on documentation to accommodate the possibilities. For example, the LMA is working on updated language for syndicated loans referencing EONIA (eg swingline loans), which it is anticipated will reflect the potential options for euro overnight lending.

EONIA and €STR+ - timing issues

€STR will be published at 08:00 CET the day after the trade date (ie on a T+1 basis). EONIA is currently published at 19:00 CET based on same day transactions. This will change on 2 October 2019, when EONIA becomes €STR+. EONIA will shift to T+1 publication at 09:15 CET, to allow sufficient time for the €STR fixing (and any subsequent re-fixing) to become available.

The practical effects of this are anticipated to be fairly limited, but the timing change means that EONIA users must:

- Consider the operational impact (if any) of a move to T+1 publication eg in terms of the timeframe for interest payments.
- Review documentation referencing EONIA to determine whether it requires adaptation to accommodate this change.

The euro Working Group have been engaging with regulators and market participants on these issues with the aim of supporting a smooth transition.

The future for EURIBOR

EURIBOR's methodology has been comprehensively reformed. A "hybrid methodology", which is reliant on arm's length transactions or, where these are unavailable, other market data sources is expected to be fully implemented by the end of 2019.

ESMA has recently confirmed that, in its modified state, EURIBOR is compliant with the BMR. Market participants may therefore continue to rely on EURIBOR going forward although, as already noted, the global shift to RFRs and away from IBORs may have some impact on EURIBOR-linked products. For floating rate transactions in euro, market participants may have a choice between EURIBOR or an €STR-based rate.

Should the preference of some or all market participants be to access or make available products (in particular those that currently use EURIBOR) on an €STR basis, the same range of issues will need to be considered as are currently being assessed in relation to LIBOR deals, ie how best to reference the RFR directly and what are the appropriate conventions. In the context of euro rates, the viability of those options may require assessment under applicable law; for example some European legal systems restrict the compounding of interest.

New fallbacks for EURIBOR deals

Where EURIBOR continues to be used, it is anticipated that documentation will be updated to incorporate €STR-based fallbacks. The euro Working Group is considering the options and is likely to be influenced by the approach being developed for legacy LIBOR deals.

Many will be aware that ISDA has been consulting on the term and credit spread adjustments to be made to RFRs if they are used as fallback rates for derivatives referencing an IBOR. In relation to the IBOR rates consulted on so far, the proposal is that swaps referencing the relevant IBORs will fall back to the appropriate RFR, compounded in arrear, plus a credit spread adjustment.

ISDA has not yet consulted on fallbacks for EURIBOR or euro LIBOR transactions. It plans to do so once €STR is being published and traded. ISDA then plans to produce fallback drafting for transactions referencing the euro rates, in the form of updated definitions that can be adopted bilaterally on a case by case basis or automatically via a protocol.

It is not currently clear, in the context of LIBOR, whether the cash markets will follow ISDA's general approach to fallbacks, or develop something different. For example, fallbacks could be based on a forward looking (ie term) RFR, to the extent available. The process in the context of LIBOR is, however, already influencing the steps for euro rates. The euro Working Group is considering options for a term €STR, recommending a methodology based on tradeable OIS quotes. Benchmark administrators have been invited to express their interest in producing and administering term-€STR by the end of September 2019.

The debates around what the conventions for referencing RFRs in the cash markets may eventually look like – whether as primary benchmarks or as fallback rates - are discussed in our July briefing.

EURIBOR – timing issues

As in relation to EONIA, there is a near-term action point for EURIBOR users, which relates to a proposed change to the basis on which the rate is fixed. EURIBOR is currently fixed on a T+2 basis (ie the rate published today is for a maturity starting two TARGET days after publication). Reformed EURIBOR will be quoted on a T+1 basis.

Regulators, banks and trade bodies are considering the practical implications of this and users should familiarise themselves with the concerns. Alongside any potential operational impact, documentation terms will need to be reviewed, to check a change in quotation day can be accommodated.

Most products referencing EURIBOR refer expressly to a T+2 fixing. The LMA's recommended forms of agreement refer to T+2 fixing for EURIBOR, but the drafting is designed to accommodate changes in market practice, allowing the Agent to determine the fixing day (see the definition of "Quotation Day"). However, not all agreements will incorporate this flexibility. Certain products, such as derivatives using ISDA's 2006 Definitions, refer to a T+2 fixing without contemplating any changes. The implications of that will need to be considered. Further, even where there is flexibility, a determination as to the point "market practice" is deemed to have changed may be needed, which runs the risk of subjective interpretation.

The LMA and ISDA are in the process of consulting with members on this topic, which is also being actively considered in relation to euro FRNs.

In summary - what needs to be done now?

Reformed EONIA – that is, €STR+ - will be implemented on 2 October 2019. Reformed EURIBOR is expected to be up and running by the end of the year. The main action point for users of the euro rates is the same as in relation to LIBOR rates: review documentation terms to identify whether existing exposures require amendment or adjustment (either in the near term, or as they are renewed). In addition, the documentary and operational implications of the proposed changes to the quotation conventions for EONIA and EURIBOR need to be assessed.

Regulators, as well as the various working groups, continue to engage with market participants on these issues. We would recommend that users monitor the output of those bodies active in relation to euro rates alongside the work being done on LIBOR transition. Where feedback or comment is requested, as in relation to all aspects of the global benchmark reform project, users are strongly encouraged to add their voice to the debate.

Slaughter and May are closely monitoring developments in relation to the transition from LIBOR, EURIBOR, EONIA and other major benchmarks across all of the major financial products. For further information, please contact any of the lawyers listed below or your usual adviser at Slaughter and May.

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