IBORS transition: progress made and challenges ahead

Remarks by Sebastián Albella, chairman of the CNMV, at the AFME 10th Annual Spanish Funding Conference - 7 February 2019. Madrid

Thank you, Michael, for your generous presentation.

Let me firstly thank the Association for Financial Markets in Europe (AFME) for inviting me to participate in this Conference and all of you for your time and attendance.

In my remarks today, I would like to focus only on an important matter for the financial system and the wider economy to which the CNMV (the Spanish Securities Market Commission), which I chair, is committed: the process of reform of the major reference interest rates, where we come from, where we are and the challenges that lie ahead.

As you probably know, the CNMV is the competent authority in Spain for applying the EU Regulation on Benchmarks as well as for coordinating actions related to the matter with other authorities and with the European institutions.

The CNMV is and has been fully committed to facilitating and following-up:

- the implementation of the new Regulation, especially the reform of the major interest rate benchmarks in the Eurozone, EONIA and EURIBOR;
- and the definition and implementation of a new risk-free interest rate benchmark, a task which is being done by the Working group promoted for this purpose by the European institutions, which is composed of representatives of them and certain market participants.

As I have already said, I intend to give in this brief speech a short review on the progress made so far and where we are going, highlighting the main challenges which lie ahead.

Starting point

Let's move on to the starting point.

As you are all aware, interest rate benchmarks play a crucial role in the economy and the financial system. These benchmarks are used in the pricing and valuation of a wide range of financial instruments and contracts as well as in the implementation and monitoring of the transmission of the monetary policy. To give an idea of their importance, the global exposure to these indices may be currently estimated at around 200 trillion euros in the case of Libor and Euribor and 6 trillion in the case of Eonia.

In Spain, the contracts linked to the most critical euro benchmark, Euribor, represent more than four times the GDP. It is worth mentioning that the exposure of retail mortgage contracts to the 12-month Euribor in Spain amounts to 600 billion euros, affecting one out of every four households.

The reform of these key benchmarks is mostly something that derived from the damaging manipulation of IBORs that happened between 2005 and 2008. As you know, as a consequence of it, several relevant financial institutions were heavily fined. Ten years later, we can still see references to the case and its criminal implications from time to time in the media.

The concerns raised by this affair prompted the G-20 and the FSB to recommend a comprehensive reform in this area: on the one hand, to strengthen the existing indices, and on the other, to create new risk-free rate benchmarks.

These reforms have become even more urgent as the liquidity needed for the IBORs to be sufficiently solid has fallen dramatically in recent years, which has raised doubts about the sustainability of panels contributing to these benchmarks.

The reforms encouraged by the G-20 and the FSB (which in the European Union have led to the Regulation known as BMR) are oriented in this field:

- towards the objective that the industry and the markets have at their disposal improved and less vulnerable benchmarks based to the greatest extent possible on real transactions,
- and towards alternative risk-free rates that are sufficiently robust.

As I said, in the euro area the most widely used interest rate benchmarks are EURIBOR and the euro overnight index, EONIA. They are both based on the unsecured interbank market. Given the systemic importance of both benchmarks, the European Commission declared them as critical benchmarks in 2016. Both of them rely on the voluntary contributions of two different panels of banks.

Since the FSB published its recommendations in 2014, EONIA and EURIBOR have been undergoing in-depth reforms conducted by their administrator, the European Money Markets Institute (EMMI), in order to reinforce the governance and management of conflicts of interest, as well as to strengthen the methodology, anchoring it as much as possible in real transactions.

In addition, in the Eurozone, as in other regions, the European Central Bank decided to develop a short-term euro interest rate benchmark (the ESTER) which will start to be published in October 2019. ESTER will reflect the wholesale euro unsecured overnight borrowing costs of euro area banks and will be calculated exclusively on the basis of transactions in euros reported by banks to the ECB.

At the same time, the Working group on euro risk-free rates recommended ESTER as the euro RFR and as a replacement for EONIA, which in principle will not be compliant with the BMR and will therefore have its use restricted as of the first of January 2020.

Where we are now

In the context described, let us take a look at where we are today in the Eurozone.

Regarding the EURIBOR, the current reform towards a new hybrid model (where the methodology is supported by transactions whenever available and relies on other related market pricing sources when necessary, on a secondary basis) is facing the last steps for the definitive implementation before the end of 2019.

The new hybrid methodology, aimed at aligning the EURIBOR to the European regulation, was tested from May until the end of July 2018. EMMI, the administrator of the Euribor, declared, on completion of the test, that it was confident that this hybrid methodology represents a robust evolution of the current quote-based methodology that will allow the Euribor to be made compliant with the regulatory requirements during the course of 2019. The supervisor of EMMI, the Belgian FSMA, has also mentioned that it would make an effort to speed up the authorization process once EMMI files for authorization.

The Euribor reform is crucial, especially given the important role that it plays in some countries in retail mortgages and consumer credit contracts.

An early authorization of EURIBOR would reduce uncertainty among market participants.

It is worth noting that the new methodology is also based on the continuous participation of a significant number of banks as panel contributors.

In this regard, I would like to stress the importance of a panel composed at all times of a large number of EU banks in order to ensure the robustness and reliability of the benchmark whilst achieving a balance between the use of the benchmark among EU banks and their commitment in its determination. Most of the banks in the Eurozone are EURIBOR users but only 19, four of them Spanish, are currently contributing to the publication of EURIBOR.

Also noteworthy is the fact that BMR establishes that EURIBOR users will need to provide for fallbacks to increase the solidity of the contracts.

Significant work is being done by the FSB, national working groups, ISDA and other trade associations in order to promote the strengthening of the contracts in light of the risk of discontinuation of major interest-rate benchmarks.

The Working group on euro RFR published last month a set of principles and recommendations promoting effective fallback provisions in new contracts for euro-denominated cash products, such as mortgages, loans and bonds, referenced to EURIBOR or EONIA.

The Working group is also tasked with evaluating ways to transition smoothly from EONIA to ESTER and identifying alternative term rates based on ESTER that could be used as a fallback in EURIBOR-linked contracts.

In respect of the former, the transition from EONIA to ESTER, the Working group has recently published for consultation a proposed roadmap for EONIA to make the transition to ESTER, which entails EONIA remaining for a few years but being calculated on the basis of ESTER plus a fixed spread. This would facilitate and encourage the transition.

Regarding the possible use of the ESTER as an alternative to the EURIBOR, the Working group has also consulted on a term structure methodology based on ESTER.

Where we are going

Now, let's look at where the reforms are taking us. As already mentioned, the FSB, in its recommendations issued in 2014, defined a roadmap initially based on two complementary actions: strengthening of existing IBORs and development and adoption of alternative risk-free reference rates that are sufficiently robust for extensive use.

Nonetheless, these two actions have converged because of the transformation of monetary markets since the financial crisis, which has led to a scarcity of underlying transactions in the term interbank and wholesale unsecured funding markets on which IBORs are based. This situation could make them susceptible to manipulation and questions their sustainability in the medium and long term.

As the FSB has highlighted, to ensure financial stability benchmarks which are used extensively must be especially robust.

According to this, it seems that we are moving towards a financial system more anchored on solid benchmarks less exposed to the risks of discontinuation or lack of real transactions.

But the transition to the new benchmarks landscape will be challenging. Their use in very different geographies around the world and by a wide range of firms, from financial firms to corporations; the variety of clients and customers impacted, from retail ones and natural persons to global systemic institutions; and the plurality of types of contracts, instruments, services, processes and activities involved, require a proactive attitude and an adequate preparation of the market to face such challenges successfully.

The Eurozone is conditioned by the short deadlines imposed by BMR and by some issues still to be resolved such as:

- the availability of suitable indices for the different current uses,
- a curve supported by a sufficiently deep and liquid market
- and all the implications of the renegotiation of the contracts.

Risks and challenges are relevant and must be managed proactively. In this regard, a careful transition planning by market participants is desirable in order to avoid disruption to markets and consumers as well as to ensure an adequate financing of the economy and financial stability.

Market preparation is essential to deal with these challenges successfully.

Let me finish by saying that the task requires the involvement of public authorities but, above all, an effort by market participants, to facilitate a smooth transition and a gradual reduction in the current reliance on IBORs.

Going back to what I said at the beginning, we at the CNMV will continue to work to facilitating the reform in progress. Proof of this is that our Action Plan for 2019, which will be presented on the 25th of February, includes as one of its objectives the implementation of measures aimed at raising awareness on the preparation and adaptation of the market and its participants.

I would like that this speech has contributed to encourage you to prepare for the challenges we face in this field.

Thank you very much for your attention.