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Standard setting agenda – Euro overnight interest rate reform

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Dear Mr Hoogervorst,

In September 2017 the European Central Bank (ECB), the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission announced the launch of the industry Working Group on Euro Risk-Free Rates (WG Euro RFR). The working group was tasked with identifying and recommending risk-free rates that could serve as an alternative to EONIA and EURIBOR used in a variety of financial instruments and contracts in the European Union¹, and developing adoption plans. Within the WG Euro RFR, a subgroup analyses risk management and accounting issues in relation to the adoption of alternative risk-free rates. I am writing to you in my capacity as chair of the WG Euro RFR.

The purpose of this letter is to inform the International Accounting Standards Board (IASB) of the objective and status of the reform agenda regarding interest rates in the euro area (Euro reform agenda) and to express some concerns in relation to potential accounting issues triggered by the reform based on the analysis of the potential IFRS accounting issues, as detailed in Appendix 1 to this letter.

The Euro reform agenda focuses on the replacement of EONIA by the recommended euro risk-free rate €STR, which will be published by the ECB starting on 2 October 2019. The rationale for the replacement is that the underlying transaction base of EONIA, in its current form, is thin, and therefore EONIA's compliance with the EU Benchmarks Regulation cannot be guaranteed².

To support the market-wide transition from EONIA to the €STR, and to ensure an orderly and time-limited process, the WG Euro RFR has recommended a transition path that has been widely adopted by the relevant stakeholders.

Key elements of the transition from EONIA to the €STR are: (a) the existence of a transition period, which will start on 2 October 2019 and end on 31 December 2021, with the consequent cessation of

¹ https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html

² Please refer to Appendix 2 for further information on the €STR, the relationship between EONIA and the €STR, and the transition period.

publication of EONIA on 3 January 2022; and (b) the dependency of EONIA on the €STR during the transition period, as EONIA will become the €STR plus a fixed spread of 8.5 basis points; the spread is necessary to avoid any basis risk between the two rates.

During the transition period, market participants must migrate their relevant business activities and relevant valuation infrastructure from EONIA to the €STR for those financial instruments and contracts that mature after this period. For financial instruments and contracts that mature during this period, migration is possible. This could have an impact on cash flows of EONIA-based instruments and net present values, since EONIA plays a pivotal role in the valuation of financial assets and liabilities for many market participants.

The transition may have a further impact on the financial accounting of the relevant market participants and could lead to undesirable accounting volatility and not provide useful and relevant information on the performance of the institutions. Consequently, the market-wide implementation of the €STR as the new reference rate could be impeded.

The working group has identified critical accounting issues with respect to the following:

- Modification of contracts
- Derecognition of hedged items or hedging instruments
- Replacement of hedging instruments
- Documentation of hedging relationships
- Ineffectiveness of hedging relationships

The WG Euro RFR asks the IASB to consider further clarifications and relief in respect of the above accounting issues, which arise solely on account of the replacement of EONIA with the €STR. The issues are described in more detail in Appendix 1 to this letter.

The working group highly appreciates the IASB's standard-setting process in support of the reforms to the interbank offered rate and the current exposure draft (phase 1), and stresses the urgency to start phase 2, especially since the transition of EONIA to the €STR will become effective on 2 October 2019³.

Please do not hesitate to contact us should you have questions or if the IASB requires further information for the upcoming deliberations on phase 2 of the standard-setting process.

Yours sincerely,



Steven van Rijswijk
Chair of the Working Group on Euro Risk-Free Rates

³ Please refer to Appendix 2 for more background on the transition period from EONIA to the €STR.

Appendix 1: Accounting issues arising from EONIA-€STR reform

The WG Euro RFR appreciates the IASB's view that the discontinuation of hedge accounting solely due to uncertainties before the reform's economic effects are known would not provide useful information to users of financial statements. As proposed in ED/2019/1, relief would enable entities to continue with the hedging relationships during phase 1. However, the Exposure Draft proposes that relief related to the highly probable and prospective assessment requirements will cease to apply when the interest rate benchmark reform uncertainty is no longer present. Since uncertainty on the transition from EONIA to the €STR could somehow be considered to have dissipated, a clarification on this specific situation would be needed.

The transition from EONIA to the €STR is fast approaching, affecting hedging relationships impacted by the benchmark interest rate reform that were continued under the relief from phase 1. More specifically, once entities have amended existing contracts so that they refer to the €STR instead of EONIA, we understand that entities are faced with "replacement issues", which the IASB seeks to address in phase 2. Since the transition from EONIA to the €STR will start in October 2019 with a fixed spread, which has already been defined, we would like to highlight the urgency of starting phase 2 in parallel with the finalisation of the amendments proposed in the Exposure Draft.

Modification of Contracts

As discussed above, a critical issue triggered by the transition from EONIA to the €STR is the resulting change in contracts that reference EONIA. Such changes could require entities to assess whether the modifications made should be considered substantial or non-substantial modifications to the contractual terms, potentially leading to derecognition and re-recognition of contracts and resulting in significant volatility on the income statement.

The large number of contracts impacted by the transition creates significant operational challenges owing to the need to analyse each contract individually. If preparers of financial statements could perform such analyses on an aggregate rather than an individual level, it would lessen some of the challenges caused by the interbank offered rate and Euro reform agenda. However, such relief would require the IASB to make related changes to IAS 39 and IFRS 9.

More generally speaking, we recommend the IASB address the issue of modifications of contracts and the potential risk of derecognition owing to the interbank offered rate and the Euro reform agenda, and provide financial statement preparers with specific guidance on how to treat changes to contracts driven by the reforms in the light of the existing IASB guidance on modifications of floating-rate instruments.

This guidance could also consider the following:

- there is a general goal of equivalence when shifting from a benchmark to its fallback rate (including the introduction of a fallback rate for an existing contract) and therefore the change should be considered a modification only when such equivalence is not fulfilled;
- whether applying the existing guidance on changes in cash flows (IFRS 9.B5.4.5/IAS 39.AG7) to a change from one overnight rate to its successor overnight rate (i.e. market-wide transition from EONIA to the €STR) would provide more useful information to the readers of the financial statements.

Discontinuation of hedging relationships

There are several circumstances under which a hedging relationship might need to be discontinued. This applies to both cash flow hedges and fair value hedges (including portfolio hedges). In the context of the transition from EONIA to the €STR, issues that require further consideration include:

- Derecognition of a hedged item or hedging instrument

If either the hedged item or the hedging instrument were to be derecognised, hedge accounting would have to be discontinued. We refer to the above regarding the potential impact owing to the amendment of existing contracts.

- Replacement of a hedging instrument

If an entity replaces an existing EONIA-based hedging instrument with a €STR-based hedging instrument, no issue should arise if the entity has already provided for the rollover of the hedging instrument in the hedge documentation. However, many entities will have drawn up hedge documentation before the replacement of EONIA was announced and did not foresee any need for a rollover at inception of the hedge. While the replacement of a hedging instrument that was not foreseen under the hedge documentation would usually indicate that the original risk management objective has changed, this is not true if the replacement has to be made in response to the market-wide replacement of EONIA with the €STR. On the contrary, the replacement is actually made in order to maintain the original risk management objective. Against this background, it appears reasonable to treat replacements of hedging instruments made solely in response to the EONIA/€STR reform in a similar way to rollovers foreseen in the hedge documentation.

- Documentation of the hedging relationship

Once EONIA is replaced by the €STR in legacy contracts maturing after 31 December 2021, in addition to the rollover of hedging instruments, there will likely be further effects on hedge documentation that did not foresee the replacement of EONIA and accordingly made no reference to the €STR. An update to the hedge documentation regarding the €STR could be viewed by some as a substantive amendment, giving rise to the discontinuation of the hedging relationship. However, as with the reasoning above, the update is made in response to the market-wide transition to the €STR and is not being made to reflect a change in the underlying risk management objective, which is still the same.

- Ineffectiveness of the hedging relationship

Under IAS 39, hedging relationships are required to be “highly effective”. Entities need to demonstrate they meet this requirement by conducting frequent prospective and retrospective effectiveness tests (80%-125% test).

However during the period of transition from EONIA to the €STR (from 2 October 2019 to 31 December 2021), hedging relationships might face (additional) prospective and/or retrospective ineffectiveness. This might be the case, in particular, in situations where the modification of the hedged item and the hedging instrument take place at different points in time or where the valuation is affected by the transition to the €STR (see Appendix 2 on valuation).

The discontinuation of hedging relationships that only temporarily fail the “highly effective” requirement (80%-125% test) would contradict the IASB’s effort relating to the relief for prospective effectiveness testing made in ED/2019/1. In order to be consistent with the objective in the Exposure Draft, similar relief is required as regards the retrospective effectiveness test (80%-125% test) under IAS 39.

In all cases, discontinuation of a hedging relationship in response to the transition from EONIA to the €STR could have an impact on releasing amounts previously recognised in other comprehensive income for cash flow hedges, with potentially significant effects on profits or losses, or the amortisation of hedge adjustments for fair value hedges, as the case may be. Discontinuation of a hedging relationship is clearly appropriate if the original risk management objective has changed. However, the transition from EONIA to the €STR does not substantially change an entity's original risk management objective but happens in response to the market-wide transition driven by the EU Benchmarks Regulation. Thus, the discontinuation of hedging relationships that is caused solely by the transition from EONIA to the €STR would not provide useful information to users of financial statements. We therefore request the IASB provide further clarification and relief, in the same manner as proposed in ED/2019/1, that the replacement from EONIA to the €STR should not trigger a discontinuation of a hedge relationship that is not otherwise amended.

Appendix 2: The transition from EONIA to the €STR

1. The Euro reform agenda

The most widely used interest rate benchmarks for euro-denominated financial contracts are the euro interbank offered rate (EURIBOR) and the euro overnight index average (EONIA). Both are based on the unsecured interbank market and administered by the European Money Markets Institute (EMMI). EURIBOR is a quote-based interest rate benchmark, available for several tenors. EONIA is the overnight reference rate for the euro computed on the basis of real transactions in the interbank market. Furthermore, the two benchmarks have also been designated as critical by the European Commission, which makes them subject to specific provisions, notably regarding the modalities for their supervision⁴.

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 was published in 2016 and became effective in 2018. EONIA and EURIBOR have been undergoing in-depth reform led by EMMI, aimed at bringing both benchmarks into compliance with the new EU Benchmarks Regulation:

- (1) EURIBOR has been reformed to become EU Benchmarks Regulation-compliant under a new “hybrid” methodology, which will be fully implemented by the end of 2019. Authorisation by the FSMA, EMMI’s supervisor, was granted on 2 July 2019.
- (2) In contrast, EONIA will be discontinued at the end of 2021 and replaced by the new euro short-term rate (the €STR) as recommended by the WG Euro RFR in September 2018.

2. The focus of the Euro reform agenda is the replacement of EONIA

In September 2018, the WG Euro RFR recommended that the €STR becomes the successor of EONIA⁵. Both the €STR and EONIA rely on transactions from the euro-denominated overnight unsecured money market segment. However, they differ in several ways:

- (1) EONIA is administered by the EMMI, while the €STR will be administered by the ECB.
- (2) EONIA relies on voluntary data input by panel banks⁶, whereas the ECB’s new rate will be built on the daily data submissions of the banks reporting in accordance with the money market statistical reporting (MMSR) Regulation⁷.
- (3) EONIA is a weighted average rate of the submitted contributions; the €STR relies on individual transactions rather than on a single contribution per bank.
- (4) The €STR is based on unsecured overnight borrowing deposit transactions, while EONIA is calculated using unsecured overnight lending transactions⁸.

Table 1 provides a comparison of the two overnight rates and their underlying characteristics. As can be inferred from Table 1, the €STR relies on a larger volume of transaction data and is less volatile. This makes the €STR less vulnerable to outliers⁹ and thereby a more robust overnight interest rate.

⁴ For the Terms of reference of the Euro RFR Group (2018), see:
https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk_free_rates/shared/pdf/2017_11_29_terms_of_reference.pdf

⁵ <https://www.ecb.europa.eu/press/pr/date/2018/html/ecb.pr180913.en.html>

⁶ <https://www.emmi-benchmarks.eu/euribor-eonia-org/about-eonia.html>

⁷ https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/html/index.en.html

⁸ https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/euro_short-term_rate/html/ester_qa.en.html

⁹ https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk_free_rates/shared/pdf/20180711/2018_07_11_WG_on_euro_RFR_meeting_Item_3.2_ECB_Presentation_on_EST_ER.pdf

Table 1: Characteristics of EONIA and €STR

	EONIA	€STR
Economic interest of index	The rate reflects overnight unsecured lending in the interbank market in the European Union and the European Free Trade Association (EFTA)	The rate reflects the unsecured wholesale euro overnight borrowing cost of euro area banks
Methodology	Volume-weighted average rate of lending transactions reported by EONIA panel banks	Volume-weighted average rate of transactions reported to the ECB in accordance with money market statistical reporting (MMSR) requirements
Representativeness of index	Panel-based bank lending	Non-panel-based bank borrowing
Average daily volume (15 Mar 2017 to 16 Apr 2019)	€4.8 billion	€32.9 billion
Lowest daily volume (15 Mar 2017 to 16 Apr 2019)	€0.5 billion	€16.4 billion
Number of reporting agents (€STR) or trading participants	28	52
Average number of banks reporting daily volume	10	32
Average number of countries represented	5	9
Performance during periods of market stress	Known to market participants	Not yet known to market participants
Standard deviation of day-to-day changes (15 Mar 2017 to 16 Apr 2019)	0.7 basis points	0.4 basis points
Publication day and time	Same day by 19:00 CET	Next day by 09:00 CET
Nature of administrator	Non-profit-making association; non-panel bank fees apply as per EMMI data subscription service package	Central bank; data to be freely available
Availability of historical data	Since January 1999	Since August 2016

3. Transition phase: fixed spread between EONIA and the €STR

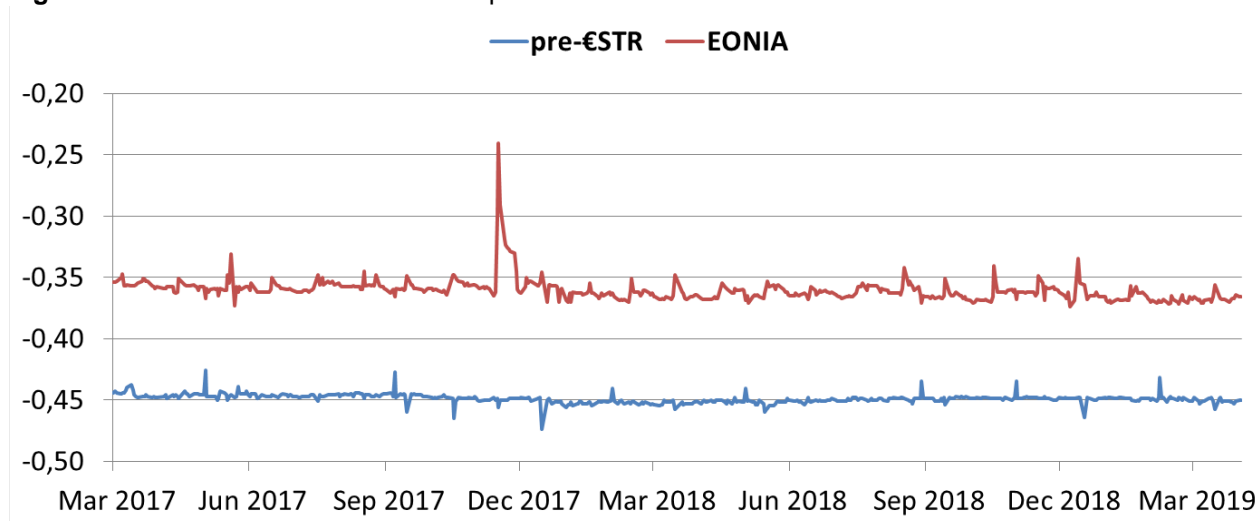
Publication of the €STR by the ECB will start on 2 October 2019 with transaction data from 1 October. For a smooth transition from EONIA to the €STR, there will be a transition period until 31 December 2021. During this period EONIA will be calculated as the €STR plus a fixed spread of 8.5 basis points. Under this new methodology, the reformed EONIA will probably become EU Benchmarks Regulation-compliant and will continue to be published by EMMI until 31 December 2021.

The ECB has provided a one-off computation of the spread between the €STR and EONIA at 8.5 basis points, based on the methodology recommended by the WG Euro RFR¹⁰:

- (1) Calculation of the daily spread between EONIA and the pre-€STR for the most recent year of publicly available pre-€STR data (from 17 April 2018 until 16 April 2019);
- (2) Ordering of the spread series from the lowest to the highest spread;
- (3) Removing exactly 15% of observations from the top and from the bottom of the sorted series (with a partially weighted inclusion of the observations at the border, if relevant);
- (4) Calculation of the arithmetic average of the remaining 70% of observations.

Figure 1 shows the two time series of EONIA and the pre-€STR and gives an indication of their relative stability over time¹¹:

Figure 1: Time series of EONIA and the pre-€STR¹²



4. Potential accounting implications during the transition period

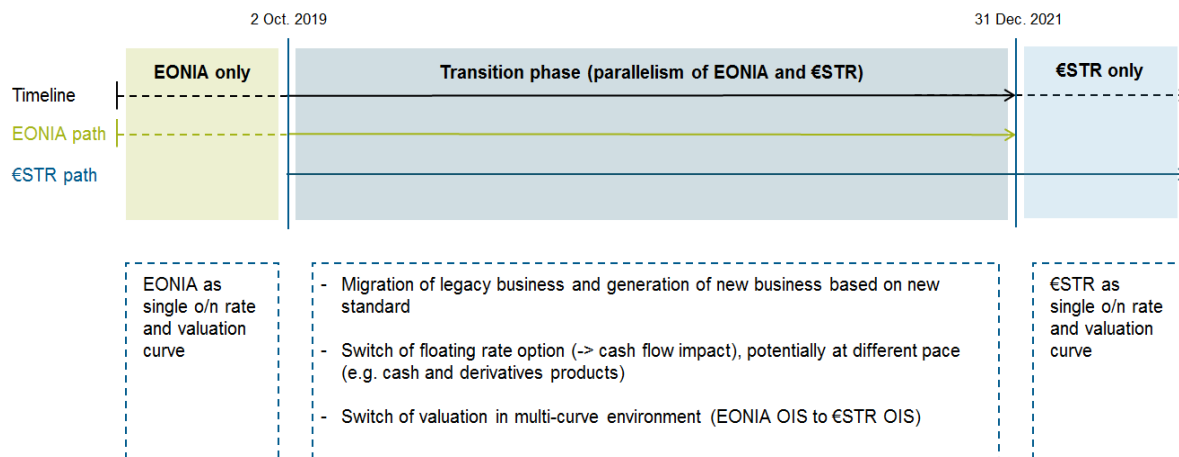
The two-year transition period serves to avoid market disruptions and provide market participants with the opportunity to migrate legacy business from EONIA to the €STR. The following figure illustrates the transition phase:

¹⁰ <https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190314~28790a71ef.en.html>

¹¹ The pre-€STR is calculated using the same methods as defined for the €STR (https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/html/index.en.html)

¹² Data source: Bloomberg.

Figure 2: Illustration of the transition period from EONIA to the €STR:



The switch from EONIA to the €STR could affect financial accounting in two main ways:

- (1) Cash flow impact: financial contracts maturing after 2021 and containing a reference to EONIA (e.g. EONIA as the relevant interest rate or underlying of derivatives) need to be adjusted. EONIA will be replaced by the €STR in these contracts.
- (2) Valuation impact: the calculations of the fair value of financial assets and liabilities using an EONIA-based valuation curve to discount future cash flows need to be adjusted. For fair value calculations, an EONIA-based discount curve will be replaced by an €STR-based discount curve (i.e. switch of valuation curve).

While the cash flow impact would affect only those institutions that have EONIA-linked contracts in their portfolios, the valuation impact would affect all institutions that use an EONIA-based discount curve for valuing their euro-denominated financial products, even those without EONIA-linked legacy business.