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EUROPEAN REGULATORS CAST SONIA OUT FOR ESTER, BUT EURIBOR REMAINS ON THE SCENE

Much has been written about the demise of **Libor** (the London interbank offered rate) as the mostly widely adopted interest reference rate for financial contracts generally and where interest is to be paid in Sterling in particular. Although debate about compounding methodology continues, it appears that Sterling Libor will likely be replaced almost universally by an application of **Sonia** (the Sterling overnight interest average) by the UK's Financial Conduct Authority (**FCA**)'s deadline of the end of next year for contracts referencing Libor. Many of Sterling Libor's perceived defects – subjectivity, susceptibility to rigging and increasing lack of depth in the market it represents were shared not only by Euro Libor, but also its more popular Continental cousin, **Euribor**. Richard Ambery and David Mallon analyse whether there has been a similar transition from Euribor and why **Ester**, a new short-term rate published by the European Central Bank (**ECB**) in Frankfurt is a substitute, rather than the European version of Sonia.

Euribor is based on the average interest rate at which a large panel of European banks is offering to take Euro denominated deposits from each other. The Euribor benchmark is compiled by the European Money Markets Institute (**EMMI**) and published by the ECB. Both bodies were all too aware of Euribor's similarities with Libor and attendant vulnerabilities to manipulation and abuse. Accordingly and in parallel with the FCA, supranational regulator, the European Securities and Markets Association (**ESMA**) sought to establish migration to a more objective reference rate for lenders, borrowers, investors and derivative counterparties dealing in Euro.

In the wake of the Libor manipulation scandal, the European Commission proposed what is now 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 (the **BMR**), which came into force on 1 January 2018. The BMR seeks

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to ensure and improve the accuracy, robustness and reliability of benchmarks applied in the provision of financial services throughout the European Union (the **EU**). Naturally, this includes interbank offered [interest] rates, or **IBORs**. To that end, the BMR creates requirements in respect of the processes used to determine benchmarks for measuring the underlying interests from which an IBOR is determined as well as registration of compliant benchmarks with ESMA. Certain EU supervised entities are prohibited from using IBORs if registration of compliance with the BMR has not been met by the extended BMR transitional period deadline of 31 December 2021 (the **BMR Deadline**).

Nevertheless on 2 July 2019, the Financial Services and Markets Authority of Belgium authorised EMMI as the administrator of Euribor under the BMR, following the positive advice of ESMA's Euribor College of Supervisors. Euribor is now considered BMR-compliant and was added to the ESMA benchmark register. This means that EU supervised entities will be able to use Euribor even after the BMR Deadline. In short therefore, those of us dealing with Euribor do not share the pressure of participants looking to rely on contracts hitherto referencing Libor. At least for the time being.

Unsurprisingly perhaps, Euribor had to undergo some reform in order to become BMR-compliant, specifically:

1. Interest rate data points are based solely on eligible transactions for the relevant Euribor tenor – e.g., one, three or six months[1];

2. Interpolation is carried out using calculation methods provided by EMMI; and

3. Results are aggregated and measured alongside data collected from other similar euro money markets in accordance with accepted modelling techniques.

Consequently, there isn't the same impetus among EU regulators to push market participants away from the new improved Euribor toward a non-term, unsecured overnight risk-free reference rate in the way that term borrowers in Sterling are being shifted from Libor to Sonia. ESMA and EMMI nonetheless set about improving Sonia's Euro equivalent, Eonia, to the extent that since March 2019, Eonia has been gradually replaced in practice by its successor, Ester. EMMI has notified the markets that from 3 January 2022, Eonia will be discontinued.

Like Eonia, Ester reflects the wholesale euro unsecured overnight borrowing costs of Eurozone banks and does not therefore allow as Euribor does, for different tenors. Ester however is more genuine than Eonia for at least the following reasons:

1 Ester is based on a more liquid wholesale market than Eoina, thereby making it a better representation of underlying transactions.

2 Ester is based exclusively on transaction data, removing any bias arising from expert judgement.

3 Ester is required to be reported daily by its panel of reference banks, as opposed to voluntarily; and

[1] From 3 December 2018 EMMI reduced the number of published tenors for Euribor from eight to five, reflecting highest use.

4 Ester was created with the BMR in mind.

European practitioners may also relax thanks to the efforts of the ECB's Working Group on Euro Risk-Free Rates resulting in ISDA's May 2019 update of its definitions for terms in derivative contracts including an "Index Cessation Event" fall back trigger whereby "Collateral Rates" revert to Ester plus a fixed spread for all new trades referencing Eonia.

In powerful contrast to their counterparts in the UK, European practitioners may continue confidently to rely on Euribor as the benchmark in agreements for a lender's cost of funds for all common funding frequencies. Likewise, there is no need to struggle applying overnight money market reference rates to typical three and six month rollover periods. At the same time, EMMI and the ECB have worked hard to ensure that with the advent of Ester, Euro overnight benchmark rates are also more trustworthy.

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