



Acuiti Special Report

The Eonia to €STR transition

Eonia to €STR: a progress report on the transition

The shift away from Libor and other traditional interest rate benchmarks is one of the most significant changes in market structure for decades. In this special report, we focus on the transition from Eonia to €STR and look at levels of readiness and the challenges to transition.

Libor, the benchmark interest rate which underpins an estimated \$350tr in financial instruments, is expected to cease being published at the end of 2021.

While Libor is the most significant, a host of other “Ibor” benchmarks across the major financial jurisdictions are being transferred to new rates.

Five major global alternative Risk Free Rates (RFRs) to Libor and existing Ibors are being developed by regional authorities. These rates reference different underlyings with Sofr in the US and Saron in Switzerland referencing overnight repo rates, and the UK’s Sonia and Japan’s Tonar referencing unsecured lending.

FIGURE 1:
Global alternatives to Libor

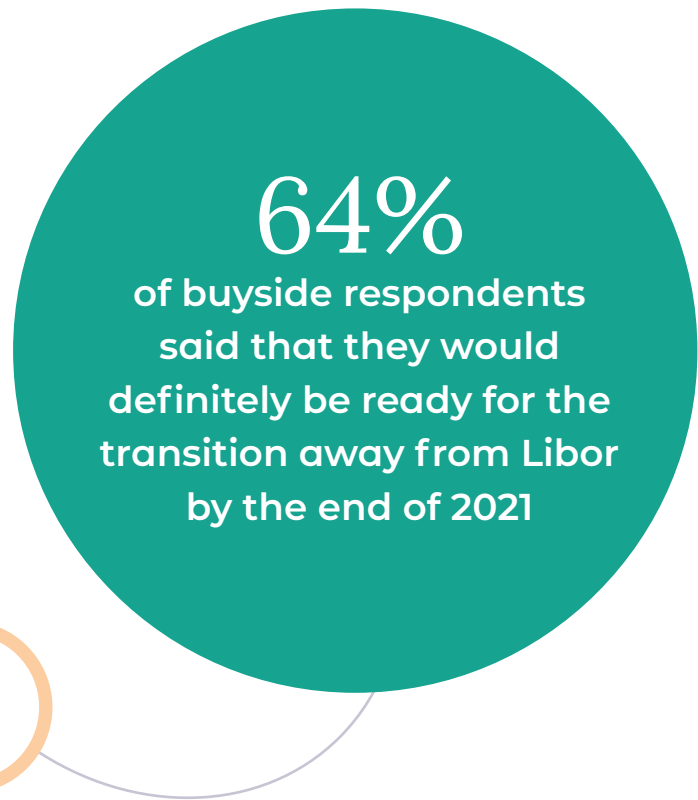
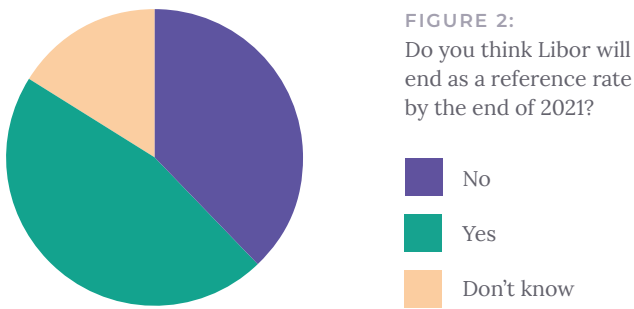
Jurisdiction	Alternative rate	Administrator	Structure
USA	Sofr	Federal Reserve Bank of New York	Secured
United Kingdom	Sonia	Bank of England	Unsecured
Switzerland	Saron	SIX Exchange	Secured
Japan	Tonar	Bank of Japan	Unsecured
Eurozone	€str	European Central Bank	Unsecured

Last month, the European Central Bank began publishing the Euro short-term rate, €STR, the new overnight unsecured rate that will replace Eonia. €STR is based on unsecured overnight borrowing deposit transactions.

Libor has been called “the world’s most important number” and with good reason. Aside from the sheer volume of instruments referencing Libor, its reach and scope in the financial markets is unparalleled.

Cash markets, both listed and OTC derivatives, insurance markets and syndicated loans all benchmark against Libor. Overall Libor is the reference rate for financial instruments with a notional value more than five times greater than global GDP.

The shift away from Ibors to RFRs represents one of the most fundamental shifts in market structure in the modern era.



Changing rates

To understand the levels of readiness across the market, Acuiti surveyed 58 senior executives in the derivatives market on the transition to RFRs to identify levels of progress and highlight any challenges firms were facing in their work on the transition. The survey was complemented by a series of interviews with market participants.

The survey contained two components: a series of broad questions regarding the global Libor transition and a set of questions focused on the Eonia to €STR transition, which were asked to market participants predominantly operational in Europe.

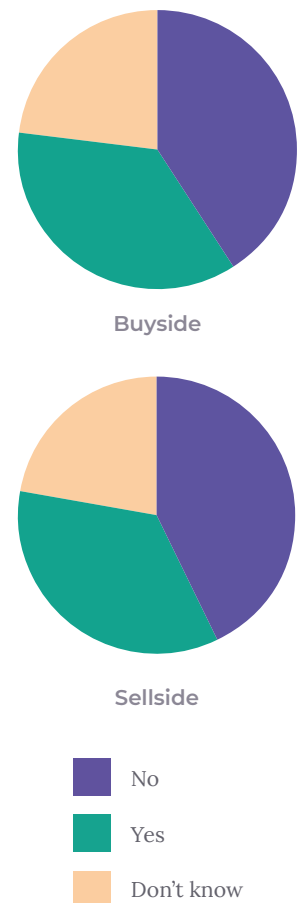
We found that despite doubt in some corners of the market as to whether Libor would fully end as a reference rate by 2021, firms were well advanced in their preparations.

64% of buyside respondents said that they would definitely be ready for the transition with the rest saying they would possibly be ready. Just 13% of sellside respondents predicted their businesses would not be fully ready by the end of 2021.

On the buyside, 67% of respondents had begun active work on the transition, compared with 63% on the sellside, with brokerage firms lagging behind banks in their preparations. For those that were not well advanced in preparations, a lack of development of market infrastructure was cited as the major reason for hesitance by both the buy and sellside.

For the sellside, issues with internal systems was also a major factor (particularly for tier 2 and 3 banks) as firms need to recalibrate internal IT systems and develop new internal finance pricing models to reflect the new rates as well as working with clients to ensure contracts and fallbacks accommodate the transition.

FIGURE 3: Have you changed what instruments you are trading to reduce exposure to Libor?



Eonia to €STR

On October 2nd, the European Central Bank began publishing the €STR bringing the EU in line with the other jurisdictions, which have already published the new rates that are designed to ultimately replace Ibors.

Ahead of the publication of the benchmark rate, the Acuiti study focused on market sentiment with regards to the Eonia to €STR transition with respondents based in Europe (85% of the total sample size) answering questions specific to €STR.

The transition from Eonia to €STR is significantly less complex than the transition away from Libor, owing to the much smaller notional and breadth of instruments that use it as a benchmark.

Our survey found that both the buy-side and the sell-side believed that a transition to €STR would be achievable by the end of 2021. 53% of sell-side and 43% of buy-side respondents said a transition was definitely possible while only 14% and 18% respectively said it wouldn't be achievable.

Among the buy-side, launching and developing €STR-based products, greater €STR-based issuance in the cash market and ensuring CCPs can clear €STR swaps, were the most important steps in facilitating the transition.

For the sell-side, clarifying margin requirements for trades based on €STR was paramount (see figure 7).

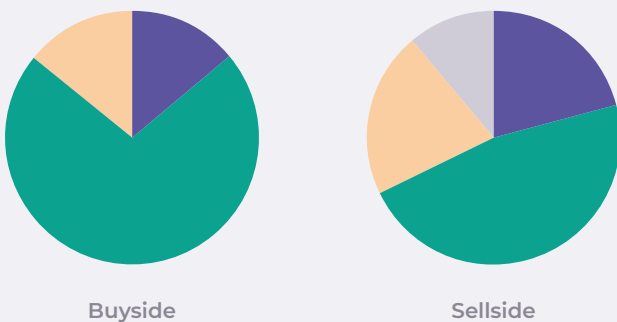
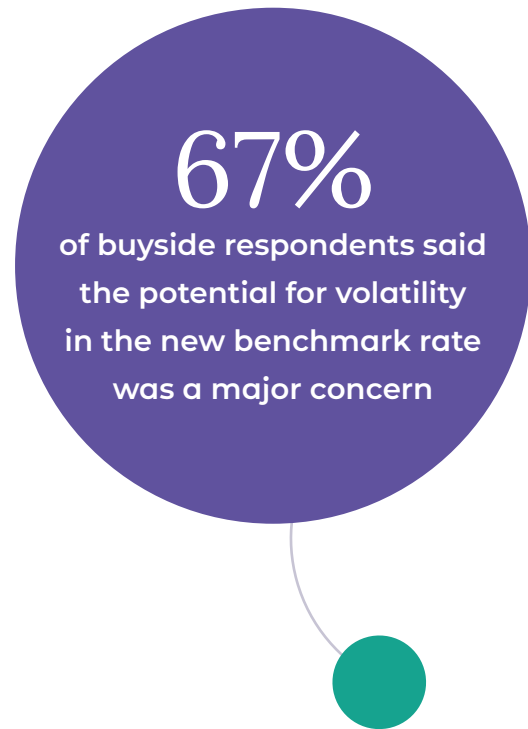


FIGURE 3:

Do you think that the transition to €STR will encourage you to change the venue on which you trade interest rates?

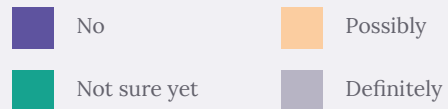
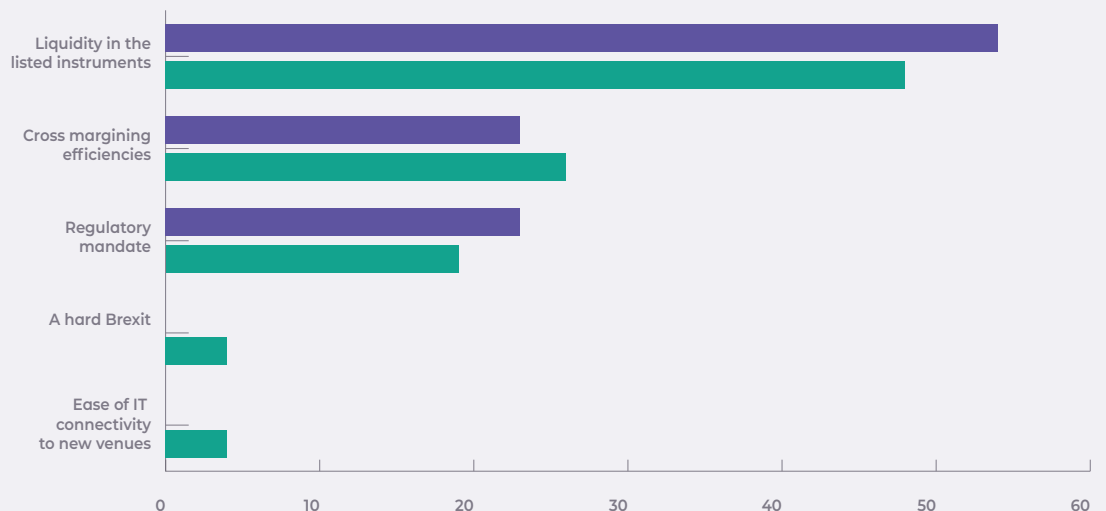


FIGURE 4:
What would be the single biggest factor in any decision to move liquidity to a new execution venue?



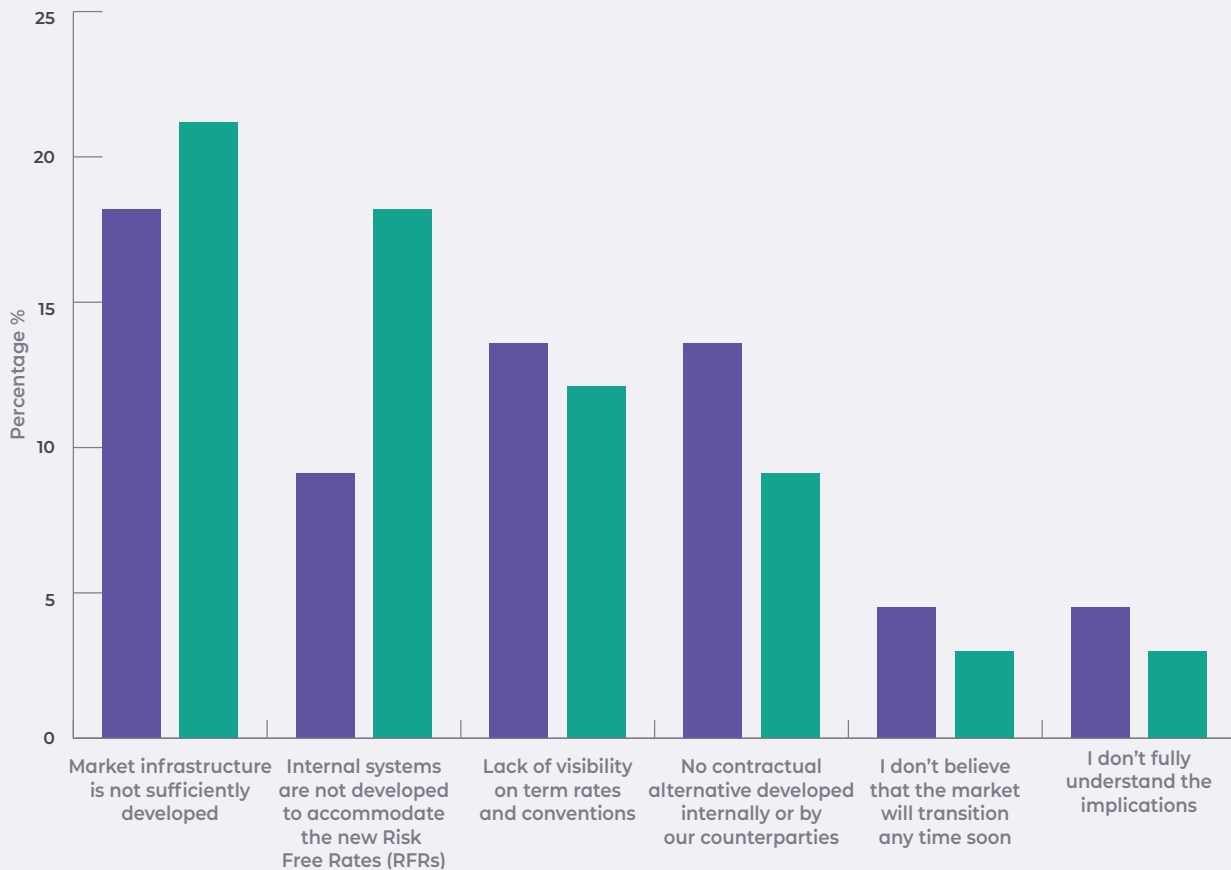


FIGURE 5:
What are the biggest barriers to change you are facing in the transition to RFRs (asked to respondents who were not well advanced in their preparations)

■ Buyside
■ Sellside

Transition challenges

Trading volumes in OTC and listed derivatives linked to the new rates are growing across the world. According to the International Swaps and Derivatives Association, interest rate derivatives referencing alternative rates totalled \$1.8tr in Q2 2019, a significant sum but still just 2.7% of the volumes referencing the current benchmark rates.

Our survey found that 41% of the buyside and 43% of the sellside were actively trading new instruments to reduce exposure to Libor. However, many respondents were still taking on Libor exposure beyond 2021 in the absence of established alternatives.

Volumes in both the listed and OTC markets in both the US and Europe remain well below that of contracts referencing Libor. Meanwhile, €STR is still in its infancy with the rate only being formally published this month, hence uncertainty over the potential volatility of the rate and lack of listed alternatives is understandable.

The €STR is published each day by the European Central Bank with Eonia being recalibrated at a spread of €STR + 8.5bps, reflecting the different structure of the underlying and the absence of the credit risk embedded in Eonia. The ECB will remove 15% of observations from the top and bottom of the data points to calculate the rate.

When modelled over the historic Eonia rate, this shows lower levels of volatility. However, building volumes across both listed and OTC instruments will be essential to ensuring a smooth transition for the new rate and will require co-ordination and a concerted effort across the market and we found that a major concern for both the buyside and the sellside is the lack of liquidity and potential for volatility in the new benchmarks.

Because of the spread embedded in the €STR, there are also worries over the potential for adverse value transfers on positions. This was reflected in the survey with 33% of the buyside and 25% of the sellside highlighting this as a major concern.

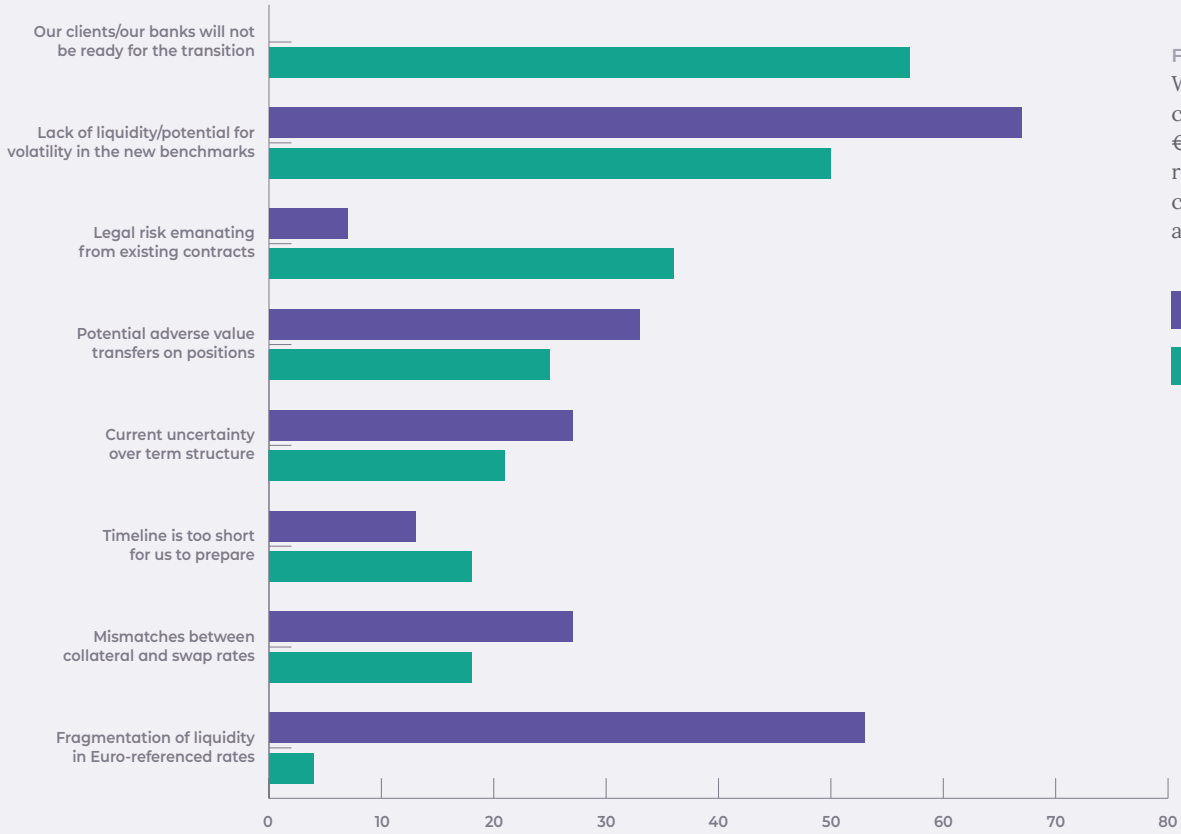


FIGURE 6: What are your biggest concerns specific to the €STR transition (% of respondents selecting choice, multiple choices allowed)?

■ Buyside
■ Sellside



FIGURE 7: What are the most important steps that should be taken to accelerate a move to €STR (% selecting choice (multiple choices allowed)?

■ Buyside
■ Sellside

“Eurex will look to clear €STR swaps on November 18th and believe that we are well positioned to help clients develop this market, together with continue to grow our franchise in EUR swaps.

“Having the ability to clear €STR swaps reinforces our ambition to be a leading liquidity pool across

in Euro-denominated derivatives, underpinning Eurex’s ambitions to offer our clients access to liquidity across our product suite.

“As the market evolves, I would expect that Eurex plays a key role in the markets development.”

Lee Bartholomew, Head of Fixed Income & FX Product R&D, Eurex

Changing execution venues

One fundamental question stemming from the impact of the introduction of €STR is how it will impact market structure in the execution of listed instruments and the clearing of OTC positions.

Our survey found that there remains some of uncertainty surrounding the long-term implications for the market structure, as is to be expected at this stage. 14% of buy-side and 32% of sell-side respondents said the transition to €STR might encourage them to change where they execute listed instruments with 72% and 47%, respectively, unsure (see Fig 3). Of the sell-side respondents, 11% said the transition would definitely encourage a change of execution venue.

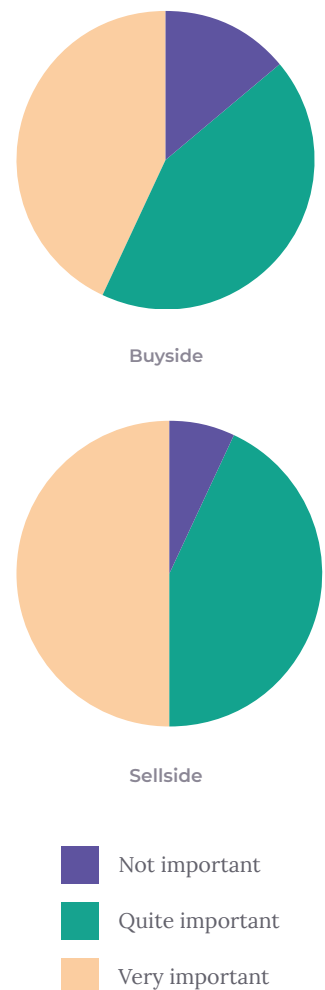
Liquidity in the listed instruments was cited as the major factor in any decision to change execution venues with 54% of the buy-side and 48% of the sell-side saying this was the single most important factor.

43% of the buy-side and 50% of the sell-side said cross margining was very important in their decision-making process regarding changing execution venues.

With Eonia scheduled to be discontinued on 3 January 2022, the timeline for development of €STR is tight. However, our survey found that only 18% sell-side and 14% of buy-side respondents thought the deadline was unachievable.

Nonetheless, challenges remain and widespread acceptance of the transition is needed. So too is collaboration across the industry to build liquidity across €STR-linked products in order to ensure a smooth transition.

FIGURE 8:
How important is cross-margining in your decision-making process regarding execution venues?



Methodology: Between 2 September and 13 September 2019, Acuti surveyed 58 senior executives active in the derivatives markets on their levels of preparedness for the transition away from Ibors as a benchmark reference rate. 23 of the executives were from buy-side firms and 35 were from the sell-side. 31 were from the UK, 18 from the rest of the EU and 8 were from North America with 1 respondent based in APAC. All respondents were asked general Libor questions and respondents from the UK and wider EU were asked questions specific to the transition from Eonia to €STR.