Euribor and Transactions: The Time Has Yet To Come

Introduction

This article throws light on an important decision about Euribor that came out this week on May 4th. The decision refers to the conclusion of the pre-live exercise that was carried out to determine the change in method of calculation of Euribor. We will proceed in the following way: first, we will explain what Euribor is and how it is calculated; then we will analyse its evolution since inception and finally what important change was voted against this week.

Origins

Euribor, an abbreviation for Euro Interbank Offered Rate, is the money market reference rate for the European Monetary Union. It is based on the interest rates at which a panel of European banks can borrow funds from each other. First published on 30th December 1998, Euribor was intended to be used as a reference rate for pricing mortgages and measuring the performance of investment funds and put an end to a number of domestic rates (such as PIBOR and Fibor) that existed before it.

The rate is computed on 8 different maturities which can vary from 1 week to 1 year and is only quoted in Euro denominations, being the main difference between Euribor and other benchmark rates such as the London Interbank Offered Rate (LIBOR).

A more technical definition of this rate is as follows: "a daily reference rate, published by the European Money Markets Institute [EMMI], based on the averaged interest rates at which Eurozone banks offer to lend unsecured funds to other banks in the euro wholesale money market (or interbank market)".

According to the Euribor Code of Conduct, the rate is computed using the following methodology:

1. Panel banks provide daily quotes of the rate, rounded to two decimal places, that each panel bank believes one prime bank is quoting to another prime bank for interbank term deposits within the euro zone.
2. Euribor is quoted for spot value (T+2) and on an act/360 day- count convention. It is displayed to three decimals place.
3. Panel banks contribute for the maturities defined by the Steering Committee.

A prime bank is defined as "a credit institution of high creditworthiness for short-term liabilities, which lends at competitive market related interest rates and is recognized as active in euro-denominated money market instruments while having access to the Eurosystem's (open) market operations". Moreover, interbank term deposits must be intended as the cash deposits between two credit institutions only maturing within one year.

In the calculation for each maturity, the highest and lowest 15% of all the quotes collected are eliminated. The remaining rates are averaged and rounded to three decimal places. Euribor is then determined and published at 11:00am each day (Central Europe Time).

Euribor is currently used as reference rate for euro-denominated forward rate agreements (FRA), short-term interest rate futures contracts and interest rate swaps. Due to the currencies that these interest rates deal in, Euribor has come to be the main rate of some of the most liquid and active interest rate markets in the world.

Evolution

As mentioned above, Euribor was founded along the guidelines structuring LIBOR (the oldest Interbank Offered Rate) and has evolved as a standardized benchmark for the pricing of floating-rate corporate loans. As a result, EMMI notes that Euribor can be broadly considered as a funding rate, i.e. a borrowing rate for banks. In

accordance with the IOSCO Principles for Financial Benchmarks, it is essential that we mention the two components of the benchmark rate;

- Underlying Interest: this is the economic variable that a benchmark seeks to measure.
- Determination of Technology: the method used to make a practical measurement of Underlying Interest.

While the combination of the two factors mentioned above is considered to be the benchmark specification, Underlying Interest represents the more fundamental factor since it helps determining the objective of establishing the benchmark.

One of the key objectives of EMMI is defined as 'making an evaluation of fluctuations in the interest rates in the money and interbank markets of the euro area and of providing the results of its research to the monetary authorities and interested parties who are active in these markets'. Since this task is to be carried out with the highest ethical standards, it is essential that the panel of banks participating in the determination of Euribor do not tamper or manipulate the data in order to benefit from personal transactions.

EMMI ensures this by involving a large number of active players of varying types, sizes and locations in the euro zone money markets. The 44 banks currently on the panel vary from savings banks to cooperative banks, from regional to international institutions. The reasoning behind this argues that, given the variety of business models and banking strategies, it should be almost impossible to find a common interest between enough members to influence the index (in theory, no possibility of collusion among panel banks). The selection of the panel banks is based on a market criteria i.e. banks of first class market standing which are selected to ensure that the diversity of the euro money market is adequately reflected, thereby aiming to make Euribor an efficient and representative benchmark.

Change in Structure

In a report titled 'Reforming Major Interest Rate Benchmarks' (published on 2nd July 2014), the Financial Stability Board recommended strengthening the "IBORs and other potential reference rates based on unsecured funding costs by underpinning them to the greatest extent possible with transactions data". This revision in method of calculation started because of a major debate when several financial institutions were fined as part of an inquiry into how rates like Euribor and Libor, which determine the rates on loans and financial contracts across the globe, are set. There have been several cases of rigging scandals in both U.S. and U.K. involving the arrests of traders of major financial institutions. According to Financial Times, the total amount of fines paid by the financial institutions involved is around $10bn. Given the importance of benchmark rates in setting interest rate of floating mortgages and other financial products, global regulators are since attempting to change the way they are computed and to anchor them to real transactions and not to quoted prices.

The EMMI came up with a method that would help determine the Euribor based on the actual transactions rather than the system of panel banks' estimates. The strategy developed would involve the following steps in determining the Euribor rates:

1. The transaction- based Euribor benchmark would reflect the average unsecured wholesale funding rates of banks in euro across the European Union (EU) and countries in the European Free Trade Association (EFTA). Each Panel Bank would submit the volume- weighted average rate and aggregate transaction volume for each respective Euribor tenor;
2. To enhance data sufficiency across all tenors, the transaction- based Euribor methodology would leverage data from earlier days (in the calculation of the benchmark rate) wherever necessary;

3. In order to reduce the volatility effects resulting from a daily change in contributing banks, an average rate would be computed for each tenor using a calculation methodology involving the central group of rates corresponding to non- zero volume contributions (referred to as the median group).

EMMI carried out a verification exercise with 31 banks over a period running from September 2016 to February 2017 (6-months) to check the feasibility of this change and published its decision not to pursue the transition yet to the proposed Euribor+ methodology in the short term on May 4th 2017. The reason cited for this was the downturn in the levels of interbank lending, i.e. too few transactions to base the rate upon. Even though a complete reform has not been possible for the Euribor, other benchmark rates such as the LIBOR are now computed putting more emphasis on the volumes and prices of true transactions, instead of quoted theoretical rates. In order to avoid further market manipulation and in an attempt to overcome the limits of the current methodology, EMMI committed itself to develop and implement an hybrid approach capable to adapt to true market conditions in the coming months.

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