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Working Group on Euro Risk-Free Rates:
Guidance for Corporate Lending Products for Implementing the Recommendations on EURIBOR Fallback Trigger Events and €STR-based EURIBOR Fallback Rates

1 Executive summary

The overall objective of the working group on euro risk-free rates (the working group) is to foster interest rate reform in the EU. This includes identifying potential impediments to the timely adoption of EURIBOR fallback provisions and putting forward recommendations and best practices to assist in overcoming such impediments.

The working group previously published recommendations for EURIBOR fallback trigger events and €STR-based EURIBOR fallback rates in May 2021 (the May 2021 recommendations). Whilst EURIBOR is not scheduled to be discontinued, this does not negate the need for market participants to include robust fallback language in their contracts. Robust fallbacks are a requirement of the EU Benchmarks Regulation (BMR) and the working group has previously stressed the importance of including robust fallbacks in all financial contracts, not just those within the scope of the BMR. Now that forward-looking €STR rates (term €STR rates) are available alongside the already existing backward-looking €STR, there is no impediment to the full implementation of the May 2021 recommendations.

The working group understands that these recommendations are not generally being adopted in corporate lending products. This has been for various reasons including some market participants choosing not to adopt the recommendations, for example, due to the previous lack of term €STR rates, EURIBOR not scheduled to be discontinued and parties preferring to use a less robust 'amendment approach' to fallbacks. The working group, however, reiterates the importance of the adoption of EURIBOR fallback rates and trigger events in new and refinanced euro denominated corporate lending products in order to avoid operational and market disruption risks. As a result, the working group decided at its December 2022 meeting to provide further guidance on corporate lending products to foster the adoption of €STR-based EURIBOR fallbacks.

The working group recognises that further guidance and clarification of the May 2021 recommendations as they apply in respect of corporate lending products can provide confidence to loan market participants. It is noted that other currency working groups have produced recommendations for conventions specific to the loan market and it would therefore be helpful to have targeted guidance for corporate lending products to enable loan market participants to follow the May 2021 recommendations and facilitate the development of standard market practice.

This guidance is specific to corporate lending products and is addressed to all parties active in EURIBOR-referencing corporate lending products, including lenders, borrowers, investors, advisers and legal firms. It does not apply to any other cash products covered by the May 2021 recommendations.

This guidance is aligned with, and does not change, the May 2021 recommendations and has therefore not been subject to consultation. It highlights the key recommendations, including loan conventions, in respect of corporate lending products contained within the May 2021 recommendations. It seeks to highlight the flexibility provided for within the May 2021 recommendations, as well as being mindful of best practice which has developed in the international syndicated lending markets.

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This paper discusses a variety of options relating to the introduction of fallback trigger events and fallback rates for contracts and financial instruments referencing EURIBOR. Recipients of this paper are responsible for making their own assessments as to the suitability of the various options discussed herein. Recipients must continue to operate in an independent and competitive manner and they should not use the content of this document to coordinate their activities in breach of applicable law.

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2 Background, objectives and scope

2.1 Background

In February 2018, the European Central Bank (ECB), the Belgian Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission established the working group. The working group was tasked with identifying and developing an adoption plan for a “risk-free overnight rate” that could serve as a basis for an alternative to the current benchmarks used in a variety of financial instruments and contracts in the euro area.

In September 2018, the working group recommended that the euro short-term rate (€STR) should be used as the risk-free rate for the euro area. Since 2018, the working group has been working extensively to identify best practices for contract robustness in contracts and financial instruments referencing EURIBOR. Although EURIBOR is not scheduled to be discontinued, the development of more robust fallback language addressing the permanent discontinuation of EURIBOR can help to enhance legal certainty and reduce the risks stemming from the worst-case scenario and, at the same time, comply with the EU Benchmarks Regulation (BMR), when applicable. The working group has also previously recommended that market participants consider incorporating fallback provisions in all new financial instruments and contracts referencing EURIBOR, regardless of whether they fall within the scope of the BMR.

In May 2021, the working group recommended EURIBOR fallback trigger events and €STR-based EURIBOR fallback rates in order to support market participants in developing contractual fallback provisions for a scenario in which EURIBOR may permanently cease to exist. The May 2021 recommendations were based on feedback from two public consultations in November 2020 on EURIBOR fallback trigger events and on €STR-based EURIBOR fallback rates.

Following the publication of the May 2021 recommendations, the working group updated its mandate in order to continue contributing to the reform efforts in the euro area. In February 2022, the working group published updated terms of reference to include fostering interest rate reform in the EU by, amongst other things, identifying potential impediments to the timely adoption of EURIBOR fallback provisions by EU supervised entities and putting forward recommendations and best practices to assist in overcoming such impediments.

The minutes of the working group meeting of December 2022 note that market practice for €STR-based EURIBOR fallbacks in loan markets is not yet well established. Existing loan fallbacks, including 'cost of funds' and 'replacement of screen rate' language are still being used, with the May 2021 recommendations not generally being adopted. This has been for various reasons including some market participants choosing not to adopt the recommendations, for example, due to the previous lack of term €STR rates, EURIBOR not scheduled to be discontinued and parties preferring to use a less robust 'amendment approach' to fallbacks.

Whilst existing loan fallbacks set out what will happen if EURIBOR is unavailable, these are designed for temporary unavailability of EURIBOR and do not generally envisage permanent cessation of EURIBOR. In addition, 'replacement of screen rate' language does not trigger specific fallback rates, but rather provides triggers for an amendment process. The May 2021 recommendations were designed to encourage the incorporation in contracts of more robust fallbacks to specific and identified fallback rates.

Corporate lending products need to move to implement robust fallback provisions in new and refinanced EURIBOR referencing loans. Cost of funds and replacement of screen rate language are neither workable permanent fallbacks nor scalable options in the case of a possible permanent discontinuation of EURIBOR.

2.2 Objectives and scope

The purpose of this guidance is to provide clarity to corporate lending products on the May 2021 recommendations and their application to corporate lending products.

The working group acknowledges that, as part of the transition away from LIBOR, international loan markets have actively been using risk-free rate based interest rates in several non-euro currencies, drawing confidence from the loan specific conventions that were published in other jurisdictions, including the sterling and US dollar markets. Whilst the position in the euro market is different, as the focus has been on fallbacks rather than transition, developments and experience in other jurisdictions are helpful when considering the appropriateness of conventions for fallbacks to EURIBOR.

Whilst the May 2021 recommendations had been mindful of providing flexibility to corporate lending products to align with international syndicated loan conventions, there has been a lack of progress in corporate lending products in adopting the May 2021 recommendations and the working group has therefore published this guidance. It is expected that clarification of the recommendations applicable to corporate lending products as provided by this guidance should enable market participants to now move towards adopting robust fallbacks, engage more readily in the process of following the recommendations and thereby facilitate the development of standard market practice.

This guidance is a reiteration of the previously published recommendations without further change and should be read alongside the May 2021 recommendations. In providing this further guidance, the working group has taken account of the strong preference for international consistency in the multicurrency syndicated loan market and operational considerations for corporate lending products. The working group also reminds market participants to consider consistency in relation to fallback provisions across related contracts, including derivatives, in order to deal with transfer value and basis risks.[1]

This guidance is addressed to market participants active in EURIBOR-referencing corporate lending products, including lenders, borrowers, investors, advisers and legal firms.[2]

3 Reiteration of working group recommendations for corporate lending products

The May 2021 recommendations applied to a wide range of cash products[3] and set out recommendations in respect of the fallback rate, fallback triggers and credit spread adjustment. The recommendations of relevance to corporate lending products are reiterated below.

3.1 €STR-based EURIBOR fallback rates

The May 2021 recommendations, based on the public consultation results, recommended that for corporate lending products, market participants (based on their institution's and counterparty's needs) consider either:

1. A backward-looking lookback period methodology (compounded €STR in arrears) with no requirement for a waterfall structure. This would be more appropriate, for example, where consistency is required between cash and derivative products to limit hedging discrepancies; or

2. A two-level waterfall solution consisting of:

   (i) a forward-looking methodology (term €STR) on the first level; and

   (ii) compounded €STR in arrears on the second level of the waterfall.

[1] The working group notes that since publication of the May 2021 recommendations, ISDA has published a memorandum and supplements relating to documenting derivatives under the 2006 ISDA Definitions using floating rate options for overnight rates, including risk-free rates that have been identified as alternatives to key IBORs, using different compounding/averaging approaches that enable firms to more closely align with conventions for overnight rates that have been developed in cash markets.
[2] Although not covered in this guidance, this paper may be of some relevance to other related use cases where the same or similar fallback provisions are being considered, for example export and emerging markets finance products and trade finance.
[3] Corporate lending products, retail mortgages, consumer loans and loans to small and medium-sized enterprises, current accounts, trade finance, export and emerging markets finance products, debt securities, securitisations, transfer pricing models and investment funds.

This would be more appropriate, for example, for corporates which require the rate at the start of the interest period.

The May 2021 recommendations also noted that market participants should, to the extent possible, aim for consistency in relation to fallback provisions across all asset classes and related contracts, including cash products and derivatives, in order to deal with transfer value and basis risks.

The working group also provided recommendations for the market conventions which could be used to calculate compounded €STR in arrears. These are covered in further detail in section 4 of this paper.

Section 5 of this paper provides further detail on term €STR.

3.2 EURIBOR fallback trigger events

The May 2021 recommendations provide that market participants should include provisions covering trigger events related to temporary non-availability,[4] permanent cessation and non-representativeness (pre-cessation).[5]

The permanent cessation and non-representativeness trigger events should cover:

1. a public statement or publication of information by or on behalf of the regulatory supervisor of the EURIBOR administrator or the EURIBOR administrator stating that said administrator has ceased or will cease to provide EURIBOR permanently or indefinitely provided that, at the time of the statement or publication, there is no successor or administrator that will continue to provide EURIBOR; and

2. an official public statement by or on behalf of the supervisor of the EURIBOR administrator that, in its view: (i) EURIBOR is no longer representative, or will no longer be representative of the underlying market it purports to measure as of a certain date; and (ii) such representativeness will not be restored (as determined by such supervisor). In the May 2021 recommendations, the working group encouraged trade associations to consider including such an event in their EURIBOR fallback standard documentation to increase global consistency across currency and products.

The working group notes that there is industry standard documentation available, for example LMA documentation, which provides for an optional switch mechanism from EURIBOR to compounded €STR which incorporates the above permanent cessation and non-representativeness triggers.

3.3 Credit spread adjustment

In order to ensure economic equivalence between EURIBOR and the corresponding €STR-based fallback rate, the working group recommended calculating and applying a spread adjustment. The May 2021 recommendations note that the preferred approach for cash products is the five-year historical median spread adjustment methodology. The spread adjustment value for each individual tenor should be the same irrespective of the term structure methodology chosen. This spread adjustment is designed to apply to fallbacks triggered by the fallback trigger events noted in section 3.2 above (i.e. permanent cessation and non-representativeness).[6]

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[4] The definition of temporary trigger events and their effects was beyond the scope of the working group's mandate and so was not covered by the public consultation or May 2021 recommendations.

[5] The May 2021 recommendations also provided that market participants should consider the appropriateness of including trigger events relating to: (i) the use of EURIBOR becoming unlawful for relevant parties to the agreement or parties being prohibited from using EURIBOR; and (ii) EURIBOR permanently no longer being published. There are various considerations around the use of such triggers and market participants should refer to the May 2021 recommendations in this respect.

[6] The May 2021 recommendations did not cover the calculation of credit spread adjustments in the situation where parties choose to transition prior to a cessation or non-representativeness event. This is because the focus is on fallbacks to EURIBOR only. Should parties choose to transition prior to a cessation or non-representativeness event, they would need to agree a method for the calculation of the credit spread adjustment.

4 Guidance on conventions for corporate lending products when using compounded €STR in arrears

The May 2021 recommendations set out conventions for using €STR compounded in arrears. Those recommended conventions were designed to apply across the various cash products covered in the recommendations. Those cash products included, amongst others: retail mortgages, consumer loans, loans to small and medium-sized enterprises, current accounts, securitisations, as well as corporate lending products. The May 2021 recommendations are broad and cannot therefore be directly compared to the loan specific recommendations and conventions published by the currency working groups in other jurisdictions specifically for the loan market. For that reason, the May 2021 recommendations provide optionality within the recommended conventions for certain market segments and parties. This included optionality to allow corporate lending products to align with the loan specific conventions published in other jurisdictions.

This section of the paper is designed to clarify the application of the recommended conventions and to draw out the optionality that has been provided for within the May 2021 recommendations. In providing this further guidance, the working group recognises the preference for international consistency for multicurrency syndicated loans, but also recognises that domestic corporate lending products may prefer to align with other cash products.

4.1 Observation shift and lag approach

The May 2021 recommendations provide that market participants use the observation shift methodology. The May 2021 recommendations recognise "*the use of the lag approach as a robust alternative to the observation shift approach*".

When issuing the May 2021 recommendations, the working group recognised that the international syndicated loan market was largely using the lag approach and that this was also the preferred approach of both the Working Group on Sterling Risk-Free Reference Rates in its Recommendations for SONIA Loan Market Conventions and the Alternative Reference Rates Committee for US dollar loan markets in its SOFR "In Arrears" Conventions for Syndicated Business Loans. The working group therefore provided for the flexibility to use the lag approach.

It is noted that parties to corporate lending products may prefer to use either the observation shift approach or lag approach, as appropriate.

4.2 Flooring

The May 2021 recommendations provide that if a floor is applied in a contract, this should be applied to the compounded €STR rate plus the credit spread adjustment.

The May 2021 recommendations go on to state that: "*The working group notes that certain market segments and parties may choose to include a floor on the daily €STR value, for example in the syndicated loan market to align with the recommendations of the sterling working group on risk-free reference rates for sterling overnight index average (SONIA) loan market conventions and the US alternative reference rate committee in its secured overnight financing rate (SOFR) "in arrears" conventions for syndicated loans.*"

The working group therefore recognised that there were use cases for daily flooring (e.g. in syndicated loans where there is a strong preference for international consistency for multicurrency syndicated loans) and that daily flooring of the risk-free rate plus the credit spread adjustment for legacy loans is also the preferred approach of both the Working Group on Sterling Risk-Free Reference Rates in its Recommendations for SONIA Loan Market Conventions and the Alternative Reference Rates Committee for US dollar loan markets in its SOFR "In Arrears" Conventions for Syndicated Business Loans.[7] Those conventions provide for a daily non-cumulative compounding calculation, which was

[7] This paper is only intended to cover fallbacks to EURIBOR and so the conventions for legacy loans are referenced here. The Recommendations for SONIA Loan Market Conventions and SOFR "In Arrears" Conventions for Syndicated Business Loans also cover new loans directly referencing a risk-free rate, and in this case recommend flooring the risk-free rate on a daily basis (i.e. without taking into account any credit spread adjustment). This is to avoid an economic difference between transactions: (i) structured on the basis of a margin only; and (ii) structured with a separate credit spread adjustment.

recognised in the public consultation on €STR-based EURIBOR fallback rates as an acceptable method of calculation. This non-cumulative compounding calculation with a daily floor allows for calculation of the compounded rate on a daily basis and allows the correct daily accrual to be calculated and posted to the general ledger for daily accounting. In these circumstances, and in line with the May 2021 recommendations, the working group accepts the use of daily flooring in corporate lending products.

The working group notes that there may be certain corporate lending products which may prefer end of period flooring (for example, when using a cumulative compounding calculation) and that this is also an acceptable approach.

4.3 Use of compounded €STR average rates

The May 2021 recommendations recommended the use of the compounded €STR average rates as published by the ECB. This recommendation was based on parties using the recommended conventions (rather than the optionality provided within the conventions), for example the use of observation shift and applying any floor at the end of the period. The recommendation for the use of the published compounded rates also had in mind the need for simplicity of deriving compounded rates for consumer products that were covered by the May 2021 recommendations.

The working group recognised that the published compounded €STR average rates could not be used where the flexibility within the conventions was being utilised to adopt the lag approach and daily flooring and where non-cumulative compounding was being used. For the avoidance of doubt, parties can choose not to use the published compounded €STR average rates if their contracts use a different compounding methodology, for example, in respect of syndicated loans.

4.4 Publication of spread adjustment and/or an all-in rate

The May 2021 recommendations recommended the publication of the spread adjustment and/or all-in rate and stated that the working group would launch a call for interest to benchmark administrators.

It is recognised that an all-in rate would be helpful for consumer-focused products and those cash products which use the recommended conventions (without the optionality provided for in the conventions). It would be less helpful for corporate lending products if they use the optionality provided for in the recommendations, for example, the lag approach and daily flooring. To the extent any all-in rate is to be published, parties are free to choose whether such rate is appropriate for their fallbacks and choice of compounding methodology.

5 Term €STR

5.1 Availability of term €STR

At the time the May 2021 recommendations were published, there were no term €STR rates available. Since May 2021, two administrators have started publishing term €STR rates (one of which is already available for use and one of which is a prototype). Whilst the working group has followed the progress of these term €STR rates, it is up to market participants to make a choice between these rates and any other rates which are or may become available. For reasons of competition law, the working group will not be able to choose or recommend a particular benchmark administrator for term €STR. Instead, any preferred administrator and forward-looking term rate will be chosen by benchmark users.

The following two term €STR rates are currently being published:

1. *EMMI EFTERM*: this was launched in test phase on 13 June 2022, went live on 14 November 2022, and is available daily in 1-week, 1-month, 3-month, 6-month and 12-month tenors.

2. *Refinitiv Term €STR*: this was launched in prototype format on 26 October 2022 and is available daily in 1-week, 1-month, 3-month, 6-month and 12-month tenors.

Further details of each of these term €STR rates can be found in document “Comparative Table of available term €STR rates”, published on the webpage of the working group.

The working group notes that there is currently no market preference established between the term €STR rates which are currently being published. As a result, the working group suggests that definitions of any available term rates be included within any industry standard documentation in order to allow market participants to make a choice between the rates.[8]

5.2 Term €STR as part of a two-level waterfall solution

Market participants are reminded that the May 2021 recommendations for corporate lending products provide that where term €STR is to be used, this is to be done as part of a two-level waterfall solution consisting of term €STR on the first level and €STR compounded in arrears on the second level.

The importance of including robust fallbacks to term rates has recently been reiterated by the Financial Stability Board in its December 2022 Progress Report on LIBOR and other Benchmark Transition Issues where it is stated that: "*contracts referencing Term RFR need to have robust fallbacks in place, in many cases linked to the overnight RFR, should these Term Rates cease to be published*".

6 Conclusion

This guidance has been designed to provide clarification of the May 2021 recommendations as they apply in respect of corporate lending products. The working group hopes that the guidance provides confidence to loan market participants to follow the recommendations and enable the development of standardised market practice.

Corporate lending products now need to move to implement robust fallback provisions in new and refinanced EURIBOR referencing loans. Cost of funds and replacement of screen rate language are not workable permanent fallbacks and do not provide scalable options in the case of a possible permanent discontinuation of EURIBOR. Market participants are also reminded that they need to be operationally ready for EURIBOR fallbacks (be that compounded €STR in arrears or term €STR with a waterfall structure). It is important for market participants to act now to avoid future market disruption and operational risks which could arise from the build-up of tough legacy contracts which do not contain workable fallbacks.

More generally, whilst EURIBOR is not scheduled to be discontinued, this does not negate the need for market participants to include robust fallback language in their contracts. Robust fallbacks are a requirement of the EU Benchmarks Regulation (BMR) and the working group has previously stressed the importance of including robust fallbacks in all financial contracts, not just those within the scope of the BMR. Now that term €STR rates are available alongside the already existing compounded €STR in arrears, there is no impediment to the full implementation of the May 2021 recommendations.

[8] Although at the date of this guidance one of the term €STR rates is in prototype format, as it is only intended to be included as a fallback to EURIBOR (such fallback being triggered upon cessation or non-representativeness) as part of a waterfall structure, the working group considers that drafting can be provided for this rate. Market participants will then need to make their own decision as to which rate to use.