

Box 5

ESTER – the new overnight rate for the euro money markets

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ESTER (euro short-term rate) is the alternative euro risk-free rate administered by the ECB, which will replace EONIA (euro overnight index average) in 2020. The European Money Markets Institute (EMMI), the administrator of EONIA, concluded that under current market conditions,

EONIA's compliance with the EU Benchmarks Regulation (BMR)¹² by January 2020 "cannot be warranted".¹³ This implies that the usage of EONIA, at least in new contracts, may be prohibited by law as of 1 January 2020.

ESTER will be based entirely on actual individual transactions in euro reported by banks in accordance with the ECB's money market statistical reporting (MMSR). It will reflect wholesale euro unsecured overnight borrowing costs of euro area banks resulting from trades conducted with banks and non-bank financial counterparties according to MMSR reporting instructions. The rate will be published for each TARGET2 business day based on transactions conducted and settled on the previous day with a maturity date the next business day and which are deemed to be executed at arm's length. For this reason, it will reflect market rates in an unbiased way.

The methodology to compute ESTER is robust, having benefited from feedback and insights from two public consultations. ESTER is calculated as a volume-weighted trimmed mean on the basis of all eligible transactions that have passed quality and plausibility controls. The ECB has also envisaged a contingency computation algorithm, which will apply for days when underlying data are not sufficient for a robust rate calculation. The ECB will endeavour to follow the IOSCO Principles for Financial Benchmarks¹⁴ to ensure consistency with the best market practices.

ESTER should bring many benefits in terms of transparency and rigour. The recommendation, made unanimously by a private sector working group established with the support of the ECB, the European Securities and Markets Authority, the European Commission and the Financial Services and Markets Authority (FSMA), followed a public consultation and was largely grounded on four elements: (1) the unsecured nature of the new rate, thus making it similar to EONIA and easier to understand and communicate to clients; (2) the compilation methodology applied to MMSR data, leading to sufficient and robust volumes; (3) the low volatility of the rate; and finally (4) the fact that ESTER is administered by the ECB, an EU public institution (see **Chart A**). Following the recommendation of the working group, ESTER will become the key interest rate benchmark for euro money markets once daily production will start, expected at the latest by October 2019.

¹² [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 and amending Directives 2008/48/EC and 2014/17/EU and Regulation \(EU\) No 596/2014 \(OJ L 171, 29.6.2016, p. 1\).](#)

¹³ "State of play of the EONIA review", European Money Markets Institute, February 2018.

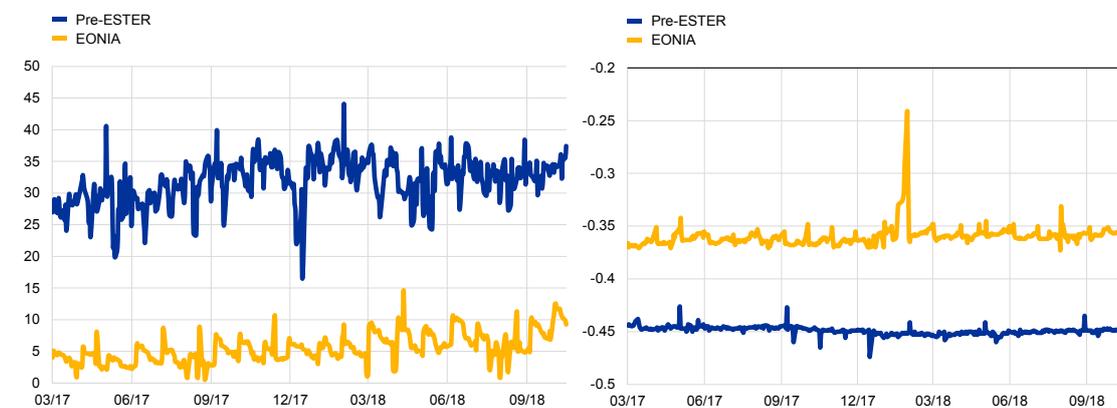
¹⁴ See "Principles for Financial Benchmarks: Final Report", The Board of the International Organization of Securities Commissions, July 2013.

Chart A

Sufficient and robust volumes, as well as low volatility, underpin the suitability of ESTER as the new euro risk-free rate

Pre-ESTER and EONIA – underlying volumes (left panel) and rates (right panel)

(15 Mar. 2017-30 Oct. 2018, € billions (left panel), percentages (right panel))



Sources: ECB and EMMI.

The transition from EONIA to ESTER, by 1 January 2020, constitutes a complex challenge.

More than €20 trillion of interest rate derivatives and securities are linked to EONIA. EONIA is used for the valuation of contracts and the remuneration of collateral and margin accounts at clearers, as well as serving as a statutory rate. A broad-based coordination across market participants and benchmark users is therefore necessary to prepare the transition to ESTER, from both a legal perspective – to ensure contract continuity – and a technical perspective – to guarantee that systems and trading venues can handle the new rate. To support the transition, the ECB is publishing the so-called pre-ESTER, a data series calculated using the same methods as those defined for ESTER, once every maintenance period. These data allow market participants to assess the suitability of the new rate and start early preparations for its use in contracts as well as in internal valuation and risk management processes.

The working group is carrying out technical analyses to evaluate different transition paths and scenarios.

More specifically, the group is focusing on two broad options. One is the “market-led transition” scenario. In this scenario, an ESTER derivatives market would be developed in parallel to the current EONIA market, so as to facilitate a market-driven switch before the end of the BMR transition period. The other is the “successor rate” scenario. This scenario envisages that all existing contracts are switched to the new reference rate as of a transition date. A criterion that all viable options should fulfil is that they should enable a full migration from EONIA to ESTER of the markets currently using EONIA and minimise resulting transfers of value and litigation risks.¹⁵ These analyses will be the basis for a recommendation, to be issued by the working group in early 2019.

Market participants using contracts linked to EONIA are expected to amend their contracts in due time.

The selection of ESTER as a replacement of EONIA is only the first step in the transition process and a lot of work remains to be done, including changes in contracts and systems. It will involve each user of the benchmark looking at its own contracts and taking decisions on how to follow the recommendation of the working group and any subsequent initiatives by industry associations.

¹⁵ The spread between EONIA and pre-ESTER is around 8-9 basis points, which implies a transfer of value for existing contracts as of the transition date.

While the financial industry has further stepped up its efforts to ensure a smooth transition to the new interest rate benchmark environment, vigilance is needed to identify any potential for mispricing, segmentation or undue increases in basis risk.