

EFAMA response to the ECB's first public consultation on developing a euro unsecured overnight interest rate

A. Preliminary comments

The European Fund and Asset Management Association, EFAMA¹, welcomes the decision of the ECB to consult market participants on the development of a euro unsecured overnight interest rate that would be complementing existing benchmark rates and serve as a backstop reference rate. We consider the feedback from a wide range of market participants and in particular users of the new rate on the representativeness of the economic reality the new rate intends to measure, its robustness and calculation methodology is very important for the success of this project. In that context, we would like to submit our views to the first consultation published by the ECB on the main features and the timing of the publication of the new rate.

Asset managers represent an important group of benchmark' users, either in the case of passive managed funds and exchange traded funds (ETFs) - where benchmarks are used as a target for index linked funds - or in the case of the evaluation of an active manager's performance - where the fund performance is measured against a selected index or a set of indices. Asset managers as benchmarks users are generally not involved in the production, calculation, and contribution to data on which benchmarks are based. Therefore, their role is limited to the use of a benchmark, for which they are called to pay high and multiple fees and are subject to extensive regulatory requirements (in particular in the case of the use of financial indices by UCITS - see ESMA Guidelines on ETFs and other UCITS issues ESMA/2012/832/EN)².

Representing benchmark users, EFAMA welcomed in 2013 the principle of developing at a European level a new regulatory framework implementing the IOSCO's recommendations on the appropriateness and representativeness of a benchmark.

In respect to indices tracking the rates of funding deals on the wholesale money markets (overnight or of a longer maturity), asset managers are using them for money market products, as well as for alternative multi-asset products as part of their performance benchmark. They use them less in equities and fixed income. At the same time, these rates influence the long-term strategy of investment funds that use instruments with such a reference rate. In this respect, it is important for

¹ EFAMA is the representative association for the European investment management industry. EFAMA represents through its 28 member associations and 62 corporate members close to EUR 23 trillion in assets under management of which EUR 14.1 trillion managed by 58,400 investment funds at end 2016. Just over 30,600 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 27,800 funds composed of AIFs (Alternative Investment Funds). www.efama.org

² http://www.esma.europa.eu/system/files/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf

asset managers and their investors that these rates are resilient to conflicts of interest and of less structural weaknesses, compared to what has been the case in the past.

EFAMA follows the ongoing work of the Bank of England (BoE) to develop an alternative risk free rate to LIBOR and has submitted its views to the BoE on to the use of LIBOR, the effectiveness of SONIA and the challenges related to a transition from the first to the second rate. Moreover, we follow the ongoing work done at the private sector, concretely EMMI's work on the reform of Euribor and the feasibility of producing a transaction based benchmark for the secured segment of the euro money market. On the later we submitted our response to the EMMI's consultation published in June 2017 expressing skepticism on the need to move forward with this new rate, given that existing national and EONIA are currently covering a big part of the market this index is aiming to cover.

For any new rate to be relevant from the asset managers' perspective, it needs to be as much representative as possible of the activity and the market-based funding costs in the market segment it covers. An unsecured money market reference rate is preferred to a secured one, because it is more standardized, doesn't depend on the quality and legal framework of the collateral and better reflects the market liquidity for money market operators, especially in stressed market conditions. Moreover, it is less susceptible to manipulation, as indicated also in the ECB's consultation paper, which mentions that the concentration of the repo market during the financial and sovereign debt crisis was much higher compared to the concentration observed at the same time in the unsecured money market. It is also important to note that institutional investors are currently using unsecured reference rates for the management and the valuation of their balance sheets.

Altogether, EFAMA members consider that even though volumes in the unsecured segment of the euro money markets have recently decreased, it is important to continue the publication of unsecured interest rates and address some of their shortcomings. For that reason, we also see merits in developing a new euro unsecured rate that could act as a backstop reference rate and would be freely accessible as a public data and we encourage ECB in its present initiative.

B. EFAMA response to the consultation's questions

Q1. Does the suggested definition of underlying interest rate provide a relevant basis for the rate to be generally accepted by the public as a reference rate?

EFAMA agrees with the suggested definition. As mentioned in our preliminary comments, for any new rate to be relevant from the asset managers' perspective, it needs to be as much representative as possible of the activity and the market-based funding costs in the market segment it covers. In this respect, a rate reflecting the unsecured segment of the euro money markets holds a high relevance for asset managers, as covering a wide scope of the relevant market. We would also see merits in expanding the scope of transactions to be covered, by including transactions with a broader range of financial counterparties. That would render the interest rate more representative of the underlying market.

Q2.1. Do you agree that a rate reflecting banks' daily funding costs would provide a meaningful reference in financial contracts, including derivatives and also for valuation contracts?

EFAMA agrees with a rate reflecting banks' overnight funding costs, given that banks are the main actors of the short-term funding market.

Q2.2. Please describe the contracts and types of valuations to which you would potentially apply the rate. Are there types of financial contracts for which it would provide a suitable reference? Are there other types for which it would not provide a meaningful reference?

The rate can be applied in derivatives and other instruments investors use to manage interest rates and duration risks. The rate would also be used for the valuation of OIS, commercial papers, repos and the remuneration of cash collaterals. In some cases a similar rate of a longer maturity may also be relevant for such instruments.

Q3.1. Do you agree that the borrowing costs of a bank in their interactions with financial institutions, including banks, provide a good basis for the computation of a meaningful interest rate aimed at measuring banks' cost of funding?

EFAMA has also noticed the currently low level in the interbank unsecured market mentioned that is mentioned in the ECB consultation paper, which entails volatility and perhaps concentration risks for the rate. As mentioned in our response to Q1, EFAMA members believe that the relevance of the rate is linked to the extensive scope of the market segment's activity that it covers. For that reason, we would be in favour of extending the sectors of counterparties and choice of transactions included in the scope of the rate. This larger volume of transactions can make the rate more representative and less volatile.

Q3.2. Do you agree that transactions with counterparties such as general government of non-financial corporations are in general not a suitable component of an interest rate based on arm's length transactions?

EFAMA considers it important that a rate covers an extensive scope of transactions and counterparties in order to ensure accuracy and representativeness. As a matter of principle, including additional counterparties in the scope of the new rate would certainly increase its accurate representing of the unsecured banks' borrowing market.

However, we share ECB's views that transactions concluded with governments or some non-financial counterparties may suffer political or commercial pressure that can distort these transactions' conditions. Therefore, we agree to exclude them. Conversely, it seems positive to include financing provided to banks by other financial institutions. Investment funds in particular are managed in the best interest of the investors according to the asset managers' fiduciary duty, which guarantees that transactions are concluded at arm's length.

It should, however, be stressed that any additional mandatory reporting/contribution policies resulting to further costs and burden for the involved parties should be avoided, as this can negatively impact the lending appetite of those counterparties towards banks.

Q3.3. In relation to the above question, do you consider it useful to apply a size threshold above which transactions with non-financial corporations can be considered as arm's length transactions and as not being influenced by specific factors, and that it would be worthwhile further investigating their use as an input to the new interest rate?

Please see our response to the previous question on the possibility and the limits regarding adding the input from non-financial corporations.

Q4.1. Would you agree that money market deposits are the only instruments on which the new rate should be based?

We consider that the scope of instruments should be further extended to cover money market instruments, such as certificates of deposits and commercial papers.

Q4.2. If you consider that other segments of the unsecured money market should be covered, which should these be and why?

Please see our response to the previous question.

Q5.1. In the case of a publication at 09.00 CET in the morning of the following day, how would this publication timing impact the usage of the published rate?

For the rate to be able to reflect accurately the underlying market, its publication should be as timely as possible, meaning a timing very close to the market developments it represents. This is of particular

importance for users of the rate which are non-banks that have no vision of the executed trades due to the few transactions they perform (in any case fewer than the banks). They need to take into account the latest possible market developments in order to reduce market timing or arbitrage risks.

For investment funds, a timely publication is important as there are cut-off deadlines to publish their NAVs taking into consideration derivatives and instruments linked to rates of unsecured markets, such as EONIA.

Q5.2. If the published rate were to be required earlier than 09.00 CET, at what time would it be required and for which purposes?

EFAMA would recommend a publication time as close as possible to the current publication time of EONIA. If it is technically not feasible to maintain the same day, it should be very early on the following day and before the market opening of 09.00 CET, so at the latest at 08.30 CET. In order to find the right balance between the technical and regulatory aspects, the publication of the unsecured reference rate should incorporate the highest volume of contribution as the preferred option.

Q5.3. When is the latest publication time, after which the interest rate would lose its value from the perspective of users? Could you explain in more detail for which usage(s) and why?

Please see our response to Q5.1 and Q5.2.

6. Are there other high-level features or issues which should be taken into account and have not been sufficiently covered by the previous questions?

EFAMA would like to highlight one additional issue related with the case of EONIA's discontinuation after 2020. In that case, the new rate will be the main substitute for all the mandates referencing EONIA, which needs to be fully taken into consideration when designing the new euro unsecured overnight interest rate.

Any transition process would first of all require good and early knowledge of the alternative rate and clarity as to the potential spread and the changes to be brought to the legal documentation.

For asset managers these changes will include the review of fund rules, KIIDs and Prospectuses, which would most likely require the approval of the client and = the regulator.

In order to facilitate this process, clarity as to the features of the rate and early communication on them, as well as concrete information on the transition process itself will be of key importance for users.

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