

# EFAMA HIGH LEVEL VIEWS ON ECB CONSULTATIONS ON EURIBOR FALLBACK TRIGGER EVENT AND €STR-BASED EURIBOR FALLBACK RATES

15 January 2021

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## GENERAL REMARKS

- Asset managers represent an important group of benchmarks' users. In this context, EURIBOR rate is used by investment funds across all kinds of asset classes and financial instruments, as well as a benchmark for measuring fund performance, driving fee calculations and determining asset allocation.
- The identification of fallback rates for the contract with reference to EURIBOR are essential for asset managers and a stable and permanent approach would make the fallback clauses more robust and ensure further transparency.
- For any new rate to be relevant from the asset managers' perspective, it needs to be as representative as possible of the activity and the market-based funding costs in the market segment it covers. Moreover, transparency as to the underlying methodology used in each step of the calculation of the fallback benchmark remains critical.
- Concerning the appropriate methodology to be used in order to build a €STR-based term structure that could function as a EURIBOR fallback, we believe that, while in principle, a forward-looking fallback rate seems appropriate given that EURIBOR is also forward looking, we still see merits in backward looking methodologies. At the same time, given ISDA's recommendations in its Fallback Protocol for adjusted versions of the RFRs compounded in arrears, we would suggest a cautious approach and choice between forward-looking and backward looking methodologies with the main aim to avoid market inconsistencies. The importance of maintaining consistency between asset classes for hedging purposes and cross asset class investment strategies is one that cannot be understated. What remains critical is a consistent approach firstly among asset classes and to the extent this isn't always feasible a common understanding of the best approach for every asset class. In addition to that, we would also see an overnight rate (e.g. €STR, SOFR) as an option for an EURIBOR fallback as we are not aware of any requirements to have a fallback on fund level that is economically equivalent to EURIBOR.
- A workable solution would also be to base the fallback definition on an OIS benchmark. Having a daily publication of a fixed rate which equals the market expectation of the overnight-compounded term rate has the advantage that like the EURIBOR term rates, the floating rate is known at the beginning of the accrual period and represents a forecast of rates on the right accrual period.

## DETAILED VIEWS

Asset managers represent an important group of benchmarks' users, either in the case of passively 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 fund's 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 mostly limited to the use of a benchmark, for which they are required to pay high and multiple fees and are subject to extensive regulatory requirements.

As supervised entities under the Benchmark Regulation, alternative investment fund managers (AIFMs) and UCITS management companies that use a benchmark are required to produce and maintain robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided. Where feasible and appropriate, such plans should nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives. The supervised entities are obliged to provide, upon request, the relevant competent authority with those plans and any updates and are obliged to reflect them in the contractual relationship with clients.

EURIBOR rate is used by investment funds across all kinds of asset classes and financial instruments, such as swaps, swaptions, other nonlinear derivatives, bonds, loans and asset backed securities. EURIBOR is also used as a benchmark for performance fee calculation and as discounting curve for certain products. Concerning the use of interest rates in investment funds, money market and fixed income funds are the main users for benchmarking purposes, while the most commonly used instruments referencing EONIA are floating rate notes, repurchase agreements, interest rate derivatives and loan agreements.

The ongoing effort to identify fallback rates for those contracts linked to EURIBOR is very relevant and important for asset managers in terms of their contracts with investors and compliance with the Benchmark Regulation. Currently fallback rates for EURIBOR vary across financial instruments and remain of a temporary nature. A stable and permanent approach would provide more clarity as to the choice of the fallback clauses, limit liabilities and ensure further transparency for investors. Given the requirement for asset managers to put in place robust continuity plans, having robust fallback rates is essential for their ability to produce these plans and be prepared in the case of material change or discontinuation of EURIBOR.

Under the EU Benchmark Regulation and the definitions of benchmark use, any use of EURIBOR for measuring the performance of an investment fund, tracking its return, defining the asset allocation or used in computing performance fees, creates regulatory requirements for the manager of the fund, among which ensuring a continuity plan is in place in case EURIBOR ceases to exist or materially changes.

For any new rate to be relevant from the asset managers' perspective, it needs to be as representative as possible of the activity and the market-based funding costs in the market segment it covers. Ensuring clarity and concrete information as regards the key features of the rate is of paramount importance for users. In this regard, transparency as to the underlying methodology used in each step of the calculation of the fallback benchmark, remains critical. Moreover, it is important that the fall-back rate is easy to implement, broadly recognised by market participants and freely accessible or accessible at a reasonable cost.

The industry would appreciate further guidance on how fallbacks are implemented in contracts – particularly in fund level documentation and the requirements for EURIBOR fallbacks for fund/portfolio level benchmarks.

Before discussing the appropriate methodology to be used for building a €STR-based term structure that could function as a EURIBOR fallback, it should be reiterated what are the most important elements to be considered in case of the EUROBR cessation.

As mentioned previously, **representativeness of the underlying market along with transparency of the methodology** are key elements due to the fact that asset managers will need a clear understanding on both elements to be able to communicate a fallback rate as the best option to investors and meet their own regulatory requirements related to how a rate is used for the purposes of the investment fund.

Moreover, the second key element of the to be considered is **consistency**, which can be contemplated as a consistent approach across asset classes and jurisdictions. Deviating methodologies for asset classes would create operational difficulties, so asset class discrepancies within jurisdictions should be kept to a minimum to facilitate implementation.

With regards to the more appropriate methodology to be used in order to build a €STR-based term structure that could function as a EURIBOR fallback, we believe that, in principle, a forward-looking fallback rate seems appropriate given that EURIBOR is also forward looking. Such approach would allow a smoother transition to the fall-back rate, if/when triggered. This would be mostly relevant for the following asset classes: financial leasing, OTC derivatives—both cleared and uncleared, exchange-traded derivatives, money market or securities lending, floating rate notes, securitisation structures, corporate lending.

However, this would be at odds with the approach ISDA is recommending through their Fallbacks Protocol, implementing adjusted versions of the RFRs compounded in arrears (not forward looking) to serve as IBOR fallbacks based. We would therefore caution use of such a forward-looking rate to the extent that it may generate market inconsistencies. In this context, some of our members would feel more comfortable with the use of backward-looking methodologies.

In addition to that, we would also see an overnight rate (e.g. €STR, SOFR) as an option for an EURIBOR fallback as we are not aware of any requirements to have a fallback on fund level that is economically equivalent to EURIBOR.

**A workable solution would also be to base the fallback definition on an OIS benchmark.** Having a daily publication of a fixed rate which equals the market expectation of the overnight-compounded term rate<sup>1</sup> has the advantage that like the EURIBOR term rates, the floating rate is known at the beginning of the accrual period and represents a forecast of rates on the right accrual period. Such a formulation can satisfy the desired consistency criterion to have a unique fallback definition for all contracts (Bonds, Loans, Mortgages, Derivatives: Swaps, FRAs, Futures, etc.)<sup>2</sup>. However, as mentioned in the previous point our concerns regarding market inconsistencies remain.

Moreover, the specified lag should be as short as possible. For example, in multicurrency loan markets the delay between the observation and interest period could result in arbitrage opportunities for borrowers to the detriment of lenders. Short lags are also better for the calculation of performance fee involving a benchmark.

Several alternative use cases have been mentioned concerning the fallback rate for EURIBOR such as corporate lending, mortgages, consumer loans and SME loans, current accounts and investment funds,

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<sup>1</sup> A “comparable” benchmark process (ICE Swap Rate) already exists for determining cash-flows of cash settled swaptions.

<sup>2</sup> The ISDA fallback definition for GBP and USD Swaps unfortunately does not satisfy the consistency criterion since it cannot be applied to other instruments than Payment In-Arrears Swaps. This formulation cannot be applied for FRAs or Payment In-Advance Swaps, requiring the knowledge of the fixing at the beginning of the accrual period. Furthermore, for bonds issuers, this formulation implying the knowledge at the end of the accrual period raises coupon detachment issues.

among others. It should also be noticed that there are even more use cases for asset managers than the ones mentioned so far. More specifically, a use case that is worth adding is the use of an interest rate benchmark such as EONIA or EURIBOR as “Risk Benchmark”.

In this context, it would be important to ensure that asset managers have recommendation and guidance for those use cases so that a clear market standard can develop. We note that, as of today, it seems that the market is still waiting before taking any clear action.

In such analysis, it is also important to highlight that, in some cases, benchmarks are only used internally and can be updated easily. In other cases, those benchmarks are part of legal documents (e.g. Prospectus, IMA) and updating those documents or including fallbacks could be more challenging due to required regulatory approvals, regular update cycles, etc.

Moreover, other than on instrument level (loans, derivatives), legal documentation on fund level has in general not included any fallback language in the past. Therefore, more guidance and clarity with respect to where and how to include appropriate fallback language in fund documentation would be essential in order to guarantee market certainty.

In respect to the consultation on fallback trigger events, we would like to highlight that generally, we agree with the approach provided by the working group to develop so called Fallback trigger events that mitigate the risk linked to the temporary or permanent cessation of a benchmark rate. We share the view that without the inclusion of a euro interbank offered rate (EURIBOR) fallback measure to an alternative benchmark rate, a party to a financial instrument or contract referencing EURIBOR (e.g. Fund Manager) could potentially dispute the contract due to the unavailability of the referenced benchmark rate and any action taken in response to that unavailability. Such general fallback trigger events will set market standards for the financial industry (e.g. fund manager) which needs to be incorporated in the fund documents etc.

More specifically, we agree with the fact that NCA or the EURIBOR administrator has to publish a statement, which establishes that the 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 administrator that will continue to provide EURIBOR.

We would also like to highlight that the relevant parties to the contract (e.g. Fund Manager) are not able to verify that at a given point in time after the official announcement the EURIBOR would be considered as non-representative. The relevant NCA has to ensure that at a given point in time after the official announcement the EURIBOR rate is not representative anymore. The Fund Manager generally do not have the internal resource to check whether the EURIBOR is further representative or not. Such a legal responsibility should be kept and official announced by the EURIBOR administrator or the relevant NCA.

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### About EFAMA

EFAMA, the voice of the European investment management industry, represents 28 Member Associations, 57 Corporate Members and 23 Associate Members. At end Q3 2020, total net assets of European investment funds reached EUR 17.6 trillion. These assets were managed by more than 34,200 UCITS (Undertakings for Collective Investments in Transferable Securities) and almost 29,400 AIFs (Alternative Investment Funds). At the end of Q2 2020, assets managed by European asset managers as investment funds and discretionary mandates amounted to an estimated EUR 24.9 trillion.

More information is available at [www.efama.org](http://www.efama.org).

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