EFAMA response to the third public consultation by the working group on euro risk-free rates on the EONIA to €STER legal action plan

6 June 2019

A. Preliminary comments

The European Fund and Asset Management Association, EFAMA[1], welcomes the actions taken by the working group on euro risk-free rates (hereafter, the EUR RFR WG) to develop a market action plan, including a legal action plan, for legacy and new contracts referencing EONIA. We believe this is key to provide users of EONIA legal clarity and guidance as to the next steps in the transition from EONIA to €STER. We also consider that feedback from a wide range of market participants is critical to ensure extensive awareness, as well as to include best practices for a smooth transition to the new risk free 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.

Regarding indices tracking the rates of funding deals on the wholesale money markets (overnight or of a longer maturity), asset managers:

- Use them mostly for money market products, as well as for alternative multi-asset products as part of their performance benchmark;
- Make less use of these rates in equities and fixed income.

At the same time, these rates influence the long-term strategy of investment funds using instruments with EONIA as a reference rate. In this respect, it is important both for asset managers and their

[1] EFAMA is the voice of the European investment management industry, representing 28 member associations, 60 corporate members and 23 associate members. At end 2018, total net assets of European investment funds reached EUR 15.2 trillion. These assets were managed by almost 62,000 investment funds, of which more than 33,000 were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining funds composed of AIFs (Alternative Investment Funds).For more information about EFAMA, please visit www.efama.org

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 is a non-voting member of the EUR RFR WG and follows closely the debate on the transition from EONIA to €STER. In this respect, we provided feedback as to EONIA's footprint in the European funds industry (relying on empirical analysis and data gathered via an internal survey of its membership)[2].

We have also identified the main impact for asset managers in respect to this transition. Overall, we don't anticipate an important impact on the investment strategy, still there are a number of important challenges for the industry. One key challenge relates to adapting the systems to T+1 publication of the new rate and the following impact for the calculation of the net asset value of funds and the redemption/ subscription process. Changes in the communication to clients, for instance in the contractual agreements and the Prospectus, is another important challenge. Furthermore, in the context of the EMIR regulation, the usage of EONIA in derivative contracts (e.g. overnight index swaps) and their transition to €STER could generally have an impact on the regulatory obligations for the valuation, portfolio compression and reconciliation with the other counterparties.

In terms of the legal action plan, it is important to have the appropriate guidance and timely information in place as regards the key features of the rate. For asset managers to implement their transition projects from EONIA to €STER important parameters are critical, such as the publication of the new rate, information on the spread between €STER and EONIA and a clear understanding as to what type of continuation of contracts would be supported by the market and the public authorities.

Therefore, we will take into account the publication of the final recommendations of the EUR RFR WG along with any future recommendations for the modification of existing master agreements and standard documentation to embed robust fallbacks in new and legacy contracts. Altogether, EFAMA members expect that 12 to 18 months – from the day of the publication of the new RFR – are necessary to be fully operational for transactions in €STER - based instruments.

[2] Please see EUR RFR WG's report published in December 2018 (revised version March 2019) on EONIA's use in investment funds (page 14) https://www.ecb.europa.eu/paym/pdf/cons/euro_risk-free_rates/ecb.eoniatransitionreport201812.en.pdf

B. EFAMA response to the report's questions

Q1. The working group intends to recommend €STR plus the Spread (as defined) as the primary fallback rate to be included in new and legacy contracts referencing EONIA. Do you agree with that fallback rate for EONIA? (yes / no / no opinion) If applicable, please elaborate on the reason for choosing "no" and propose any alternative fallback rate for EONIA.

YES
EFAMA agrees with the recommendation of the EUR RFR WG for €STR plus the Spread (as defined) to be included as the primary fallback rate in new and legacy contracts referencing EONIA. From a user's perspective, this will allow additional time for the transition of legacy contracts (as the evolved EONIA will aim at getting a time-limited authorisation until 2021) and further clarity on the methodology. Moreover, the fixed spread allows for a stable framework and can mitigate legal risks regarding the continuity of legacy contracts.

EFAMA urges the administrator of EONIA, as well as public authorities to continue communicating thoroughly on the evolved EONIA and the transition path to reduce litigation risks.

Q2. Do you agree in principle that the working group should recommend that ISDA consider amending the definition of EONIA in the 2006 ISDA Definitions so as to include a fallback to €STR plus the Spread (as defined) triggered by the cessation of EONIA? (yes / no / no opinion)
If applicable, please elaborate on the reason for choosing "no" and propose any alternative course of action.

YES

Q3. Do you agree that the working group should encourage CCPs and Exchanges to clarify their position with respect to the transition to €STR and modify their rulebooks as detailed in this consultation paper? (yes / no / no opinion) If applicable, please elaborate on the reason for choosing "no" and propose any alternative course of action.

YES

Q4. Do you agree that the working group should recommend that the sponsors of European local master agreements consider amending these agreements to include (i) fallback provisions dealing with the permanent cessation of a benchmark and (ii) an acknowledgment that the EONIA methodology is expected to change and that references in contracts to EONIA shall be understood to be references to EONIA as changed? (yes/no/no opinion) If applicable, please elaborate on the reason for choosing "no" and propose any alternative course of action. Sponsors of local master agreements are particularly invited to comment on this.

YES

Q5. Would market participants value robust fallback provisions in new collateral contracts? Please elaborate on your preference.

EFAMA supports the inclusion of fallback provisions in new collateral agreements to allow switching to a reference to €STR or €STR plus the Spread.

EONIA is widely used as the applicable interest rate to € cash collateral balances, and impacts, via a derived EONIA discount curve, the mark-to-market of derivatives traded under the relevant collateral contracts. Moreover, asset managers, as supervised entities under the Benchmark Regulation, are requested to have contingency plans and, where feasible, include fallback provisions and alternative rates in their contracts. Therefore, a robust fallback provision in new collateral contracts, subject to the parties' agreement, can help to avoid an impact on derivatives' valuation.

At the same time, as amending all legacy collateral contracts can entail important challenges, we also see merits in having the option of a transition to €STR or €STR plus the Spread without an introduction of a fallback provision as an alternative in some cases for market participants.

Q6. Do you agree that new cash contracts and instruments that mature after December 2021 should include fallback provisions? (yes / no / no opinion) If applicable, please elaborate on the reason for choosing "no".

YES

Q7. Regarding the EONIA discontinuation fallback language templates described in Annex 1 for new cash products referencing EONIA, which alternative do you prefer? (alternative 1 / alternative 2 / other options) If applicable, please elaborate on the reason for choosing "other options".

We prefer alternative 2 (unified fallback provisions relating to both temporary and permanent unavailability of EONIA).

Do you have any further comments or suggestions regarding the suggested templates? (yes / no) If applicable, please elaborate on the reason for choosing "yes".

YES

To avoid confusion, if different Relevant Nominating Bodies (as defined in Annex I for alternatives I and II) make recommendations which are inconsistent, we would suggest to clarify the order in which each of their designated, nominated or recommended rates (if multiple) be chosen by the parties to the relevant agreement.

Q8. Do you agree with the proposed recommendation that priority should be given to legacy contracts maturing after December 2021? (yes / no / no opinion) If applicable, please elaborate on the reason for choosing "no".

YES

Legacy contracts that mature before end-2021 may continue using EONIA (following the extension provided under the Benchmark Regulation and the fact that EONIA isn't scheduled to be discontinued before end-2021). We would therefore consider appropriate to give priority to legacy contracts maturing after December 2021.

Q9. For legacy derivative transactions, would it be useful to have documents and/or protocols which facilitate (i) the incorporation of the EONIA index cessation event trigger and related fallbacks, and/or (ii) the amendment of legacy trades to switch from EONIA to €STR plus the Spread (as defined)? (yes / no / no opinion) If applicable, please elaborate on the reason for choosing "no" and propose any alternative course of action.

YES

Q10. Do you agree that the working group should encourage CCPs and Exchanges to clarify their position with respect to the transition to €STR and to follow the ISDA approach with respect to fallbacks for EONIA? (yes / no / no opinion) If applicable, please elaborate on the reason for choosing "no" and propose any alternative course of action.

YES

Q11. For legacy derivative transactions that are already documented using European local master agreements, which is the most feasible option for amending them? (develop common templates / develop a protocol / both / another option / no opinion) If applicable, please elaborate on the reason for choosing "another option". Sponsors of local master agreements are particularly invited to comment on this.

BOTH OPTIONS

Q12. Do you foresee any additional regulatory or legal requirements or costs that may hamper the amendment of legacy derivative contracts and which need to be clarified / waived? (yes / no / no opinion) If applicable, please elaborate on the reason for choosing "yes".

YES

For investment funds, the transition from EONIA to €STR may require amendments to a significant number of fund documents. This entails risks that national competent authorities will seize the occasion of such update to require compliance with other regulatory guidance or developments, for which otherwise compliance at a later date would be possible.

Thus, it would be very useful to add in the recommendation on amending legacy derivatives a clear statement that any update to fund documents made for transition to €STR should be considered as a trigger to comply with other non-related rules or regulations for which compliance at a later date would otherwise be possible.

Q13. Which are the critical elements to consider when transitioning from EONIA to €STR in collateral agreements from a legal, operational and valuation standpoint?

Overall we consider that there are several elements to consider:

- From a legal standpoint
  As mentioned in our previous response to Q5 we would be in favour of amending existing contracts and including fallback provisions to make these agreements robust from a legal point of view in case of benchmark rate disruption. The critical element would be to implement this transition though an ISDA Protocol to avoid a huge number of bilateral discussions/re-negotiations. We also favour a uniform adoption of fallback methods.

- From a valuation standpoint
  Transit to €STR or €STR plus spread should be considered in relation to maintaining contract valuation continuity, avoiding value transfers, and ensuring that CCPs methodology for valuation of derivatives matches practices in bilateral contracts.

- From an operational standpoint
  Adaptation of IT system is critical and will take time.

Q14. Do you agree with the bilateral amendment agreement template for cash products (see Annex 2)? (yes / no / no opinion). Do you have any suggestions regarding it? If applicable, please elaborate on the reason for choosing "no"

YES
We also have the following comments concerning the template suggested in Annex 2.

- <u>Offsetting clause</u>

As it is expected that the shift from EONIA to any of the alternatives which may be foreseen by the amendment agreement may result in a transfer of value between the parties, we would suggest including an additional clause in the template amendment agreement, aiming at offsetting any transfer of value resulting from the shift from EONIA to the alternative rate by a balancing payment(s) to the party detrimentally affected by such rate modification.

- <u>Definition of the Affected Covered Transaction Document</u>

We suggest aligning the definition of the Affected Covered Transaction Document with the definition of the Affected Covered Credit Support Document as it is not clear why documents not mentioning EONIA should still fall within the scope of this definition.

- <u>Discontinuation Date</u>

We would suggest further refining the definition of Discontinuation Date on the basis of the definition of "Availability / Unavailability" foreseen in Annex 1 by including those trigger events in the Discontinuation Date definition included in the "Availability / Unavailability" definition, which are not of temporary only nature.

Q15. Do you foresee any regulatory or legal requirements that may hamper the amendment of legacy cash contracts and which need to be clarified / waived? (yes / no / no opinion)
If applicable, please elaborate on the reason for choosing "yes"

YES
We would welcome a statement clarifying that amendments to legacy contracts to include fallbacks or replace non-compliant benchmark would not trigger any additional regulatory or legal obligations. Please see also our previous response to Q12.

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