Frankfurt am Main,
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BVI's position on the first public consultation by the working group on euro risk-free rates on the assessment of candidate euro risk-free rates

1. General remarks

BVI[1] supports the initiatives started by the ECB to develop and to consult with the relevant market participants new alternative benchmarks complementing existing benchmark rates.

Asset managers as benchmark users are generally involved neither in the production and calculation of nor the contribution to data on which benchmarks are based. But fund (AIF and UCITS) and asset managers represent an important group of benchmark 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 the fund performance is measured against a selected index or a set of indices. The use of benchmarks is often subject to payment of high and multiple index data fees and complex license requirements currently under scrutiny by DG COMP as well as extensive regulatory requirements (in particular in the case of the use of financial indices by UCITS – see e.g. ESMA Guidelines on ETFs and other UCITS issues ESMA/2012/832/EN).

The new reference rate will be the main substitute for EONIA and other benchmark rates. It will therefore be relevant for all (investment fund) mandates which are currently linked to EONIA, e.g. for the replication or at least determination of the asset allocation of an EONIA linked money market or short term bond fund, or as hurdle rate to be able to fix a (minimum) investment target or performance fee for a fund or a mandate.

More importantly, our members invest on a day to day basis billions of Euros in a wide range of money market instruments and securities which are linked to EONIA and other critical benchmarks. Therefore, these rates influence the long-term strategy of investment funds that use instruments with such a reference rate.

In this respect, it is very important for asset managers and their investors that these rates are resilient to conflicts of interest, fraud, and of less structural weaknesses, compared to what has been the case in the past. We would also like to stress the importance of a seamless transition for the existing instruments/contracts from EONIA to the new risk free rates to minimise market impact.

Also, the transition process requires good preparation, including a reasonable time table taking into account the different market demands and full transparency on the mechanics of the new alternative rate. Among other things, we need clarity – inter alia – as to the potential spread over the modified rates but also the legal documentation of the rate, because fund management companies need to review

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Fund companies act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's over 100 members manage assets of more than 3 trillion euros for private investors, insurance companies, pension and retirement schemes, banks, churches and foundations. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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their funds' legal documentation (e.g. fund rules, KIIDs and prospectuses) to account for the index change. These changes would require the approval of the client and in certain cases also of the supervisory agency of the fund in a process that needs from 6 months up to a year to be completed.

Compared with the other suggestions on an alternative repo rate, we would expect that such risk-free rates are impacted by seasonal factors and quarter ends, as well as year ends, where market participants would consider to rebalance their portfolios.

2. Specific responses to the consultation's questions

Q1. Do you agree with the working group's analysis of the ECB monetary policy candidate rates and the unsecured candidate rates? Please elaborate.

BVI agrees with the methodology and the set of criteria for the selection of candidate rates proposed by the working group and the analysis that the existing ECB monetary policy candidate rates are not appropriate to reflect the immediate reactions of market participants.

BVI considers the new unsecured overnight borrowing rate (ESTER) as an appropriate replacement to the existing rate. We agree this rate to be recommended for the Euro RFR if a number of shortcomings can be addressed in the near term.

These relate to timeliness of publication, as regards the time of publication and the availability of historical data but also to the representativeness of the rate – given that the institutional money markets in Europe and the US today have largely moved to secured transactions. In recognition of this development the US and Switzerland have moved to secured rates, while the UK has not. Therefore, some consideration should be given to combine more the euro risk-free rate with repo rate elements, like in the US. We encourage the working group to take into consideration how such elements could be integrated into ESTER.

Given the high importance of a risk-free rate for the financial and asset management industry, a fallback rate should also be considered. The acceptance and reliance of a new risk free rate by the market participants will also be based on available fall-back options. A fall-back rate should also be designed as close as possible to the ESTER approach. The working group has developed three candidates: Choosing one leaves the two other as fall-back rate candidates.

Q2. Do you support the working group's conclusion that ESTER is the most reliable and robust unsecured candidate euro risk free rate? Please elaborate.

Our members are principally of the view that an appropriate candidate to serve as a replacement for EONIA and as a complement to existing rates could be ESTER.

According to our estimates, ESTER could be a reliable and robust unsecured euro risk-free rate with a broad market and transaction data basis and a robust data volume. Furthermore, the ECB could be a credible administrator with a strong reputation in the market place. Also, the ECB would not ask for licensing fees paid by the benchmark users (e.g. investment fund management companies) unlike commercial providers who may not relinquish their perceived intellectual property rights on the rate for unlimited term. As the EU competition authorities are currently reviewing exchanges with respect to anti-competitive behaviour relating to sales and licensing of market and index data, this risk should not be under estimated.

For retail and institutional investors/users alike the ESTER approach could be more favourable, understandable and trustable compared to a private firm based administrator concept, thereby increasing the likelihood of early and widespread acceptance of the new rate.

We acknowledge further the merits ESTER offers in comparison to other candidate unsecured rates, such as the robust volume of daily reported transactions, the highest level of liquidity, the largest panel of reporting banks and the credibility of the administrator. In that context we agree that it is the most reliable unsecured candidate rate.

It is however important to amend some of the key features of ESTER to tackle important operational constraints that may rise under the currently proposed structure.

In particular as to the time of publication BVI would strongly support an earlier publication of the ESTER, as the expected publication at 09:00 CET on T+1 is far too late for data that is already delivered by 17.00 CET the previous day. This causes operational issues to asset managers which may seriously impact their ability to conduct on time important activities such as the pricing of the NAV of the fund. There is also a fear that ESTER may change retroactively as banks are allowed to change their ECB statistical reports up to ten days after submission.

We also note the absence of historical data which is not the case for the secured rate proposals. The working group may want to consider ways to mitigate that risk. We also question why the consultation excludes the first half of 2018 data and thereby implicitly underscores the severity of the Italian banking crisis with the low contributions to EONIA in May of this year.

Q3. Do you agree with the working group's analysis of the secured candidate rates? Please elaborate.

BVI supports the analysis that the selected secured candidate rates offer higher volumes and they both provide hindsight in terms of historical data.

Another very important argument for money market fund managers is that secured indices could probably move with non-monetary factors related to regulation, market mood (risk aversion), counterparty risk management measures and supply/demand imbalance of core collateral. Secured indices may likely be also less responsive to change of policy rates while ESTER is expected to move in line with change in policy rates.

We need to evaluate further to what extent secured rates are driven by special events as they could be very much impacted by the seasonal factors and quarter ends, as well as year ends, where market participants would consider rebalancing their portfolios. These factors are not related to pure functions of the market, but rather to each bank's balance sheet requirements for a given day, and still can distort overall repo rates. It is also important to note that there is no single collateral being traded on a high volume basis in the repo market, but different types of collateral with different credit quality, which raises justified liquidity concerns. Moreover, what should be further assessed is the impact of the decisions taken by a CCP (such as a decision for haircuts) for the underlying trades of a secured candidate rate, as well as their possibility for a wide acceptance as risk-free rates given that they are provided by private administrators (in comparison to a rate administered by the ECB).

GC pooling seems less prone to such volatility concerns as it is backed by a large pan-European homogeneous funding pool of 14,000+ ISINs of ECB eligible collateral in two standardised credit baskets effectively replacing individual credit and counterparty risk with average basket quality risk. Also, since 2013 spreads between EONIA and GC pooling are with single day exceptions very stable. For example, EONIA created volatility due to the Greek situation in November 2017 while the secured rate was stable.

Q4. Do you support the working group's conclusion that GC Pooling Deferred and RepoFunds Rate are the most reliable and robust secured rate candidates for the euro risk-free rate? Please elaborate.

Yes – as explained above. However, we would like to highlight the criterion of a forever free and open access to Euro RFR as a key one for the selection of an appropriate candidate. Hence, for any secured rate offered by a private administrator this obligation needs to be secured.

Q5. Which of the final three candidate rates do you think would be the most appropriate future euro risk-free rate? Please elaborate on the reasons for your preference, taking into account that your preferred rate could serve as the basis for an alternative to current benchmarks used in the euro area.

BVI has a preference for an unsecured rate and ESTER, as this is most comparable to the existing rate, EONIA. Moreover, ESTER has the highest credibility and resulting trust due to its public administrator, ECB.

Q6. Do you think the working group should consider assessing potential fallback rates to the euro risk-free rate?

Please elaborate on:

(i) the main reason for your opinion that the working group should or should not undertake this exercise.

(ii) the critical issues that the working group should consider with respect to nominating fallback rates.

BVI sees merits in considering potential fallback rates to the euro risk-free rate, in particular as users are required by Art. 29 BMR to put in place robust written plans in case an index used is materially changed or ceases to exist. Moreover, clarity as to the fallback rates can further strengthen the structure of the market.

Also, there remain concerns whether ESTER is able to reflect liquidity conditions for money market operations in stressed markets. Statistics show that the demand for and therefore the representativeness of secured rates over unsecured rates tends to be higher in stressed market conditions when just a handful of banks may be able to borrow in an unsecured manner. A CCP cleared repo rate is worth looking at as regulation is driving more and more financial products into daily margined CCP cleared markets and such rate is able to facilitate cross border funding in a crisis as demonstrated by the 2013 to 2015 data.

Therefore, besides incorporating elements of secured rates into ESTER serious thought should be given to designate secured fallback rates, ideally administered by a public authority at no cost or licenses to users. Critical issues to be considered when nominating fallback rates are inter alia the spread between benchmark and fallback rate, the robustness of the fallback rate in very volatile environments or disrupted markets, their liquidity and safeguarding that any mismatch, asymmetry or financial imbalance between banks and buy-side actors are avoided. Also, mitigants to knock-on effects on the FX cross currency swap market need to be taken into account if the market moves to using a US secured and an EU unsecured rate.