PUBLIC CONSULTATION ON THE PUBLICATION BY THE ECB OF COMPOUNDED TERM RATES USING THE €STR

I. General remarks

Spanish CNMV Advisory Committee (hereinafter "the Committee") welcomes the public consultation on the publication by the European Central Bank (ECB) of compounded term rates using the €STR (euro short-term rate).

The ECB, along with other European authorities, has driven a reform of EURIBOR and EONIA, alongside IBOR Index reform in order to increase their transparency and to adapt to European standards and recommendations from international organizations.

The ECB objective is to provide benchmark users with compounded values of the €STR for selected maturities. These values will be published every TARGET2 day, similarly to the €STR itself. This initiative has two aims:

- Encourage and support the wider use of the near-risk-free rates (RFRs) and hence the €STR, by providing a "**golden source"** for the compounded €STR values.
- Provide a rate that may be used in contractual fall-back provisions by users of the EUR LIBOR and EURIBOR who are required to prepare in their contingency planning for a scenario in which the EUR LIBOR and the EURIBOR may cease to exist.

Prior to this proposal, the current situation of the legal action plan could be described as follows:

- EONIA is extensively used as a reference rate in contracts for variable interest rate products denominated in euro. Until October 1st, 2019, it was calculated as the average of all overnight unsecured lending transactions, as reported by a panel of 28 contributor banks to the European Monetary Market Institute (EMMI). It was considered as a critical benchmark.
- EONIA is not compliant with the Benchmarks Regulation (BMR), which entered into force on 30th June 2016. Index providers were able to continue developing benchmark indexes (already existing) until 1st January 2020.
- The working group recommended on 13th September 2018 that €STR should serve as the alternative euro risk-free rate and the replacement for EONIA.

- On 14th March 2019 it also recommended that the European Money Markets Institute (EMMI), as the administrator of EONIA, should modify the current EONIA methodology to become €STR plus a fixed spread.
- The ECB began publishing €STR on 2nd October 2019. From that date and onwards EONIA is calculated at a 8.5 basis points positive spread on the basis of a new rate: the Euro short-term rate (€STR). This new benchmark is calculated as the weighted average of the individual transactions in the European monetary market reported by 50 credit institutions every day to the ECB.
- The €STR was published for the first time on Wednesday, October 2nd, with a fixing set at -0.549%, with reference date October 1st, 2019. The ECB's calculation was based on 32 active banks and 432 actual transactions. The resulting EONIA was -0.464% (-0.549% plus the aforementioned +0.085% spread) with reference date October 1st, 2019, in continuity with the September 2019 fixing (-0.451%).
- At the end of 2021, ECB will cease the publication of EONIA.

All this events envisaged in the legal action plan have contributed to ensure the successful outcome of the benchmark reform and the rate compound initiative continues along the same line having positive impact in that path.

The Committee strongly agrees that the ECB should calculate and publish the €STR compound interest rate on a daily basis and therefore is clearly in favour of this initiative.

With the aim of contributing to the abovementioned objectives, below you may find the Committee answers to the questions raised in the consultation.

II. Answers to the different questions raised in the public consultation

QUESTION 1.-
Are you in favour of the ECB publishing €STR compounded rates? (Y/N). Please elaborate your answer.

YES.

The ECB publishing €STR compound rates follows recommendations from the Financial Stability Board, to encourage and support the wider use of the near-risk-free rates (RFRs) and hence the €STR. The compound interest rate is a necessary reference for the markets. Its calculation and publication will provide predictability, support, diffusion and credibility. In this manner, its introduction should be welcome for the stakeholders and will be accepted and used by all market players.

Additionally, the publication of €STR compound rates will surely help benchmarks users to comply with the EU Benchmarks Regulation, that requires a rate that may be used in contractual fall-back provisions specially under the scenario in which the EUR LIBOR and the EURIBOR cease to exist.

Moreover, this initiative could reduce the risk of IBORs reform, in particular:

- Establishing a robust alternative rate anchored in a sufficiently liquid market, being available even in adverse market circumstances because is based on active borrowing overnight markets, that remains by far the most liquid, and will be as robust as the €STR.
- Promoting the wider use of the RFRs across market segments reducing the direct reliance on IBORs in contracts and complementing other types of rates, such as forward-looking rates stemming from the €STR derivatives market, that present drawbacks to provide an alternative to the EURIBOR.
- Facilitating the increased usage of the €STR in the cash market using the compounded €STR rates as a reference rate in new products (rather than only as IBOR fall-backs) and this could help establishing standards and best practices.
- Supporting international benchmark consistency across jurisdictions according to the Federal Reserve Bank of New York as well as the Bank of England have also committed to publishing compounded RFR rates and/or daily indices. It would not make sense that the ECB (and the euro currency) would stay out of this Central Banks "initiative/ practice" publishing the compound interest rate in their respective currencies (the dollar and the pound).

- Improving the robustness of all contracts that make use of IBORs by introducing workable fall-back provisions (the EURIBOR in the future may cease to be published and a compound interest rate calculated and published by the ECB at various tenors may be used as a good fall-back), as an important way to support the necessary acceleration of preparations and contract amendments by and within the industry.

Therefore, the Committee agrees on the proposal of publishing €STR compound rates.

QUESTION 2.-
Do you agree with the proposed calculation methodology? (Y/N). Please elaborate your answer.

YES.

The Committee agrees with the propose calculation methodology, basically because it is a formula already proven and widely used mainly in derivatives markets. In particular, it is a longtime used formula by ISDA (International Swaps and Derivatives Association) in many derivatives well known for all market users.

QUESTION 3.-
Do you agree with the index calculation methodology? (Y/N). Please elaborate your answer.

YES.

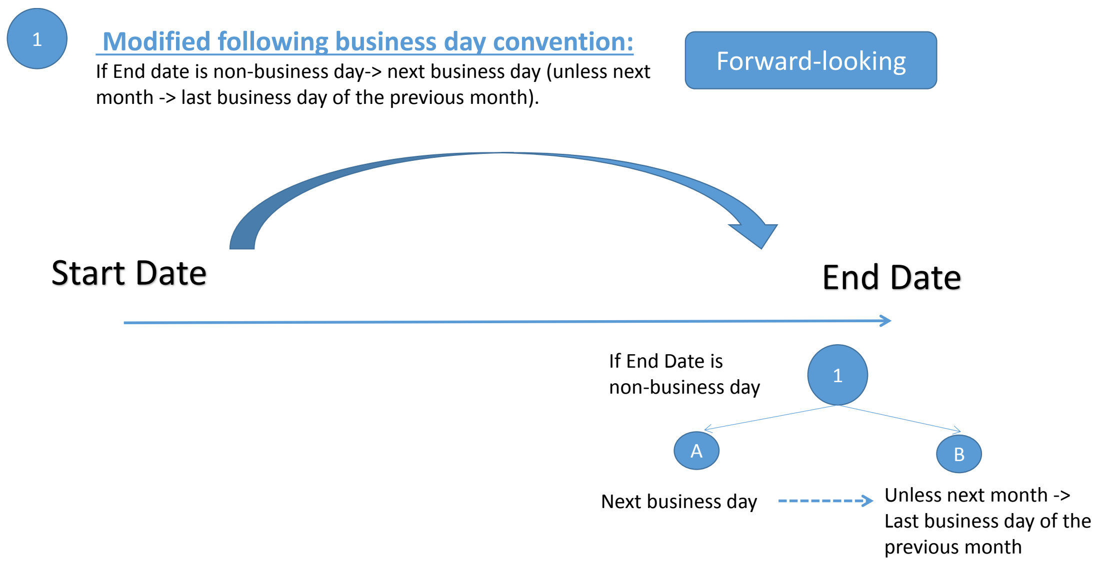
The Committee considers that it is a simple and transparent methodology that will be very useful for all users. Its simplicity lies in the way to calculate non-standard days.

QUESTION 4.-
Do you agree with the proposed day-count convention, namely the modified previous business day convention? (Y/N). Please elaborate your answer.

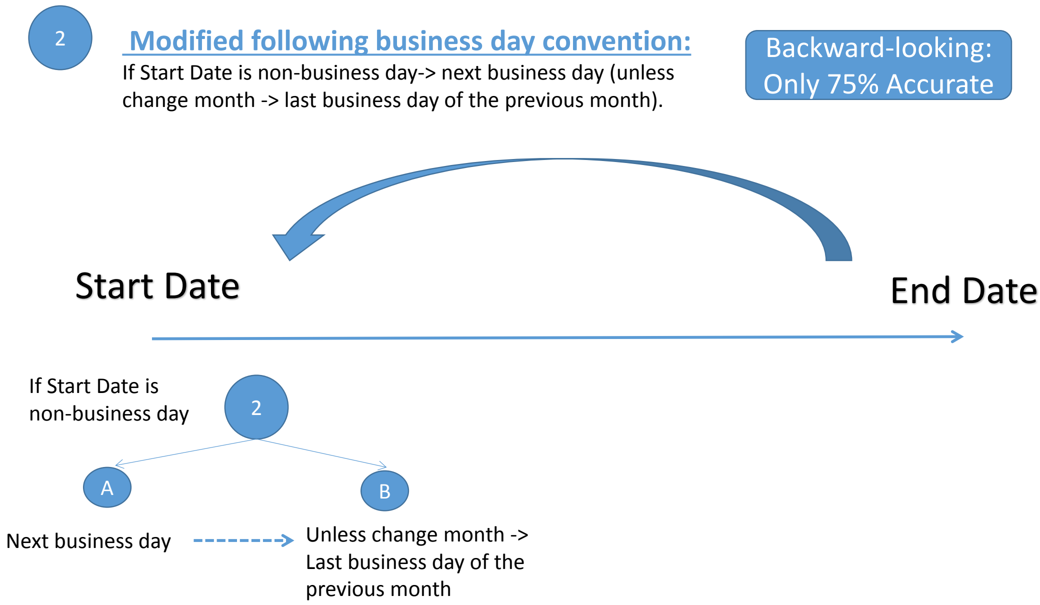
YES.

Consultation introduces different approaches for the day-count convention in order to minimize potential discrepancies:

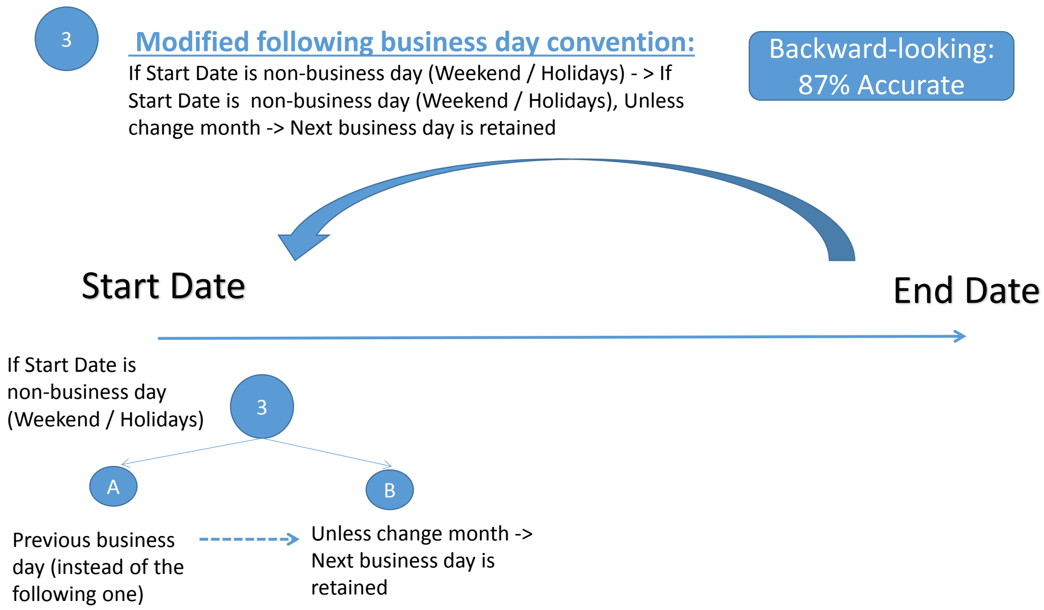
1. **<u>"Modified following business day convention"in FORWARD-looking:</u>** trader experience in European money markets states its general use. When users negotiate contracts to certain term they know the start and end date. But they also have recourse to the modified following business day convention. If the end date of a contract falls on a non-business day, then this convention shifts the end date of the contract to the next business day, unless this date falls in the next month. In this case, the end date is the last business day of the previous month and therefore the way to adjust the price of the operation.



2. **<u>"Modified following business day convention" in BACKWARD-looking:</u>** however, when using the same day-count convention in a backward-looking fashion (to the start date), the length of interest periods only appears to be "accurate" to within one day in 75% of cases, leaving a mismatch for the other 25% (in particular, shorter interest periods, since the start date is shifted to the following business day).



3. **<u>"Modified previous business day convention" in BACKWARD-looking:</u>** another day-count convention may give better results when used in a backward-looking way, namely the modified previous business day convention. This convention mirrors the modified following business day convention by adjusting non-business days over weekends or holidays to the previous business day instead of the following one. If this results in a change of month, the next business day is retained.



The two first options do not seem feasible alternatives because of the uncertainty regarding the accuracy, credibility and sustainability of the compound rate.

Therefore, the Committee considers that option 3 the **<u>"modified previous business day convention"</u>** is the most appropriate and alternative to practically implement because returns better results and minimizes discrepancies. This should favor this alternative to be massively used by market participants.

QUESTION 5.-
Do you agree that the use of the daily index value is a simple and transparent solution for the non-standard situations described in the Public Consultation document? (Y/N). Please elaborate your answer.

YES.

Despite the modified previous business day convention proposed could be a partial solution, it does not resolve all issues. In around 12% of cases, it will bring discrepancies in tenors' definitions of more than one day.

Using the index for non-standard situations (as long as the start and end dates fall on TARGET2 business days) seems, in the Committee´s opinion, a proper solution to reduce the leaving discrepancies and shows potential benefits stemming its simplicity and transparency to ensure statistical representativeness facilitating its understanding by all users.

QUESTION 6.-
If you have replied "No" to Question 5, what other alternative approach would you suggest? Please explain the advantages you associate with this alternative approach. Please elaborate your answer.

N/A.

QUESTION 7.-
Does the proposed range of maturities cover market participants' business needs? (Y/N). Please elaborate your answer.

YES.

The Committee agrees that these are the range of maturities that users require. Other factor in its favour is that these terms are the same applied in the EURIBOR, which encourages its use as a fall-back in the event that the EURIBOR ceases being published.

QUESTION 8.-

Do you agree that (a) four decimal places for the published term rates, and (b) nine decimal places for the published index values are sufficient to meet users' needs? (Y/N). Please elaborate your answer.

YES.

The publication of rates for the various maturities with four decimal places and the index with nine decimal places states a level of precision that approximates current practices for similar published benchmarks and therefore the Committee deems it adequate to market practices.

In fact, EURIBOR shows 3 decimal places, so 4 in the rates and 9 in the compound index are more than sufficient in any case.

QUESTION 9.-

Do you agree with the envisaged publication timing and correction policy? (Y/N). Please elaborate your answer.

YES.

The Committee considers that the publication of the rates for the proposed maturities and the index value for the respective day shortly after 09:15 CET each TARGET2 day comply with IOSCO principles.

Therefore, the Committee considers the timing is adequate for users' needs. In the event that an error might be detected in the calculation once published, it should be corrected without time limitation, in order to preserve the accuracy of the rate publication.

To allow the market users to be duly prepared and organized before the new ECB compound rate is launched it is of utmost importance to have enough time to develop the systems and applications, and also running tests avoiding operational errors and disclosure issues.

In this regard, the ECB should also publish how frequently it aims to review the new index calculation methodology, as it should be always adequately linked to the evolution of the markets to which the new index is based.

Therefore, it will be really helpful knowing as soon as possible the new index behaviour and evolution in terms of volatility, levels, etc. during a period of time. The expected disclosing dates shown at the ECB consultation may be adequate with this aim but it will depend on the prior milestones such as the observation period, the calculation and subsequent revision events.