EUROPEAN CENTRAL BANK
EUROSYSTEM

Summary of responses to the ECB's second public consultation on developing a euro unsecured overnight interest rate

May 2018

Executive summary

The ECB's second public consultation on developing a euro unsecured overnight interest rate closed on Friday, 20 April 2018. The consultation drew considerable interest from the financial sector. 48 market participants – just under two-thirds of them from the banking sector – submitted responses or comments in relation to the consultation document. The response sample ensures suitable geographic coverage and adequately reflects relevant (sub-)sector views. The main messages from the financial sector may be summarised as follows:

1. A large majority of respondents agreed that a €1 million threshold would adequately reduce the administrative burden resulting from the consideration of all transactions while ensuring an effective representativeness of the future ECB reference rate.

2. Respondents broadly agreed with the proposed methodology of a volume-weighted mean with trimming though expressed some reservation on the proposed 25% trimming level, with a small majority expressing a clear preference for a trimming at the 10% level based on a larger and more diversified volume of transactions for the calculation of the rate.

3. Respondents largely approved of the proposed criteria-based data sufficiency policy.

4. Respondents agreed with the proposed criteria for moving to a contingency procedure.

5. Approximately half of respondents recommended enhancements to the data sufficiency policy, the most frequent suggestion being an additional criterion to ensure adequate country representativeness.

6. A majority of respondents agreed with the proposed calculation methodology for the contingency rate but requested clarification on the application of the contingency rate for more than two days in a row.

7. Respondents viewed a rate expressed to three decimal places as ensuring precise information, as well as continuity and consistency in market practices.

8. Respondents generally welcomed a high degree of transparency, although they also raised concerns about confidentiality and market manipulation related, in particular, to the publication of the “percentage of volumes reported by the five largest banks”.

9. Respondents saw merit in republishing a rate only if serious error resulted in a significant difference between the published rate and the recalculated rate.

10. Respondents viewed the envisaged publication of daily rate and volume data during the preparatory phase as sufficient in terms of scope and planned start date.

11. High-level features or issues that respondents viewed as important to highlight fall into two broad categories: (i) transition issues and market preparation; and (ii) further methodological considerations.

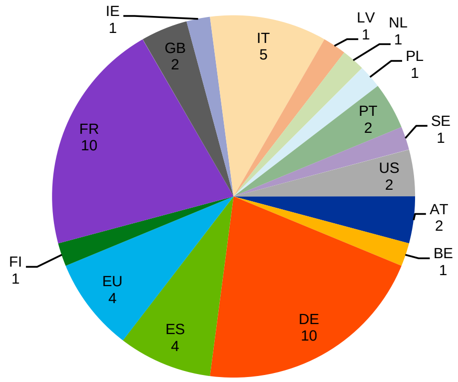
The ECB will continue to inform market participants on the progress made. The ECB also intends to ensure an effective information flow to provide the financial sector with as much information as possible to prepare for a smooth implementation of and transition to the new rate.

Chart 1

Response sample ensures appropriate geographic coverage …

April 2018

(number of respondents by geographic area)



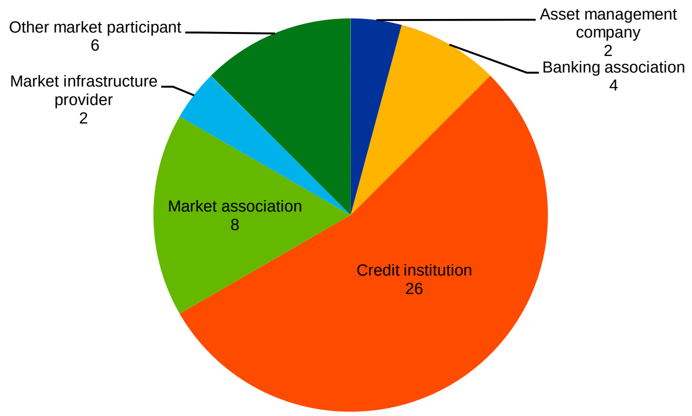
Source: ECB.
Note: EU refers to international associations.

Chart 2

… and reflects relevant stakeholder groups

April 2018

(number of respondents by sector)



Source: ECB.

1 Specification of threshold

Do you agree that a €1 million threshold is preferable to any higher threshold, as it adequately reduces operational burdens while limiting any loss of information?

A large majority of respondents agreed that a balance should be reached between the administrative burden resulting from the desire to consider all transactions and the effective representativeness of the new interest rate.

Respondents generally agreed that a threshold of €1 million would be adequate and acceptable: a 0.2% reduction in total volumes would not affect the quality of the intended measurement, while the average and minimum number of transactions per day would remain significant after the introduction of the threshold.

The remaining respondents were equally split between those who expressed a preference for an even higher threshold (€10 million) and those who generally disagreed with the introduction of a threshold.

Respondents in favour of a €10 million threshold argued that it would result in a minimal loss in volumes, number of banks and number of countries, and hence would not materially reduce the robustness of the future ECB rate. A €10 million threshold would also capture a meaningful population of transactions while reducing noise and operational costs associated with a lower threshold. Finally, it would better reflect wholesale funding in the interbank market.

Respondents in favour of a higher threshold also suggested that lowering the threshold from €10 million to €1 million, if volumes dropped below a specified level, could be an element of the contingency methodology.

Respondents disagreeing with the introduction of the €1 million threshold generally viewed any threshold as making the future ECB reference rate more vulnerable to manipulation.

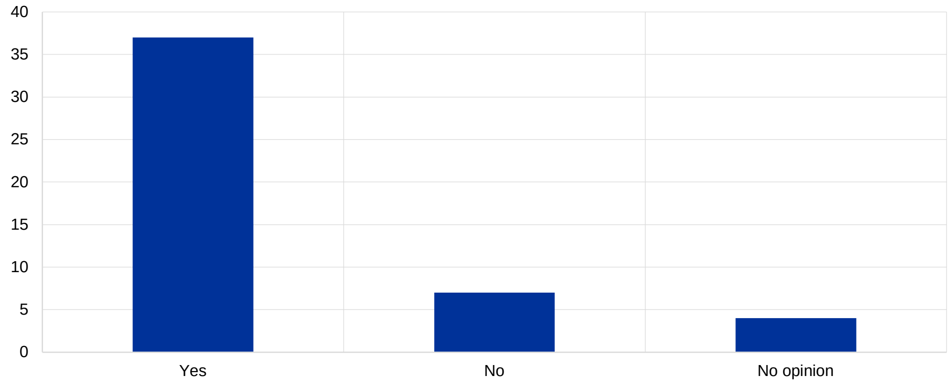
Respondents also noted that a threshold higher than €1 million may lead to larger transactions being split so they are under the threshold.

Chart 3

A large majority of respondents agreed that a €1 million threshold would adequately reduce the administrative burden resulting from the consideration of all transactions while ensuring an effective representativeness of the future ECB reference rate

April 2018

(number of responses)



Source: ECB.

2 Application of trimming

Do you agree with the proposal to apply trimming at the level of 25% in order to reduce the volatility of the daily rate?

While respondents broadly endorsed a volume-weighted mean with trimming as the optimum methodology, a small majority of respondents expressed a preference for a lower trimming level, commonly defined at the 10% level.

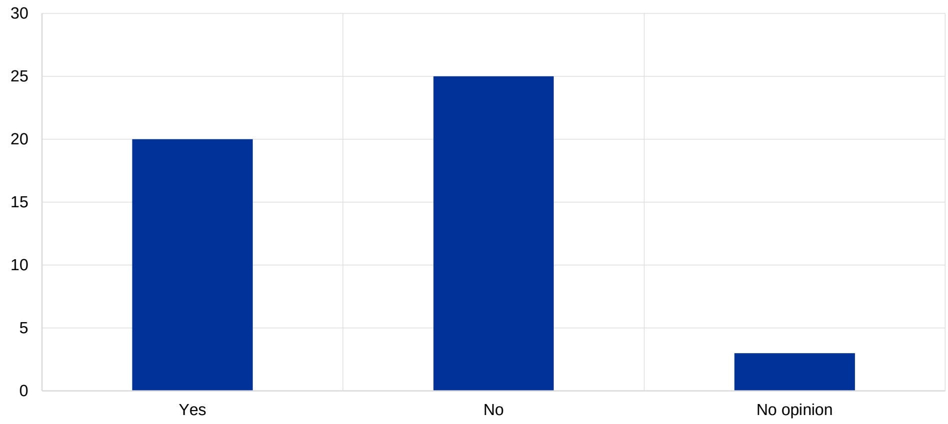
Respondents argued that the interest rate benchmark should present a good balance between stability and reactivity to market conditions. Respondents in favour of a trimming at the 10% level pointed to the benefits of having a larger and more diversified volume of transactions, with a similar level of volatility, for the calculation of the rate.

Chart 4

Respondents broadly agreed with the proposed methodology of a volume-weighted mean with trimming though expressed some reservation on the proposed 25% trimming level, with a small majority expressing a clear preference for a trimming at the 10% level based on a larger and more diversified volume of transactions for the calculation of the rate

April 2018

(number of responses)



Source: ECB.

3 Data sufficiency policy and contingency procedure

Do you agree with the proposed data sufficiency policy?

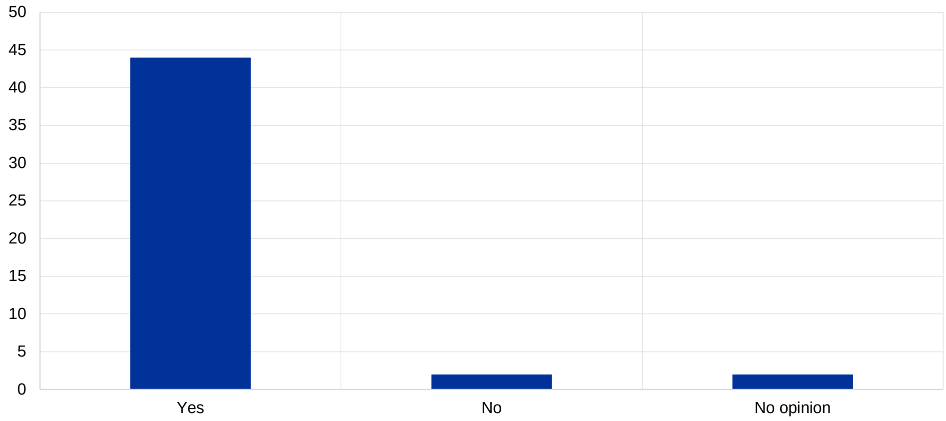
Respondents largely agreed with the proposed criteria-based data sufficiency policy, as opposed to a principle-based policy, in the light of the empirical back-testing evidence provided in the second public consultation document.

Chart 5

Respondents largely approved of the proposed criteria-based data sufficiency policy

April 2018

(number of responses)



Source: ECB.

Do you agree with the proposed criteria for moving to a contingency procedure?

A large majority of respondents agreed with the proposed criteria for moving to a contingency procedure.

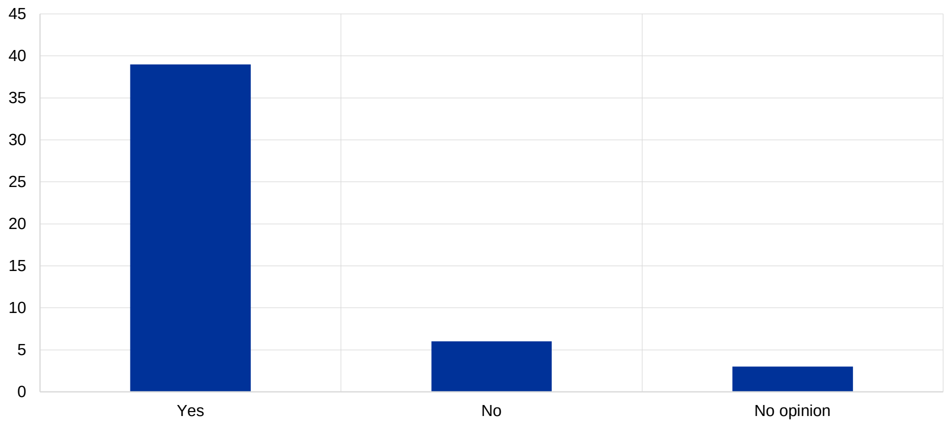
Respondents disagreeing with the proposed criteria suggested basing the decision to move to a contingency procedure on a broader set of criteria (e.g. a minimum €1 billion volume criterion or a time period-based criterion) or easing existing criteria (e.g. triggering a contingency procedure only if fewer than 16 banks contributed). These respondents suggested conducting additional back-tests to assess the frequency with which contingency procedures are triggered based on different criteria.

Chart 6

Respondents agreed with the proposed criteria for moving to a contingency procedure

April 2018

(number of responses)



Source: ECB.

Would you suggest other criteria for implementing a contingency procedure, taking account of the specificity of the euro area?

A number of respondents suggested additional criteria for implementing a contingency procedure.

Criteria mentioned by respondents included an additional criterion ensuring adequate country representativeness (with the minimum threshold ranging from four to six countries) and an average spread to the policy rate for a given number of days, as in reformed SONIA.

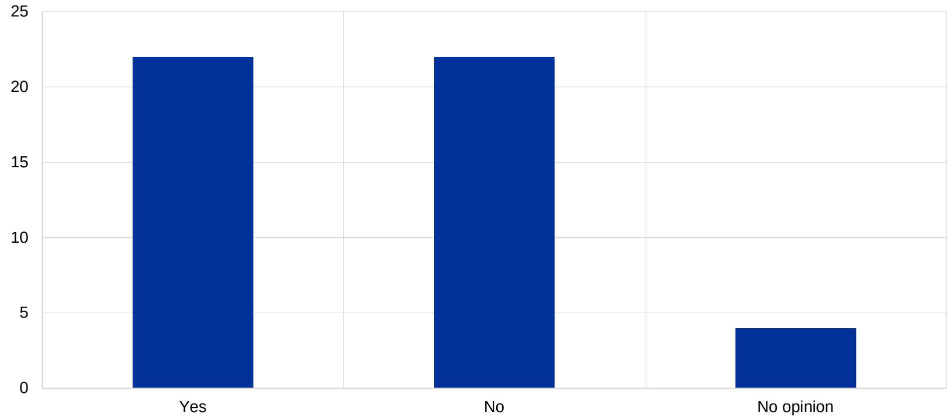
Several respondents also asked for further testing of the contingency procedure to avoid contingency measures being triggered too frequently as a result of changes in market conditions.

Chart 7

The number of respondents recommending enhancements to the data sufficiency policy and the number of respondents not seeing a need for additional criteria was evenly balanced

April 2018

(number of responses)



Source: ECB.

4 Calculation methodology for the contingency rate

Do you agree with the proposed calculation methodology for the contingency rate?

A majority of respondents agreed with the proposed calculation methodology for the contingency rate. The main argument for disagreeing with the approach – also raised as a caveat by a large number of supportive respondents – is that the proposed methodology only ensures representativeness of the rate for a very small number of days and does not factor in market moves that occur independently of policy moves (e.g. month-end, quarter-end, year-end or other seasonal effects).

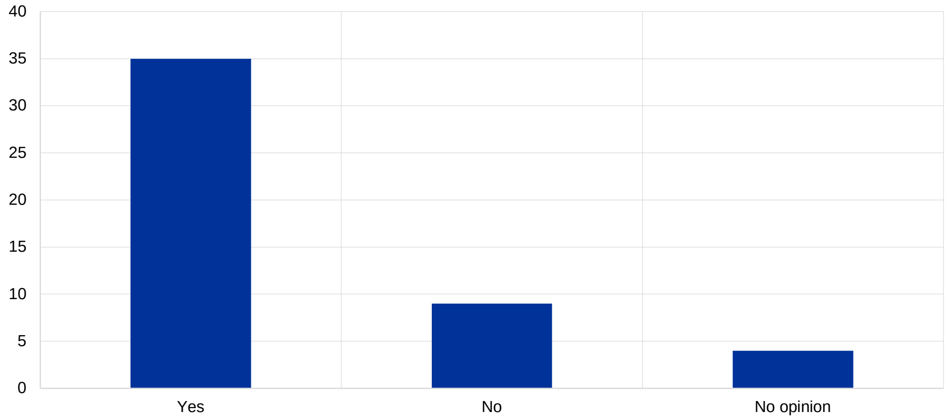
Besides asking for greater clarity on the current formulation of the methodology, respondents put forward a number of enhancement proposals, including: a cap on the number of days that the methodology would continue, the application of an empirically grounded spread, the implementation of a steering committee, which would – based on published procedures – convene to discuss a methodology change or emergency solution. Against this background, respondents expressed support for periodic reviews in line with IOSCO (Principle 10).

Chart 8

A majority of respondents agreed with the proposed calculation methodology for the contingency rate but requested clarification on the application of the contingency rate for more than two days in a row

April 2018

(number of responses)



Source: ECB.

5 Rate publication

Do you agree that a rate with three decimal places provides sufficiently precise information?

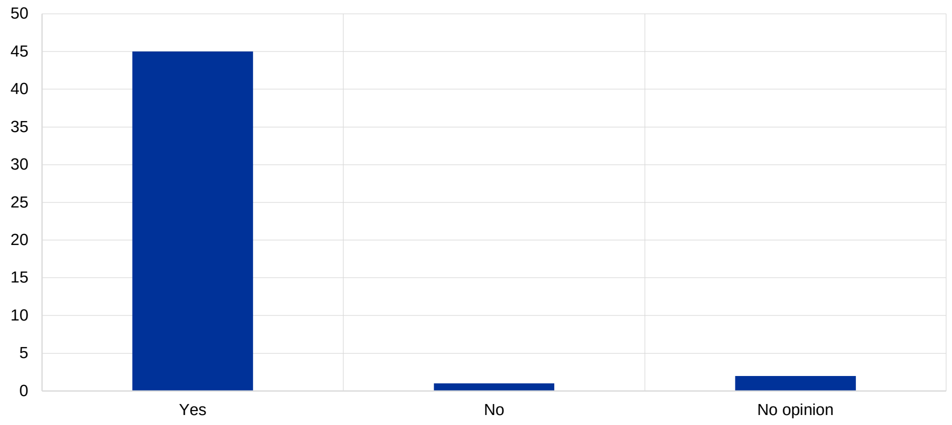
Respondents agreed that a rate expressed to three decimal places would provide sufficiently precise information and ensure consistency in market acceptance and continuity in market practices.

Chart 9

Respondents viewed a rate expressed to three decimal places as ensuring precise information, as well as continuity and consistency in market practices

April 2018

(number of responses)



Source: ECB.

Do you agree with the daily publication of the variables listed in the bullet points above (i.e. on page 25 of the second public consultation document)?

Respondents generally welcomed a high degree of transparency. More specifically, they valued the publication of the suggested list of variables and saw it as enhancing the understanding of the underlying market that the interest benchmark seeks to measure.

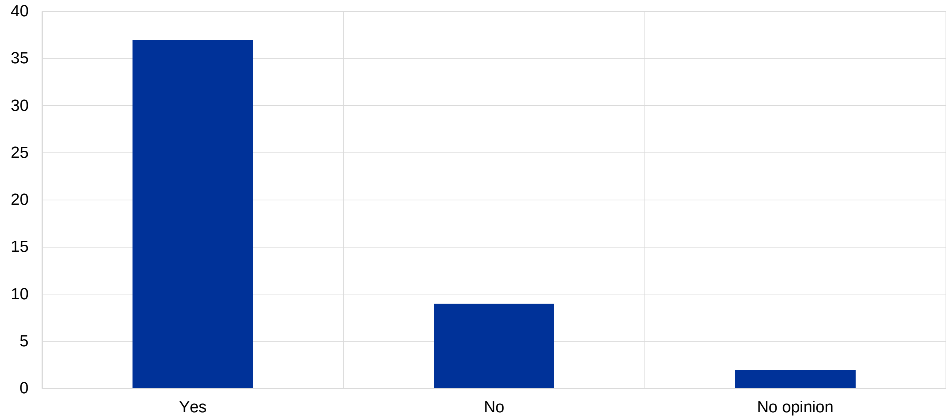
Some of the respondents, however, expressed concerns about confidentiality and market manipulation related, in particular, to the publication of the "*percentage of volumes reported by the five largest banks*" and "*number of banks reporting transactions before trimming*" items. These respondents expressed the view that the publication of these items might offer – in certain market configurations – asymmetrical visibility on the rate to be published the next day, especially to the five largest banks concerned. Some of these respondents therefore recommended not publishing the information at this stage but to review the usefulness of different items proposed for publication after a pre-specified period of time (e.g. after one year).

Chart 10

Respondents generally welcomed a high degree of transparency, although they also raised concerns about confidentiality and market manipulation related, in particular, to the publication of the "percentage of volumes reported by the five largest banks"

April 2018

(number of responses)



Source: ECB.

Do you think that correcting an already published rate would be necessary?

Respondents clearly stated that republication of a rate should be limited to serious errors of material impact and only if recalculation results in a significant difference (to be determined in advance, with some respondents suggesting a 2 to 3-basis point threshold) from the already fixed rate.

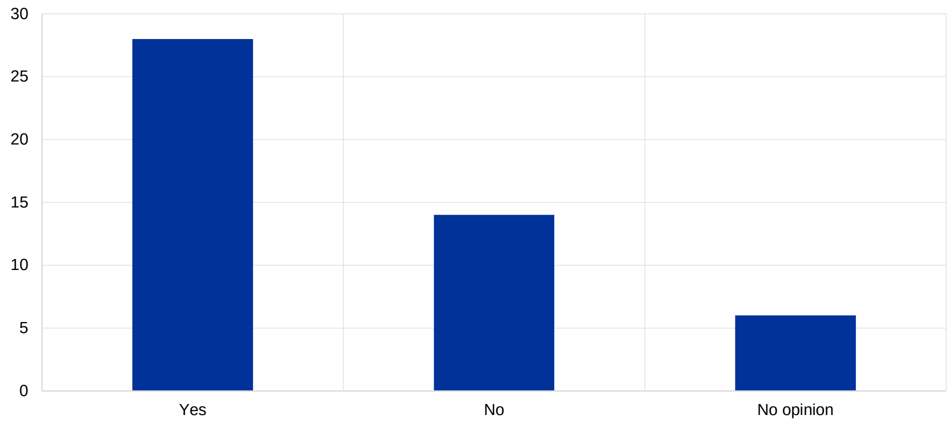
The respondents pointed to the operational burden of correcting transactions that referenced the rate, especially if settlement had already taken place. Respondents suggested republishing the rate within a 1 to 2-hour window.

Chart 11

Respondents saw merit in republishing a rate only if serious error resulted in a significant difference between the published rate and the recalculated rate

April 2018

(number of responses)



Source: ECB.

6 Rate publication

Do you regard the envisaged delayed publication of daily rate and volume data during the preparatory phase as sufficient in terms of its scope and the planned start date?

Respondents by and large considered the envisaged delayed publication of daily rate and volume data during the preparatory phase to be sufficient in terms of scope and planned start date.

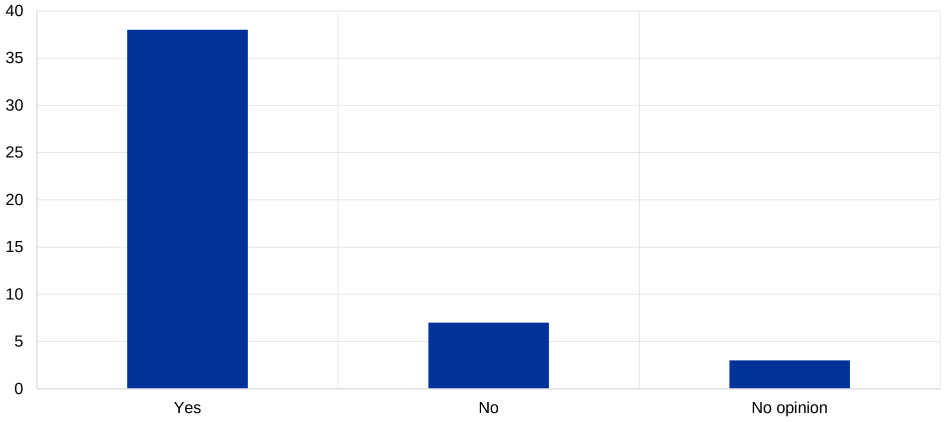
Respondents emphasised the need for the data to be based on the approved and published methodology. Releasing the data as early as possible, once the details of the final methodology had been approved, would ensure that market participants could familiarise themselves with the statistical properties of the new rate and provide them with the opportunity to adjust processes and procedures adequately for a seamless transition to the new rate.

Chart 12

Respondents viewed the envisaged publication of daily rate and volume data during the preparatory phase as sufficient in terms of scope and planned start date

April 2018

(number of responses)



Source: ECB.

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

High-level features or issues that respondents viewed as important to highlight fall into two broad categories: (i) transition issues and market preparation; and (ii) further methodological considerations.

1. Transition issues and market preparation

- **Launch date and name:** Respondents underlined the need for the ECB to communicate, as early as possible, the name and launch date of the new ECB reference rate to allow market participants to duly prepare for its publication. Respondents emphasised the value of continuous communication by the ECB, addressing all market participants.

- **Publication time:** A few respondents reiterated that publication of the new ECB reference rate at 09:00 (CET) on T+1 would impact internal operational and accounting processes; others expressed their preference for an earlier (preferably same day) publication time.

- **Transition:** Many respondents asked for particular consideration to be given to the potential legal and operational risks related to the transition from the old benchmark to the new rate in order to avoid disruptive, unjustified and speculative movements. Such risks might materialise from the synchronisation between different kinds of instrument. Respondents highlighted the need for the Working Group on Euro Risk-Free Rates to address such issues and to promptly come up with legal and operational solutions to guarantee a smooth management of the transition from the old rate to the new rate. Respondents frequently referred to a period of 6-12 months as sufficient for business to prepare for a smooth transition.

- **Hedging:** Respondents pointed to the need to account for the expected difference of 7-9 basis points between the EONIA and the new rate if the new rate were chosen as the new reference rate for the effectiveness of hedging and for trading portfolios.

- **Derivative market:** Respondents underscored that the development of a liquid derivative market for the rate would be a main driver in ensuring its usefulness and acceptance.

2. Methodology

- **Definition and scope:** Respondents asked for the definition of the new rate to be further refined or detailed, in particular highlighting in the definition text that the euro overnight funding costs would be unsecured and specifying the wholesale nature of transactions considered. Respondents moreover requested clarification of the coverage of transactions with central banks. They also called for consideration to be given to a wider base of reporting entities, representing at least the major institutions of each euro area country to ensure that the definition of the new rate truly "reflect[ed] the averaging borrowing costs of euro area banks".

- **Unsecured rate:** Respondents expressed their preference for an unsecured over a secured money market reference rate, given that it is more standardised, irrespective of the quality and legal framework of the underlying collateral, and more reflective of market liquidity for money market operators, especially in stressed market conditions. They also note that many users are currently applying unsecured reference rates for the management and valuation of their balance sheets.

- **Periodic methodological reviews:** Respondents saw the need to plan periodic reviews and adaptations of the methodology to ensure that the new benchmark remained representative and robust, also to avoid any negative impact in the index owing to future market conditions. Related to this point, it was also noted that given the focus of the consultation document on historical simulations, the risk of manipulation was not adequately taken into account. Reporting agents might strategically adapt their behaviour, thereby changing the statistical properties of the new ECB rate.