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EACB comments on the proposal to review the Benchmark Regulation (COM (2020) 337, 2020/0154 (COD))

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The EACB would like to provide its comments on the review of the Benchmark Regulation (COM (2020) 337, 2020/0154 (COD)), based on the following areas:-

1) Scope of the Delegated Act
2) Functioning of statutory power amendment in the Delegated Act
3) Proposed exemption of Spot Foreign Exchange Rate
4) Other issues beyond the amendments proposed in the Delegated Act

1) Scope of the Delegated Act

The first and most important issue from our members' point of view is the interpretation of scope of the proposed amendments.

As a first observation, the Explanatory Memorandum indicates that the aim of the proposal is to cover **all** LIBOR-referencing contracts that mature beyond 2021. However, the proposed draft amending regulation 2016/1011 is narrower in personal/material scope but also jurisdictional scope in that it only covers contractual agreements (i) falling within the scope of the BMR, and/or (ii) entered into with EU supervised entities in scope of the BMR. Therefore, it would appear that the following agreements and entities would be out of scope according to our interpretation:

(i) agreements governed by the **law of an EU member state**;
(ii) agreements under the **laws of a third country** where both parties are residing/established in the EU;
(iii) agreements regarded as **"tough legacy" contracts**, which actually covers most loans;
(iv) **wholesale loans** – whereas consumer loans that reference LIBOR are in scope it seems that the proposed amendments do not provide legal certainty in relation to business/wholesale loans that referenceLIBOR, since the scope of the BMR is limited to consumer loans. This means that national regulation may be required additionally for business/wholesale loans that reference LIBOR.

If the above interpretation is correct, the proposal also technically seems to cover these limitations by **urging Member States to apply complementary national initiatives to the statutory replacement tool** to prevent gaps which could impede the intended effect. In addition, the Explanatory Memorandum and recitals propose to **Member States to replicate the use of the EU statutory replacement rate in contracts between two parties which are non-supervised entities under BMR**. However, the recitals do not mention the fact that the recommendation would relate to contracts subject to national law and does not expressly address the issue of "tough legacy contracts" not covered by the BMR and/or agreements between non-supervised entities.

Second, the powers being proposed seem to apply to a cessation of a benchmark that would cause disruption to the EU financial markets in general, but then the Explanatory Memorandum focuses on the LIBOR cessation. We understand of course the critical urgency of the upcoming cessation of LIBOR but our members are concerned **that the proposed statutory replacement tool may not specifically provide for non-LIBOR benchmarks that already have agreed transition powers (e.g. EONIA) or for other types of IBOR replacements (e.g. in case of cessation of EURIBOR).**

Third, it is unclear even for the cessation of LIBOR itself **whether the scope of the statutory replacement rate would apply to one tenor**, e.g. 6m USD LIBOR but not to a different tenor (e.g. 2 month USD LIBOR); and

Fourth, the **proposal is not applicable to *"contracts concluded after entry into force of the implementing act designating the replacement rate"*** which means that it would become a real economical issue if the cessation of a benchmark is replaced by a statutory replacement rate, but the latter cannot be used for new contracts to the extent that novations, basis swaps, equal and off-setting trades and so on, cannot be executed. It may also be the case that a working group or central bank, for example, recommends a live benchmark as an alternative to the affected benchmark rather than a synthetic version of the affected benchmark. In this scenario, market participants must be able to continue to reference the live benchmark in new contracts.

In this context, we would like to list down some calls for clarification regarding scope:-

(i) There is a need of clarifying the scope of application of the statutory replacement rate: the proposed amendments should preferably be applied to all types of contracts and financial instruments beyond those subject to BMR. This approach would allow institutions to deal with the "tough legacy" contracts which de facto will be the most difficult to amend. We understand that another approach could be for the Member States to add complementary corrective measures through national legislation but this would be unsatisfactory for several reasons. It does not, for instance, address EU cross-border harmonisation, and so will not avoid discrepancies and competitive distortions within the EU – instead we risk ending up with an inconsistent patchwork. Second, there will be added complexity and inefficiency since the sources of the corrective measures will be this patchwork of EU and national provisions, requiring similar action by 27 national legislatures. Thirdly, on a purely practical level, as it will not be possible for member states to attempt their own national measures until the final scope of the EU level measures is settled, even this patchwork will be subject to further delay. For all these reasons, we consider this a much inferior alternative since the intended effect of providing legal certainty and avoiding potentially systemic risks can best be achieved via a concerted effort at EU level.

(ii) There is a need of a global and well-coordinated solution across jurisdictions: This is the only solution to avoid basis risk among currencies and tenors (the conversion powers should be exercised at the same time for all LIBOR currencies and tenors). And even so, there remains a risk of not completely erasing the basis risk. For instance, between (i) contracts subject to the statutory replacement rate and (ii) related transactions covered by suitable bilaterally agreed fallbacks (e.g. ISDA Protocol for hedging derivatives) in case the two fallbacks are not aligned. The UK has also recently announced that it will extend the transitional period for third-country benchmarks until year-end 2025. This would create an uneven playing field and would harm the competitiveness of EU firms;

(iii) There is a need of clarification regarding the application to contracts governed by EU and / or third country laws (UK, US): However, we note that the legal text refers to "all contracts" concluded by at least one supervised entity from which we may infer that the intention of the Commission is to cover all contracts concluded by at least one supervised entity notwithstanding the law governing such contracts. It should be clarified in the final amendments how this would work in practice considering litigation risks and situations where third country courts may not respect replacement benchmarks set by EU law;

(iv) There is need to clarify the powers in relation to non-LIBOR benchmarks: This should include how the statutory replacement in these cases will be determined, publicised and the timeline. In particular, we strongly believe that specific reference should be made that the statutory replacement for EONIA in legacy contracts is already established as €STR, and that €STR + 8.5bp spread is accepted as a replacement for "tough legacy contracts"; and

(v) Inclusion of scope of "new contracts": We are unsure if this is a linguistic inaccuracy or if the intention is truly that „new contracts" are <u>completely prohibited</u> from using the statutory replacement when a benchmark ceases to exist, but this should be clarified in any case. We thus propose clarification that new contracts would be able to use the EU statutory replacement rate following a change or cessation of a critical benchmark.

2) <u>Functioning of statutory power amendment in the Delegated Act</u>

(i) Clarity on trigger events

Apart from the above, much will depend on whether the Commission will indeed exercise its implementing powers and designate a replacement benchmark according to Art 23a BMR (new).

In this regard Art 23a BMR defines certain trigger events: According to Art 23a (1) BMR the Commission should exercise its implementing powers only in situations where it assesses that the cessation of a benchmark may result in negative consequences that produce *"significant disruption in the functioning of financial markets in the Union."*

It may be unclear whether the cessation of CHF-LIBOR for example, *"may result in significant disruption in the functioning of financial markets in the Union".* **Therefore, it should be clarified that a significant disruption in the functioning of financial markets in at least one Member State of the Union and/or the cessation of an indicator that is predominantly used as a reference benchmark in consumer loans (in a currency, in which the indicator is being published) in at least one Member State should lead to the designation of a replacement benchmark.**

When the Commission assesses whether these conditions are met, it should involve national competent authorities (NCAs).

Furthermore, if we use the same example of CHF-LIBOR in contrast to the current developments in the UK more issues arise. If CHF-LIBOR will continue to be published in the UK, none of the three alternative trigger events (foreseen in Art 23a (1) lit a - c BMR) would occur, although CHF-LIBOR would not fulfil the requirements of the BMR anymore.

Hence, this situation (CHF-LIBOR will continue to be published in the UK) should be considered in Art 23a (1) BMR. Situations, in which CHF-LIBOR will continue to be published in certain currencies, although not fulfilling the requirements of the BMR anymore, should be considered as a trigger event in the proposed Art 23a (1) BMR as well.

A practical clarification is also required regarding the trigger related to the public statement to be published by the competent authority for the benchmark at stake. In particular, it **should be clarified who will be the competent authority for LIBOR post-Brexit** (e.g. the FCA or an EU NCA competent for supervising the EU entity endorsing LIBOR).

(ii)Clarity on how the Commission will exercise its implementing powers

Furthermore, it is unclear how the Commission will exercise its implementing powers. Apart from references to certain working groups/committees, whose recommendations should be taken into account, there are no further specifications/determinations in the current proposal on how the Commission should exercise its implementing powers. We acknowledge that such a specification/determination is difficult to make. Nevertheless, the fact that further specifications/determinations on how the Commission should exercise its implementing powers are missing in the current text proposal could lead to unexpected results. For example, there could be a scenario where no solution is identified/recommended by the working groups. **In this case, the European Commission should have the power to recommend the statutory replacement rate, adjustment spread and its methodology, and how this decision could be taken in order to mitigate basis risks**.

Furthermore, it has to be considered that designating a replacement benchmark alone might not be enough. **The application method (for example *in advance* or *in arrears*) of the designated replacement benchmark has to be defined as well by the Commission – otherwise this would create further legal uncertainty**. Our understanding is that for the cessation of LIBOR, the European Commission does not intend to take into account methodology changes but rather base the statutory replacement on a forward-looking term rate that would be a "synthetic temporary" LIBOR similar to the synthetic EONIA until transition to €STR. This application method may cause least disruption for contracts based on LIBOR but might not be suitable for contracts referencing other benchmarks.

We propose the below practical way forward in this regard:-

- The designated replacement benchmark will (as already set out in the proposal) be based on industry-agreed replacement rates (which may include adjustments such as spreads) that are likely to be recommended by the risk-free rate working groups that have been convened by the central banks in several currency areas. But in cases of no consensus at working group level, **we are of the view that the Commission should be empowered not only to define the replacement benchmark but also its application method (if necessary due to different characteristics and currencies/tenors of the replacement benchmark);**

- **The risk-free rate working groups should be able to identify different statutory replacement rates depending on the product type, but the Commission should have the power to intervene in situations where the working groups do not give clear recommendations on which rates should be used for which products.** This is to avoid situations where parties can simply use their discretion on which rate to use. For example, for some products or ceased benchmarks we do not see useful the application of a "temporary synthetic" rate similar to what we understand will be proposed for LIBOR. Indeed a replacement in such cases would be based on a new benchmark accepted / used in the market and recommended by the relevant working groups (with any adjustments suggested by the working group which ensure that this statutory fallback resembles the benchmark it replaces economically as much as possible). On the other hand, there could be instances of statutory replacement that would be served better if a new methodology is applied for a still existing benchmark (e.g. hybrid EURIBOR) rather than a new benchmark mandatorily replacing the former. In this respect, we believe that **the Commission should clarify whether it will take into account any methodology changes made to LIBOR (and other IBORs, if possible) in determining the replacement rate.**

- **The Commission should allow stakeholders to react to the proposed alternative rate in the form of a public consultation** or, at the very least provide sufficient notice to market participants that it is about to trigger the automatic amendment process. In this vein, **we would appreciate clarification on when the statutory replacement would apply**. For example, for LIBOR would the trigger event be the cessation of any "synthetic LIBOR" being published or upon a pre-cessation trigger. The current trigger events are unclear in the current proposal.

- Replacements or mechanisms for replacements bilaterally agreed between the parties (including replacements or mechanism for replacements based on solutions developed for standard market documentations or introduced by protocols for such standard documentations, however, excluding general contractual provisions which are limited to calling for or requiring agreement between the parties) **will not be**

overwritten by / take precedence over such BMR statutory replacement. The relevant provisions in the Delegated Act introducing BMR statutory replacement would have to specify the types of contractual replacement provisions taking into account market practices and developments at the relevant time.; and

- Powers should be designated to the Commission **to account for the adjustment spread and other changes** in order to mitigate valuation transfer or for contract continuity.

(iii) **Definition of "suitable" fallbacks":** is not accurate enough and needs to be clarified ideally in Level 1 (Article 28(2)),to avoid potential litigation between counterparties. Page 12 of the Explanatory Memorandum gives some proposals of what is NOT considered a "suitable" fallback which includes: legacy contracts that contain no contractual fallback benchmarks; contracts that only have temporary fallbacks; and contracts that fallback to the last quoted fixing of the benchmark. However, it is uncertain whether impacted parties could agree to the above unless it is specifically determined by law. If this cannot be clarified, we would support that instead of "suitable fallback" the use of the following phrasing - *"contract that contains a fallback that does not contemplate permanent cessation"* - would make more sense especially in the context of the issues explained in sub-section (iv) below on the "opt-out" clause ('Optional use of the statutory replacement');and

(iv) **Optional use of the statutory replacement rate:** Page 12 of the Explanatory Memorandum further advises situations where counterparties could opt-in/opt-out of the statutory replacement rate but does not elaborate on this in the draft proposal. For example, the <u>statutory replacement tool is optional for private contracts with a fallback provision</u> (e.g. the numerous and diverse private contracts with retail clients involving EURIBOR). Our members from the Austrian banking industry have advised that in Austria there is a passage in most contracts which states that in the case when a benchmark is no longer announced, the credit institution shall fall back on the "economically closest rate". As contracts in Austria do contain contractual fallback benchmarks, the assumption is that Austrian banks could make optional use of the replacement rate, as it says in the table on page 12, whilst in other countries (with no fallback clauses), banks would have to mandatorily use the statutory replacement. Austrian experts are discussing at the moment whether the "economically closest" would be aligned with the statutory replacement rate at EU level but this is hard to determine. The issue of international consistency (especially USA, UK, CH, JP) is indeed pertinent in this regard.

Furthermore, fallback provisions differ very much from contract to contract. Our Spanish members indicate that there is a broad diversity of different „fallback rates" in retail contracts, in some cases involving old and not currently used benchmarks or,precisely due to the difficulty to find a suitable rate which could act as a fallback, simply stating that *"in the case when the benchmark [Euribor] disappears or becomes impossible to obtain, it will be applied the rate decided by the financial authorities as a substitute.".* It is clear then, that a cessation of a benchmark, even with a legal substitute, does not eliminate the uncertainty involved in thousands of contracts with retail clients, with different clauses and interpretations. Some of them would be covered by the proposed BMR modification, but some others will not. Therefore, we believe that the European Commission's proposal to issue recommendations for NCAS to establish national statutes mandating the use of the EU statutory replacement rate, should also cover contracts with fallback clauses already in place. It is also important that co-ordination between national markets and the capital market is ensured (i.e. revision of fallback standards under ISDA Master Agreement and ISDA 2016 Definitions), whereby the same fixed rate should be used for customer contracts as for hedging purposes in the interbank market).

(v) Increased obligations of supervised entities: We note that under the newly proposed Article 23a, the Commission obliges supervised entities to determine *"that the capability of that benchmark to measure the underlying market or economic reality cannot be restored through the exercise of any of the remedial powers referred to in Article 23"*. This is similar to the level of responsibility expected under Article 28(2) BMR which *"aims to ensure that supervised entities other than benchmark administrators are prepared for the cessation or material change of a benchmark".* In Article 28(2), supervised entities are expected to verify when a critical benchmark (as defined under Article 20 BMR) "materially changes" or "ceases to be provided". Whilst the verification of a critical benchmark that "materially changes" or "ceases to be provided" could to an extent be carried out by supervised entities, the same entities cannot possibly verify when the critical benchmark "ceases to be representative of its underlying market". By way of example, the contractual changes with respect to the transition from EURIBOR to EURIBOR with the hybrid methodology were developed by EMMI. EURIBOR measures the cost of wholesale funding of credit institutions in the unsecured euro money market. A supervised entity cannot reasonably verify if the hybrid EURIBOR represents its underlying market, neither does it have the data nor the capacities to assess the money market of eurozone Member States. Therefore, the EACB does not consider it feasible to expand Article 28(2) BMR to 'supervised entities' nor to introduce such similiar responsibility under the newly proposed Article 23a.

3) <u>Proposed exemption of Spot Foreign Exchange Rate</u>

The EACB considers the proposed spot FX rate exemption to be a helpful amendment to the BMR, but our members have nonetheless identified some issues in this regard:-

(i) Narrow scope: The relevant recital appears to limit the scope to "non-deliverable currency forwards and swaps". As these terms can be interpreted very narrowly this could mean that many other types of FX-transactions which face the same challenges may not be covered by the exemption. In addition, institutions will not be able to clearly delineate transactions which would be covered, and which would not be covered. We therefore suggest a broader/wider definition in order to avoid such difficulties; and

(ii) Determination of list of exempted rates: The envisaged solution may not be agile enough as the European Commission will have to set-up a list of the exempted third country foreign exchange rates (which can prove to take considerable time). In addition, some supervised entities will have to provide a report at least every 2 years on the use of these benchmarks, which will then be used in the European Commission review to check whether the exemption can still apply. The list of the third country foreign exchange rates used in non-deliverable forward (NDF) and non-deliverable swap (NDS) was already shared to the European Commission: INR, KRW, PHP, RUB, ARS, TWD, and KZT.

4) Other issues beyond the amendments proposed in the Delegated Act

We understand that the proposed Delegated Act is a sort of quick fix solution without consideration of the general BMR review mandated in the Regulation. However, many issues discussed in the December 2019 consultation still remain open. We strongly advise that the following points should also be included as amendments to the Delegated Act:-

(i) ESMA Benchmarks Register: Some of our members have experienced the following issues with the use of the ESMA Benchmarks register:

(a) search for EU benchmarks is difficult and the register does not include which benchmarks have been approved. This means there is no clear-cut avenue to find out if a specific benchmark is approved;
(b) it does not provide visibility of administrators who are pending approval, endorsement or registration as well as;
(c) withdrawal or suspension of authorisation/registration;
(d) there is no audit trail to track changes (i.e. removal of benchmark/ administrator) in the register; and
(e) the third-country register does not include benchmarks from jurisdictions which have been deemed applicable.

As we understand that the proposed review of the Benchmark Regulation not only serves as a quick fix but also replaces the regular review, we believe the opportunity of this review should be used to adjust the register to allow proper legally compliant use: (a) EU administrators should be required to enter its benchmarks in the register, (b) the register should flag those administrators who have applied but not yet been approved, (c) the register should flag those administrators which were withdrawn/suspended by the CA to reduce the risk of legal uncertainty, (d) removed administrators/benchmarks should not be deleted from the register but marked as removed, and (e) benchmarks from third-country which have been deemed applicable have to be added in the register.

A time stamp (date of approval, registration, withdrawal, suspension, removal, etc.) would be very helpful to have an audit trail for assessing transactions as BMR-compliant.

In addition, the ESMA Register could be upgraded by a "newsletter function" to inform registered market participants as soon as administrators/benchmarks are added to or deleted from the register to ensure a timely information to the market. Problems also arise concerning the search criteria, e.g. the distinction between "Supervising Authority" and "Relevant Authority" is unclear, and the sensible use of the function "Select criteria to add".

The user-friendliness of the register could be achieved by clarification/explanation of the meaning of these search criteria. In addition, an explanation should be attached to the overview of abbreviations. We would also strongly welcome a comprehensive benchmark specific register maintained by ESMA with common industry identifiers which is available to all to use in order to improve the transparency and availability of benchmark specific compliance data relevant. This would benefit all users of the benchmarks and help achieve the key objectives of the regulation to protect investors. This will improve the reliable use of the register;

(ii) **NCA powers**: Extension of the powers of NCAs would permit the use of non-compliant benchmarks in legacy contracts even in cases where the authorization is withdrawn, which is a mandate we support; and

(iii) **Clarification of definition of index:** The BMR describes an index as any figure that is published or "made available to the public" (i.e. accessible by a potentially indeterminate number of recipients), and is regularly determined. Clarification is still required on the definition of "made available to the public".

Contact:

The EACB trusts that its comments will be taken into account.

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