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Permanent Representation of the Italian Republic to the EU
The Presidency of the Council of the European Union

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Rapporteur
ECON Committee
European Parliament

25 September 2014

Dear Sirs,

Dear Madam,

Legal consequences of the introduction of a new index replacing the Euribor

As you are aware the European banking industry is currently studying the feasibility of eventually replacing the Euribor with a new transaction-based Euro benchmark, as the main reference rate for the euro unsecured money market.

The European Financial Markets Lawyers Group (EFMLG)¹ would like to contribute to the discussion of the legal consequences that the replacing of the current Euribor by a new index could have on financial instruments and contracts. The EFMLG has analysed this question from different perspectives and points of view, which are summarised below, and has reached the conclusion that the best option available to minimise the possible market impact and adverse legal consequences in the event that Euribor were to

¹ The EFMLG is an international group of senior lawyers acting on behalf of the major commercial banking institutions of the European Union. The EFMLG is committed to provide legal support to the historical task of achieving an integrated financial market in the European Union (EU). It aims to examine legislative and regulatory issues and differing market practices that hinder the full development of an EU-wide single financial market and to identify the major barriers. In that regard, it provides advice and recommendations and identifies best practices with the aim of facilitating harmonisation and convergence in EU financial markets.

be substituted by another benchmark, would be to adopt a regulation at European Union level, which would address this situation and would have widespread and uniform effects throughout the Union.

1. Current initiatives on financial benchmarks and indices

It is widely recognised that reference rates are critical to the functioning of financial markets. For this reason several initiatives have been undertaken both at public and private level in order to improve the accuracy, robustness and integrity of existing and future benchmarks and indices:

- At the public sector level, organizations responsible for setting standards, such as the European Securities Markets Authority (ESMA) and the European Banking Authority (EBA) (June 2013) and the International Organization of Securities Commissions (IOSCO) (July 2013) have established principles for setting benchmarks. These principles aim to mitigate governance and incentives issues relating to benchmarks provided by the private industry. This means that existing benchmarks or any future benchmarks must comply with such principles.
- The Financial Stability Board (FSB) was tasked by the G20 to undertake a fundamental review of major interest rate benchmarks. With this aim, the Official Sector Steering Group (OSSG) and the Market Participants Group (MPG) have been set up and have prepared recommendations on improving governance and processes for IBORs but also have done work to encourage the private sector to identify additional benchmark rates. In particular, the MPG analysed transition issues involved in the event of a move to an alternative rate- see in particular the FSB report of July 2014 and the MPG report of March 2014².
- At the private sector level, several initiatives have been launched to improve Euribor's governance. Contributors to the panel, its calculation agent and its administrator have undertaken certain measures, such as establishing protocols, signing Codes of Conduct and submitting their activities to verification by external auditors. These measures are periodically assessed by EBA and ESMA.
- Besides these initiatives, there is the broader effort at Union level to regulate benchmarks. The Commission's proposal for a Regulation on indexes used as benchmarks in financial instruments and financial contracts³ is currently being discussed in a Council working group at financial attachés level under the Italian Presidency ("proposed regulation") and the Council has recently issued a compromise proposal⁴. The EFMLG considers the proposed regulation could also serve to strengthen the legal robustness of any substitution of Euribor by another benchmark. We therefore hope that work on this important initiative is continued and that with the support of the new Commission, the Council can adopt a General Approach by end of this year so that the trilogue negotiations can then start.

² See MPG report of March 2014, section 5 p. 375 et seq. and also the final FSB report "Reforming Major Interest Rate Bench Marks" of 22 July 2014, section 2, p. 5.

³ COM (2013) 641/3.

⁴ See Council Presidency compromise text of 9 September 2014, file 2013/0314 (COD), 12983/14.

2. Towards a new index

The European industry, under the auspices of the Euribor-European Banking Federation (Euribor-EBF), now renamed as European Money Markets Institute (EMMI), and with the technical advice of the ECB in its role of catalyst of market initiatives, has conducted a number of exercises to ascertain the feasibility of a transaction based alternative to Euribor. This is in line with the IOSCO principles, which promote the concept of a benchmark linked to real transactions as well as by the FSB, which advocates the objective in its July 2014 report that reference rates should be based exclusively on actual transactions⁵. Depending on the result of the EMMI study and market feedback, a transaction based alternative may eventually replace the current Euribor.

We have been informed of progress being made in designing the technical features of a new index, and in particular of the methodology to calculate such benchmark. In accordance with its mandate the EFMLG has initiated an analysis of the legal consequences of the introduction of a new index to be used as a benchmark in transactions, financial instruments and contracts that use the Euribor as a benchmark.

In this context, given the wide-ranging implications of this project, the EFMLG considers that special attention should be paid to legal issues involved, especially if we bear in mind that the Euribor is used as a benchmark in millions of different types of transactions including bonds, deposits, financial instruments and derivatives, lending agreements of all types, ranging from loans to corporates, to student's loans, residential mortgages and other types of loans.

For the sake of legal certainty and in order to avoid the risk of financial instability, a smooth introduction of the new index is essential. An initial analysis of this question, suggests that there are two possible transition scenarios to be considered:

- (i) a 'big bang' type scenario or
- (ii) a scenario of progressive introduction of the new index with a transitional period in which the Euribor would co-exist with the new index.

However, some EFMLG members have expressed doubts about the viability of two co-existing benchmarks with identical aims. In any event, the introduction of the new index will require careful study and preparation from different perspectives (market considerations, legal issues, organization of contributions, reputational risks, etc). It is, therefore, essential that the changes are adequately communicated to stakeholders and the public at large, who should be also informed of the reasons for introduction of the new benchmark and the benefits from a public and financial stability perspective.

In addition, it would be desirable that contributors to the index do not face legal actions by the mere fact of being members of the Euribor panel once that it has been replaced by a more robust index. It should be recalled that, currently, and especially in the period that would precede the introduction of the new index, the contribution to the Euribor is considered by the European authorities crucial and necessary to ensure financial stability, and essential for maintaining the viability of transactions. Since the IBOR scandal was widely discussed in the course of 2012, the decline in the size of the Euribor panel from an

⁵ See Final FSB report "Reforming Major Interest Rate Benchmarks", 22 July 2014. See further section 3.1 below.

original of 44 panel contributors to currently 26 has triggered significant concern. This worrying development is partly due to litigation risk and legal uncertainty faced by the contributors. Future changes to a critical benchmark such as Euribor should aim to minimise these negative consequences and try to contain the negative effects on financial stability.

3. Legal issues

3.1 FSB and MPG recommendations on transition issues

The international banking community is fully cognizant of the need to minimize transition costs and risks – including legal risks - arising from the move towards transactions-based rates⁶. This is largely due to the work of FSB advisory groups like OSSG and MPG, including subgroups set up to cover each of the major currency areas, which have been examining transition related risks (see section 1). In particular, the MPG was tasked to identify viable alternative benchmarks to the current globally critical rates such as Libor and Euribor and to recommend potential transition paths.

The MPG's final report of March 2014 includes detailed findings and recommendations, which are partly based on legal reports for the euro area to which a special EFMLG task force contributed⁷. The outcome of the MPG's preliminary analysis was that "if the transition from EURIBOR to EURIBOR+ is considered as economically significant, transitioning to EURIBOR+ without any EU regulation, national legislation or/ and industry-wide solutions, like ISDA protocols, bears risks".⁸

Whilst this was a preliminary analysis only, EFMLG considers that the EU legislative bodies should be aware at this stage of the available legal options for minimising disruption to contracts that reference Euribor from any move to a transaction based rate.

3.2 Legal options to ensure continuity of contracts

It can be assumed that in any transition scenario it is very likely that the current Euribor is discontinued sooner or later. Therefore, if the introduction of the new index is not undertaken in a careful manner and backed by a sound legal construction, it could be the basis of legal disputes which could lead to high-scale litigation. The substitution of the Euribor by a new index raises the issue of continuity of contracts or legacy contracts, a question which has already arisen several times in the financial markets (i.e.

⁶ See Final FSB report "Reforming Major Interest Rate Benchmarks" of 22 July 2014, pages 12-13:

"in pursuing the objective of moving to transactions-based rates, transition risks and costs - which can include legal risks arising from litigation and contract frustration [or equivalent] - should be minimised as much as possible. However, whilst risks and costs arising from legacy contracts should not be ignored, they should not be used to prevent changes regarded as necessary from a systemic perspective. Authorities should work with and guide the private sector to seek to ensure that any costs arising from transition are borne in a proportionate way amongst market participants and should not unduly impact the real economy."

⁷ See the Market Participants Group on Reforming Interest Rate Benchmarks - EUR Currency Report -Legal Analysis on pages 375-6. The presented findings are subject to the reservation that a full legal research might result in different findings.

See: http://www.financialstabilityboard.org/publications/r_140722b.pdf

⁸ See bottom of page 375 of the MPG final report.

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substitution of local money market rates such as Fibor, Pibor, Mibor, etc for Euribor on the occasion of the introduction of the Euro).

In order to assess the legal implications of substituting Euribor, it is important to determine whether the new index replacing it is substantially the same or, if it is a wholly different benchmark. According to our information, it seems that the future benchmark aims at measuring the economic reality that had inspired the definition of Euribor – cost of funds for EU banks in the senior unsecured money market. However, adaptations are envisaged for the new index, which take account of the changes in the market since the inception of Euribor. Noticeably, Euribor reflects the rate at which Euro unsecured deposits are lent from one bank to another (interbank) while the new index envisages to broaden the concept to also include other sectors and represents the rate at which banks have borrowed on an unsecured basis in the wholesale euro money market. Thus, it has to be ascertained whether the continuity between benchmarks is of a sufficient degree to achieve the continuity of contracts which reference Euribor as their benchmark.

Regarding the transition from the current Euribor to the new benchmark, there are basically two policy options:

- **The first option** would be to provide a solution at regulatory level, ensuring the continuity between benchmarks. This solution would provide legal certainty to contractual relations, and would be transparent and uniform. However, and although it could be argued by some interested parties that such solution would be an intrusion in the freedom of contract of the parties, there are enough precedents of legislation providing similar solutions, as mentioned above. In addition, it is considered that the benefits of such a solution would overcome the inconveniences it may cause.

Within the regulatory solution it should be analysed whether legislation should be passed by each Member State or at the Union level, using the legal powers of the EU.

If the Euribor is to continue to be considered a critical benchmark for the euro and, therefore, systemically important, in order to protect the single currency's reputation of the euro and financial stability, it seems advisable that a solution to the transition issue should come from the Union and be uniform in its application. This type of solution would prevent fragmentation in the euro area and would also contribute to the process of building a single market in Europe. Finally, it would provide a benchmark for parties in third countries outside the Union that have entered into transactions using the Euribor as a reference or benchmark.

As far as the appropriate Union legal instrument to be used is concerned, the EFLMG considers that the proposed regulation could be a good opportunity to address the issue of the continuity between critical benchmarks.

We note that the proposed regulation currently does not directly address the issue of continuity of contracts resulting *per se* from changes to a benchmark and its methodology. It does however include *transitional provisions* (Article 39) under which, in circumstances where an existing benchmark does not meet the requirements of the proposed regulation but changing it to conform with the regulation would result in frustration, force majeure or otherwise breach the term of any

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financial instrument or contract referencing that index, such existing benchmark may continue to be used “*until such time as the benchmark references financial instruments and contracts worth no more than 5% by value of the financial instruments and contracts that referenced this benchmark at the time of entry into force of the regulation.*”⁹

Such a transitional regime assumes that the benchmark continues to be produced as it is allows the use of the benchmark which is not compliant with the regulation until the time when no more than 5% are referenced. This is however an unlikely scenario in the case of a transition of Euribor to a new index. First, the two indices would likely not be produced in tandem for any prolonged period of time (or even at all). Second, for the value of the Euribor referenced contracts to decline to less than 5% will take many years given the large amount of loan mortgages that use this rate as a benchmark.

Furthermore, the envisaged wording of Article 39 applies to benchmarks which would not be in line with the Regulation and it is questionable whether Euribor would not be considered to be in line. However, if an existing benchmark were to be compulsorily withdrawn due to non-compliance with the regulation - for example after the value of the instruments or contracts to which the benchmark refers had declined to the 5% threshold - there is a risk that legacy contracts could be considered as frustrated (or equivalent) by this change in circumstances, Such situation would cause uncertainty not just in the market for the relevant instrument but also in other markets using the benchmark¹⁰. We also consider that the currently proposed equivalence requirement for third countries from which administrators provide benchmarks into the Union¹¹ carries risks to the continuity of contracts, which refer to such benchmarks in the event that the third country legal system is not granted equivalence by the Commission and the parties want to withdraw from the instrument or contract as a result. Currently, many of the financial benchmarks that are widely used in the Union are provided from jurisdictions with no regulation or no regulation of the kind envisaged by the Union.

Additionally, to ensure the proposed regulation for continuity between critical benchmarks will be globally effective, it should also address the continuity of contracts governed by a third country law – particularly the law of jurisdictions with globally important financial markets (e.g. New York State). To achieve legal certainty, such third country jurisdictions should be encouraged to adopt supporting legislation. It should however be acknowledges that this is unlikely to occur before the Union itself adopts legislation in this area.

Given the above, in our view the proposed Article 39 does not include techniques that sufficiently address the issue of transition of a given benchmark and the resulting questions relating to the continuity of contracts.

⁹ Title VIII, Article 39 (4), of the draft regulation, COM (2013) 641/3. We note the Presidency compromise proposal of 9 September 2014 also includes such provision, extending its application to benchmarks provided by administrators located in non EU countries that are used by supervised entities in the Union and for which the Commission has not issued a decision that (inter alia) the legal and regulatory practice of that third country, are equivalent to those of the regulation.

¹⁰ See also FMLC Paper, Issue 177 – Benchmark Reform, of March 2014, Section 5 on the 5% threshold under Article 39(4) if the proposed regulation.

¹¹ Article 20 and 39(5) of the Presidency compromise text.

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- **The second option** would be to take no action at regulatory level, so that public authorities would not adopt any regulation on this matter. Thus the issue would be lie at a purely private level, to be solved either by novating the agreements between parties. In the absence of agreement between the parties to such novation, fall-back provisions of the instrument or contracts referencing the Euribor would be triggered and the substitutes for the Euribor would be applied. This scenario could pose several problems, which can be very different in nature:
- (i) In a large number of agreements, the fall-back provisions require the parties to ask for quotes from reference Banks; if this is to be done in hundreds of thousands of contracts at the same time, it could turn impracticable. In this context, and as the Lehman Brothers bankruptcy showed, asking for a high volume of quotations for the same products at the same time, affects the quotations obtained, and do not reflect the “real market value” of the product.
 - (ii) In some contracts fall back solutions are clearly unrealistic and burdensome for one of the parties.
 - (iii) In many agreements Euribor is already being applied by operation of a fall-back provision, there being no further fall-back provisions to be applied.
 - (iv) Finally, many agreements do not provide for fall-back provisions.

On the other hand, some market associations sponsoring Master Agreements, specially covering Derivatives and Repos, could probably contribute to achieve a solution to the problem of substitution of the Euribor benchmark. However, any solution forwarded by them would be very limited in scope and not applicable to other financial contracts and financial instruments. In any event, opening a process of renegotiation of thousands of agreements in a wide variety of financial transactions involving market counterparties, institutional investors, corporates and consumers, does not seem viable or even advisable.

In this situation and given the lack of adequate contractual provisions or the inappropriateness of the foreseeable solutions, large-scale litigation cannot be ruled out. Such litigation could be initiated, not only by individuals and companies (financial institutions and corporates), but also by consumers and consumer associations. The outcome of litigation involving the enforcement of rights arising from the type of agreements to which we have referred above, could differ from case to case, and therefore, solutions would be asymmetric, not only in different Member States, but also within the same jurisdiction, and then again they may differ depending on the kind of end-user of the benchmark.

Given the above, under this scenario the solutions to the legal problems of substituting the Euribor as a benchmark, could be costly and burdensome and the problems that would be created could lead to financial instability and could potentially have an adverse impact on the reputation of the euro.

In summary, considering the issues involved and the options forwarded in this letter, the EFMLG is of the opinion that the best option available to minimise the impact and the adverse legal consequences of the substitution of the Euribor as a benchmark, would be to undertake a legislative solution at European Union level, with widespread and uniform effects.

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3.3 Legal basis for EU instrument

Finally, in order to contribute to the discussion and study of this matter, a brief analysis of the legal basis for the design of a legal act addressing the issue of the substitution of the Euribor by a new index is of importance.

In our opinion, Article 114 TFEU would have been an appropriate legal basis for the approximation of national laws with regard to the transition to a new index. This is so because there is clearly a need for action at the Union level, in order to avoid inconsistencies that may have significant cross-border effects. As the introduction of a new index poses a threat to the orderly functioning and integrity of financial markets or to the stability of the financial system in the European Union, a clear and coherent answer to 'Euribor+' seems to both necessary and proportionate.

We hope that the reflections herein contained are useful to you. The EFMLG remains at the disposal of your institutions to continue contributing to the discussion that we hope will lead to a satisfactory and efficient solution to the issue of the substitution of the Euribor by a new index.

Yours faithfully,

[signed]

Holger Hartenfels

The Vice-Chair

Cc: SCHEUREN Marcus, ECON Secretariat