

- THE VICE-CHAIRMAN -

Mr. Olivier Guersent
Director-General
Directorate-General for Financial Stability,
Financial Services and Capital Markets Union
European Commission
1049 Bruxelles/Brussel
Belgium

16 October 2018

Dear Mr. Guersent,

European Benchmark Regulation. Transition-related issues

The European Financial Markets Lawyers Group (EFMLG)¹ would like to express concerns as to calendar constraints especially in light of recent developments on the reforms to interbank offered rates (IBORs) (i.e. the European Benchmark Regulation (BMR)²).

As you probably know, the EFMLG has addressed the European Commission and the European Money Markets Institute (EMMI) in the past³, to highlight concerns on the future of critical benchmarks and particularly to emphasize the legal risks that may arise as regards to transitioning to the new risk free rates. Our concern was, and still is, to ensure contract continuity in order to avoid market disruptions while ensuring financial stability.

Because Euro OverNight Index Average (EONIA)⁴ and Euro Interbank Offered Rate (EURIBOR)⁵ are benchmarks of systemic importance for financial stability, they were

¹ The European Financial Market Lawyers Group is a group of senior legal experts from the EU banking sector dedicated to making analysis and undertaking initiatives intended to foster the harmonisation of laws and market practices and facilitate the integration of financial markets in Europe. The members of the Group are selected amongst lawyers of major credit institutions based in the EU active in the European financial markets. The Group is hosted by the Legal Services of the European Central Bank.

² Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 (OJ L 171, 29.6.2016, p. 1).

³ Letter of 25 September 2014 on the legal consequences of the introduction of a new index replacing the EURIBOR.

⁴ Commission Implementing Regulation (EU) 2017/2446 of 19 December 2017 amending Implementing Regulation (EU) 2016/1368 establishing a list of critical benchmarks used in financial markets pursuant to Regulation (EU) 2016/1011 of the European Parliament and of the Council (OJ L 346, 28.12.2017 p. 1).

declared critical under BMR and must undergo changes in order to comply with the authorization deadline of 1 January 2020 (Article 51 of the BMR).

The issues arising in both benchmarks present different legal difficulties that need to be addressed accordingly. For EURIBOR the key question is how to ensure that a change in methodology does not jeopardise contractual certainty and continuity. And as to EONIA, the concern remains how to ensure a smooth transition from a benchmark that will no longer exist to the newly developed Euro Short-Term Rate (ESTER), which will be administered by the European Central Bank.

We strongly believe that in both cases a statutory intervention using an already existing vehicle (BMR) would be necessary or at least very helpful in ensuring a seamless transition that would reduce contractual and legal issues for all market actors as well as for end users.

EONIA. EMMI's decision not to reform EONIA to make it BMR compliant means that as of 1 January 2020 it will not be possible to use EONIA in new contracts. Whereas non-applicability to new contracts is clear, the ongoing calculation and publication of this benchmark for legacy contracts has yet to be decided by the competent authority (Article 54(1) of the BMR). Banks and other market participants consequently face multiple scenarios and variables.

The ECB's Governing Council has developed ESTER that will complement existing benchmark rates produced by the private sector and will serve as the alternative rate to EONIA. Whilst it is a substantial accomplishment, it remains that the legal mechanism that will ensure the effective and least disruptive succession of EONIA by ESTER has yet to be developed.

EURIBOR. EMMI, as Administrator of EURIBOR, is currently reforming the benchmark's methodology to make it BMR compliant by shifting to the so-called hybrid methodology; which would allow for calculation based, in priority, on actual transactions. The adaptation of the methodology of a benchmark to render it BMR-compliant is subject to supervision and validation by public authorities. The presence of the national competent authorities in this process should presumably grant suitable coverage for benchmark changes and contribute to the continuity of such benchmark. For this reason legal certainty should be ensured to the extent the relevant authorization is granted in time to allow market contributors to perform the necessary operational and regulatory adjustment.

However, concerns arise as regards contractual parties and consumer protection, where relevant, if authorities involved in the validation of the methodology determine that the benchmark has materially changed.

Indeed, the responsible national competent authority, with the assistance of the college established per Article 46 of the BMR, should determine if EURIBOR still measures the same market reality before and after the changes to the methodology. The relevant assessment must be made as to whether EURIBOR remains materially the same in spite of

⁵ Commission Implementing Regulation (EU) 2016/1368 of 11 August 2016 establishing a list of critical benchmarks used in financial markets pursuant to Regulation (EU) 2016/1011 of the European Parliament and of the Council (OJ L 217, 12.8.2016 p. 1).

the changes to its methodology or if, conversely, the changes are of such magnitude that they result in the creation of a new benchmark. In the case of a new benchmark transition issues similar to the issues related to EONIA would need to be considered and addressed within organizations.

Alternatively, in light of Article 51(6) of the BMR, the Commission, using the powers granted to adopt delegated acts in accordance with Article 49 of the BMR, could give the competent authority the role of determining, in the event of modification or cessation of a benchmark, whether the identity of such benchmark remains the same or not. The relevant national authority would be also entitled to specify which changes to a benchmark would not constitute force majeure, frustration or breach of financial contracts or instruments, thus confirming that those changes do not affect the continuity of such contracts or instruments.

Another concern is the EURIBOR panel membership, which has declined from the original 45 to the present 20. The lack of symmetry between EURIBOR contributors and end users is a subject of interest, which deserves closer attention by the competent authorities. Preserving panel stability, most importantly in the case of critical benchmarks, is one of the key conditions for the smooth and reliable operation of a reference rate. The question we would like to raise is what measures, other than requiring the mandatory contributions set out in Article 23 of the BMR, can be adopted by the official sector to build a much more broadly based panel of banks

Timing considerations. Currently, the BMR transition period ends on 31 December 2019. This timing constraint leads to a situation where there is no leeway to handle unexpected delays and operational uncertainties. Emphatically, having sufficient time to formulate viable alternatives and fallbacks is essential. Therefore, the 31 December 2019 deadline is too tight, and merits a review by legislators, regulators and the official sector. It further puts market contributors and supervisory authorities at risk especially where the required authorization for EURIBOR is not issued. If EURIBOR is not BMR compliant at the end of the transition period, actors would no longer be allowed to reference EURIBOR in new contracts.

For the market to effectively transition to ESTER after its first publication in the second half of 2019 there needs to be a liquid derivative market based on ESTER. Concerns as to obtaining a liquid derivative market in less than three months are warranted in this instance. In addition banks and other market participants should receive daily information on ESTER behavior patterns to understand the potential of this new rate and how it works. The development of a term structure based on a new overnight reference rate, which may be required for cash transactions, will also take time. Moreover, we refer to the high-level implementation plan prepared by the Working Group on euro risk-free rates and posted on the European Central Bank's website, which also highlights these concerns, requests the corresponding legislative adjustments and provides additional detail in those regards⁶.

For these reasons, the EFMLG respectfully urges the European Commission to consider the adoption of the following proposals:

⁶ https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/shared/pdf/20180913/Item_3_High_level_implementation_plan.pdf

- (i) A minimum two year extension of the BMR transition period for critical benchmarks, thus extending the term for permitted use of those benchmarks (this extension would align the BMR with other international initiatives on benchmark reform). This would prove an adequate step towards allowing for smooth transition, and
- (ii) Appropriate legislative action at European level to ensure a smooth transition, which would reduce contractual and legal issues and safeguard the continuity of contracts, in the sense of the considerations made above.

We remain at your disposal for any assistance or support you may need on this matter. Please keep the EFMLG informed on the above questions.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Holger Hartenfels', is written over the typed name.

Holger Hartenfels

Vice-Chairman