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EXPLANATORY MEMORANDUM ON MPG REPORT

To EMMI

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Subject **The different transition paths for EURIBOR**

This memorandum will set out the four possible transition paths for benchmarks and summarize why the seamless transition path is favoured by EMMI.

This document is not a standalone memorandum. It is intended to be an explanatory text to the Final Report of the Market Participants Group Report on Reforming Interest Rate Benchmarks published in March 2014 (**MPG Report**). The Market Participants Group made an in-depth study of the different transition paths and their respective advantages and disadvantages. The pages referred to in this memo are the pages of the MPG Report

1. FOUR POSSIBLE TRANSITION PATHS

The MPG Report identified four different transition paths: Seamless Transition, Successor Rate Transition, Market-Led Transition and Parallel with Cut-Over Transition. The first two transition types are Type I transitions (i.e. transitions to another IBOR). The last two transition types are Type II transitions (transitions to benchmarks that are materially different from an IBOR).

The Seamless Transition is a transition where changes are made to the methodology of the existing benchmark but where the definition, value and volatility of the IBOR-benchmark remain similar after the changes are made.

The Successor Rate Transition is a transition where, after a long lead-in period, the publication of the existing benchmark would cease and the next day the successor benchmark would be published.

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The Market-Led Transition refers to a transition where the parties voluntarily transfer to a newly introduced benchmark.

The Parallel with Cut-Over Transition refers to a transition where the new benchmark for a certain period would run in parallel with the existing benchmark before the forced final transition towards the new benchmark.

These four transition paths are described in detail on pages 40-45 of the MPG Report.

2. STRONG PREFERENCE FOR SEAMLESS TRANSITION

It is clear from the MPG Report that there exists a nearly unanimous preference for the Seamless Transition path if it is available. The reasons for this preference are set out in detail on pages 42-45, 47, 48, 50-52, 54, 58 and 68-70 of the MPG report.

The main reason is that Seamless Transition is the most efficient possible transition because it requires the least amount of transition measures and because it is the least risky from a legal/accounting point of view.

From a legal point of view, the contract frustration risk is more limited under the Seamless Transition path. The existing features of the benchmark, which are incorporated into market standard terms and legacy contracts will be retained under this transition path (p. 70). Several general agreements like ISDA or LMA do not contain detailed provisions relating to the applied calculation methodologies. These agreements often quote EURIBOR as a so-called screen rate, i.e. the reference in financial instruments and contracts to the EURIBOR are made by reference to certain screen pages, such as the respective Reuters page EURIBOR01 where the EURIBOR fixing is published (p. 377). This increases the chance that from a legal point of view the reference to EURIBOR in the existing contracts will be understood to refer to the revised benchmark as well because well because the transition is considered to be a methodological change instead of a distinct index (p. 58).

The main disadvantage of Successor Rate Transition is that, because of the different way in which different legal systems may handle the implementation of the successor rate in existing contracts, legislation would be required in order to avoid contract frustration and obtain legal certainty. For the EURIBOR, this would require legislation at the European level, which will be difficult to obtain. Implementing Successor Rate Transition will also require synchronisation on a global scale (across currencies, products and instruments) to avoid disruption to cash flows and failure of hedges, which will also be extremely challenging to implement (see p.47 transition timing).

The main drawbacks to the Market-Led Transition are inertia in moving to the new benchmark and bifurcated liquidity between contracts referring to the existing benchmark and contracts referring to the new benchmark. The existing benchmark would also need to run for a long time until discontinuation no longer represents a systemic risk. This will require the banks to contribute for a long time to the existing EURIBOR (with the associated risks, see A&O liability advice). There will also be significant accounting and tax issues (see p. 50).

The Parallel with Cut-Over Transition may lessen the inertia risk of a Market-Led Transition, but the risk of bifurcated liquidity between contracts referring to the existing benchmark and contracts referring to the new benchmark remains. Moreover, the same legal problem as for Successor Rate

Transition may also apply here. Finally, the MPG report mentions that running benchmarks in parallel may create problems with tax and accounting (see p. 50), portfolio management and corporate treasury systems.

Given that Seamless Transition is the preferred transition path, it is advisable from a legal point to first try to transition EURIBOR using Seamless Transition. Only if it is not feasible to use this transition path can other transition paths be considered.

In order for a Seamless Transition to be feasible, the definition, value and volatility of the benchmark should remain similar after the changes in the methodology are implemented.

As set out in the Consultative Paper on the evolution of EURIBOR, EMMI states that the Underlying Interest (what the benchmark seeks to measure) of EURIBOR has not changed (even though the text of the definition of the EURIBOR has changed). The goal of this clarification in the definition is however to define the Underlying Interest more explicitly. If the Underlying Interest has not changed, the condition that the definition of the new benchmark should be similar to the definition of the existing benchmark will in our view be fulfilled.

The value and the volatility of the benchmark should remain similar after the changes in the methodology are implemented. This will be tested during the pre-live verification phase and it is only at that point that it can be determined with certainty whether the Seamless Transition path is feasible for the new EURIBOR methodology.

When interpreting the results of the pre-live verification exercise, the MPG Report mentions that even if there is a material difference, in some situations a case could be made that the new rate is more representative of the intended legal definition of the benchmark (p. 42). The MPG Report also suggests that in order to mitigate the risks of conversion, the benchmark administrator and official sector might consider steps that could promote convergence of the two indices in the run up to conversion. For example, during the notice period the administrator could collect and publish inputs used in the new calculation methodology. Contributing banks could then be encouraged to use this data to refine their own EURIBOR submissions. The objective would be to align the existing EURIBOR and the new EURIBOR-methodology fixings as closely as possible, or at least for any basis to be readily understood and predictable (p. 59).

3. WHY IS SEAMLESS TRANSITION NOT ADDRESSED IN THE EURO CURRENCY REPORT?

The MPG report consists of a general chapter called “Cross Currency Summary” and chapters for specific currencies. In the Euro currency chapter of the MPG report, the Seamless Transition path is not dealt with in detail. Instead this chapter focuses on the Successor Rate Transition and the Parallel with Cut-over Transition. The reason is that it was assumed that significant methodological changes would be made to the existing EURIBOR and that the rate itself might be fundamentally altered, affecting the economic equivalence of the parties (p.72). Therefore, the Seamless Transition path was deemed infeasible and less attention was paid to it (even though the Euro group also recognized that the Seamless Transition path is the most efficient and riskless possible transition path: p. 364 and 370).

At the moment the MPG Report was being drafted, EMMI was focused on developing a transaction-based methodology to bring EURIBOR in line with regulatory recommendations. Upon

the publication of the MPG report, EMMI looked more closely into the different possible transition paths. On the basis of the MPG Report EMMI came to the conclusion that the Seamless Transition was the most efficient possible transition path for EURIBOR. It should also be noted that other benchmark administrators are also targeting a Seamless Transition to adapt their benchmarks (for example ICE).

EMMI considers that the proposed changes to the EURIBOR-methodology will not fundamentally alter the rate itself and consequently, the economic equivalence of the parties will not necessarily be affected by the proposed changes. For the sake of clarity, EMMI proposes to distinguish the Underlying Interest (what the benchmark intends to measure) from the determination methodology (how this will be measured) of the EURIBOR benchmark. While indeed changes to the determination methodology will be undertaken, we understand that the Underlying Interest will not undergo any change. Since the Underlying Interest of EURIBOR will remain unchanged, the Seamless Transition path is feasible for EURIBOR, subject to a positive outcome of the pre-live verification exercise.