ALLEN & OVERY

Legal Working Group

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Agenda

1 Transition

Seamless transition vs. other transition paths

EMMI's stakeholders outreach programme

2 Regulatory Backing for Transition

Description of efforts made by EMMI to obtain regulatory backing

FSMA supervision process

Discussion of further potential initiatives regarding regulatory backing

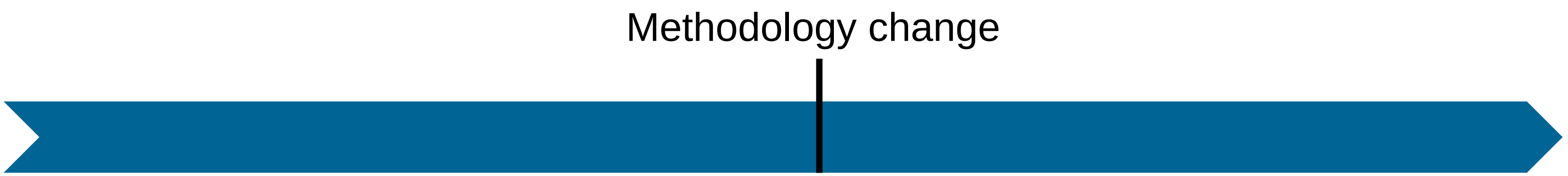
Agenda

Transition

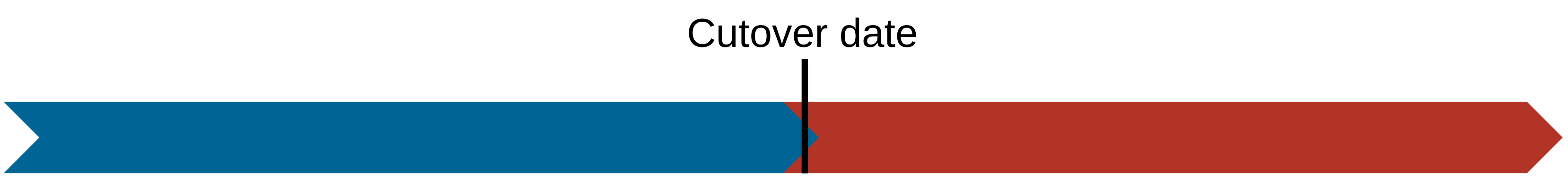
Transition types (1/2)

Type I transitions

1. Seamless transition



2. Successor rate

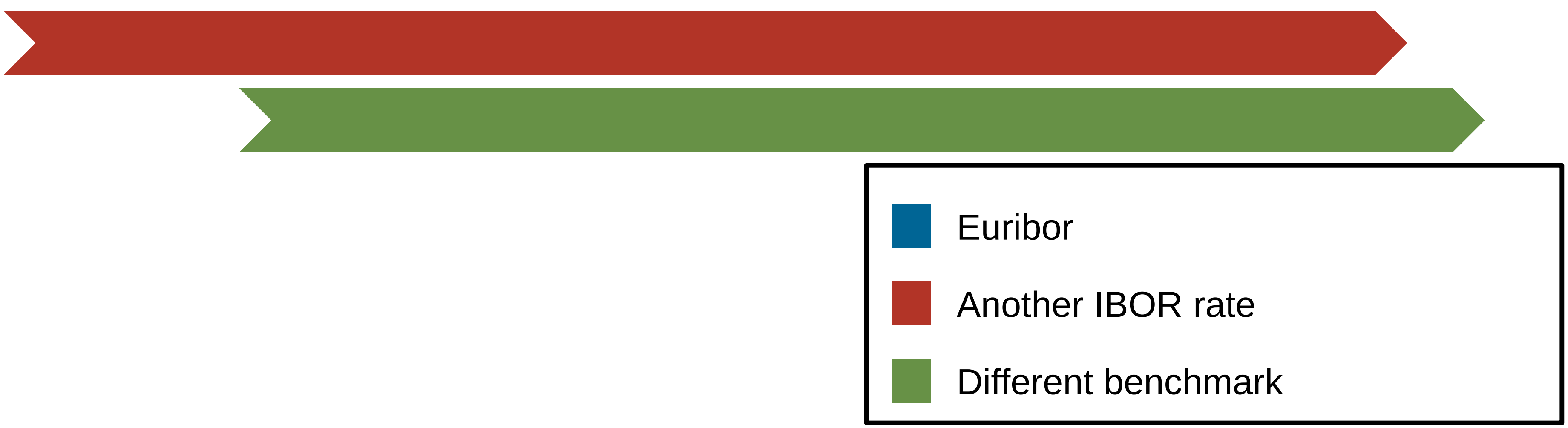


Transition types (2/2)

Type II transition

3. Parallel with Cut-Over

4. Market led transition



Successor Rate Transition

- Risky from legal point of view:
  - Assumption that courts would rule that the parties had entered into contracts with a view to preserve legal continuity, therefore the new reference rate can be deemed an implicit successor rate for the discontinued IBOR
  - This assumption is unlikely to be upheld in all European legal systems
  - EU legislation would be required to enhance legal certainty for this transition path → EU Benchmark Regulation does not contain any provisions
- Practical obstacles (synchronisation on a global scale)

Parallel with Cut-Over

- Legal risk
  - Similar to Successor Rate Transition at the Cut-Over Date
  - Enhancing legal certainty will require legislation
- Practical issues
  - Bifurcated liquidity between contracts referencing the legacy benchmark and contracts referencing the new benchmark
  - Running benchmarks in parallel may create complications for tax, accounting, portfolio management and corporate treasury systems
  - Huge number of outstanding agreements

Market-led Transition

- Main issues are practical
  - Huge number of outstanding agreements
  - Inertia in moving to new benchmark
  - Bifurcated liquidity between contracts referencing the legacy benchmark and contracts referencing the new benchmark
  - Running benchmarks in parallel may create tax, accounting, portfolio management and corporate treasury systems

- From a legal point of view, parties are in principle free to change interest rates in their agreement
  - For some products special rules may apply: changing securitised and structured credit notes may require supermajority of noteholders
  - Panel Banks need to continue the legacy benchmark until no more systemic risk

Seamless Transition

- Widely seen as the most efficient transition path

- Least amount of legal risk:
  - Interpreting the will of the parties: many agreements do not contain detailed provisions on methodology (ISDA and LMA refer to screen rate; others simply state Euribor)
  - If the definition (Underlying Interest) / rate / volatility remain similar, it increases the chance that the reference to the existing benchmark will be understood to refer to the revised benchmark
  - Contract frustration is less likely

- Practical:
  - Least amount of transaction measures required

Seamless Transition

- Three Conditions:
  - Similarity of definition
  - Similarity of rate
  - Similarity of volatility

- Similarity of definition:
  - Current definition of Euribor: *Euribor® is the rate at which Euro interbank term deposits are being offered within the EMU zone by one prime bank to another at 11.00 a.m. Brussels time*
  - New definition of Underlying Interest: *the rate at which banks of sound financial standing could borrow funds in the EU and EFTA countries in the wholesale, unsecured money markets in Euro*

Seamless Transition

– Similarity of rate and volatility:

  – To be checked during the pre-live verification process

  – "*if there is a material difference, in some situations a case could be made that the proposed rate is actually more representative of the intended legal definition of the benchmark than that provided by the legacy fixing*" (MPG, p. 42)

  – "*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 IBOR+ calculation methodology. Contributing banks could then be encouraged to use this data to refine their own IBOR submissions. The objective would be to align IBOR and IBOR+ fixings as closely as possible, or at least for any basis to be readily understood and predictable*" (MPG p. 59)

Seamless Transition

- The EURO chapter of the MPG Report did not consider the Seamless Transition because:
  - (unproven) Assumption of significant methodological changes and fundamentally altered rate, affecting the economic equivalence of the parties
  - Benchmark Regulation was still in the drafting stage

EMMI stakeholders outreach programme

- ✓ As part of its consultation programme on a transaction-based methodology for Euribor (i.e. Euribor+ project), EMMI has organized **since 2014** workshops with Panel Banks and end-users to consult on and present the transaction-based methodology.
- ✓ On **30 October 2015**, EMMI published its *"Consultative Position Paper on the Evolution of Euribor"* outlining EMMI's proposals for the **reform of the determination methodology for Euribor**, as well as EMMI's planning for a **Seamless Transition** to a transaction-based Euribor. Distributed widely to all Euribor stakeholders, including market participants, financial services regulators, benchmark users and other interested parties.
- ✓ Accompanied of **National Roundtable meetings** in key Euribor constituencies (Finland, Portugal, Germany, the United States, France, Spain, Italy, the United Kingdom, and Brussels – for stakeholders from the BeNeLux).
- ✓ Stakeholders were generally supportive of EMMI's proposal for the overall design of a transaction-based determination methodology and its transition strategy.

EMMI stakeholders outreach programme

- As determined on the MPG Report, *"[i]n order to be successful, a major benchmark transition will require the support and coordination of leading market participants, financial services industry organizations, legal associations, and a range of official sector entities. A broadly coordinated approach is essential to avoid significant disruption and to promote wide market adoption of alternative benchmarks."*
- EMMI is planning to **intensify its communication program to raise stakeholder awareness and enhance support from public authorities**
  - **Current Panel Banks**
  - **Prospective Panel Banks**
  - **Regulators (ESMA, IOSCO, FSB, EBA...)**
  - **ECB and National Central Banks**
  - **Legal Groups (i.e. EFLMG)**
  - **ISDA**
  - **End user associations at both European and national levels**

Regulatory backing for transition

Efforts made by EMMI to obtain regulatory backing 1/2

- ✓ **Since 2012**, EMMI has been continuously raising awareness of public authorities and other stakeholders with regard to the vulnerability of the Euribor panel and the threats to the benchmarks' continuity.
- ✓ Among other things, EMMI repeatedly wrote letters to the CEOs of panel banks, to the ECB, to some national authorities (e.g. BaFIN), to EBA and ESMA, to the European Commission and to IOSCO to request public authorities to further encourage panel banks to stay in the euribor panel for the sake of the continuity of the panel.
- ✓ EMMI supported the EFMLG letter sent to the European Commission, the Council Presidency and the European Parliament in **September 2014** raising the legal consequences of transition without any public intervention.
- ✓ In its position paper on the EC's Proposal for a Regulation on Indices used as Benchmarks in financial instruments and financial contracts published in **October 2014**, EMMI raised its concerns with regard to legal implications of transition and called for public intervention.

Efforts made by EMMI to obtain regulatory backing 2/2

- ✓ **From 2013 to September2015**, EMMI has repeatedly reached out to the European Parliament, the European Commission and the Council to call for a European legislative act or guidelines issued by public authorities to ensure consumer protection, preserve the functioning and integrity of financial markets and avoid severe market disruptions.

- ✓ In **March 2016**, EMMI answered to the ESMA consultation paper on regulatory technical standards by underlining that EMMI would welcome a general mechanism to support benchmark administrators that make material changes to the methodology of benchmarks, in particular when such changes could result in Contract Frustration.

- ✓ EMMI has also been raising the need for regulatory backing to the transition to Euribor+ towards ESMA and the FSMA.

Draft Euribor Royal Decree

Anticipation of the Benchmark Regulation

FSMA

AUTORITEIT
VOOR FINANCIËLE
DIENSTEN
EN MARKTEN

AUTORITÉ
DES SERVICES
ET MARCHÉS
FINANCIERS

Reminder: Benchmarks Regulation ("BMR")

FSMA

BMR - timing

- European Parliament vote: April 2016
- Publication: end of May 2016 (d)
- Entry into force: day after date of publication (d+1) + entry into application of some articles of the BMR (e.g. provision on the establishment of a college for critical BM's, provision on mandatory contributions)
- Entry into application: Entry into force + 18 months (d+1)
- Application for an authorization (d+1) + 42 months

Euribor College

- Establishment of College for critical BM’s
  - → 30 working days after inclusion of BM in list of critical BMs (date?)
  - → It supposes that each Member state has designated the national competent authority responsible for carrying out the duties under the BMR
  - → Concretely, the Euribor college will be installed with the national competent authorities already designated on that moment
  - → Written arrangements: cooperation with ESMA and the FCA in order to have similar rules for Euribor and Libor

Mandatory contribution provision

- Entry into application on the date of the entry into force of the BMR (d+1)
- Concretely, this provision can only be enforced from the date of the establishment of the Euribor College
- « Last resort mechanism » that will be used under the strict conditions of the BMR
- Not to be used in order to enlarge the number of panel banks
- Persuasion tool

Level II measures

- Benchmark Task Force created by ESMA: participation of the FSMA
- ESMA must draft Regulatory Technical Standards (RTS) on some BMR provisions (e.g. oversight committee, input data, methodology, code of conduct, benchmark statement)
- Submission of the RTS to the European Commission by 9 months after the entry into force of the BMR ((d+1) + 9 months = February/March 2017)

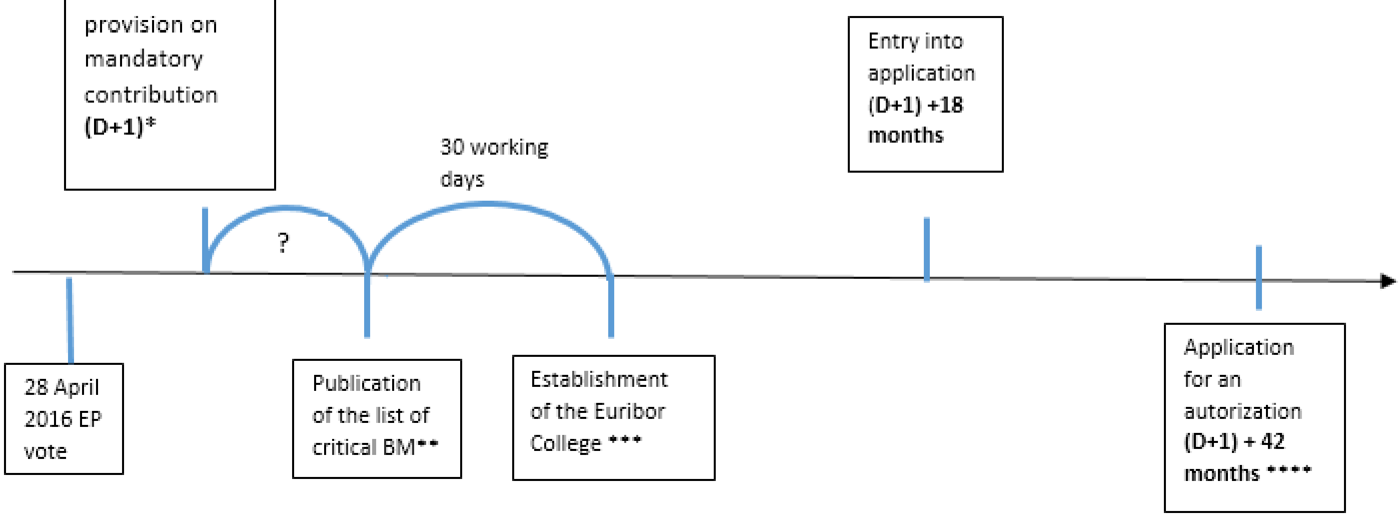
Benchmark regulation timeline

*From a practical point of view, the provision on mandatory contribution can only be enforced from the date of the establishment of the Euribor College.

**Ideally, the Commission would publish this list at the moment of the publication of the BMR.

***It supposes that each Member State has designated the competent authority responsible for carrying out the duties under the BMR. The college will be installed with the competent authorities already designated on that moment.

****For index providers providing a benchmark on the date of the entry into force of the BMR.



Draft Euribor Royal Decree (the “Royal Decree”)

To facilitate the transition to the Euribor + methodology

Royal Decree: timing

- Entry into force expected in June 2016

- Application for an authorization within 30 working days of the entry into force

→ Anticipation of BMR because the application for an authorization under BMR must take place by 42 months after the entry into force of the BMR ((d+1) + 42 months = by November/December 2019)

Draft Euribor Royal Decree: timing

- Automatic revocation the day preceding the entry into application of the BMR ((d+1) +18 months) -1
- But authorization remains valid until the granting or the rejection of an authorization under the BMR

→ EMMI will have to re-apply for an authorization

Draft Euribor Royal Decree: provisions

- Broadly similar to the BMR
- Scope: limited to EMMI and Euribor
- Obligation of authorisation for EMMI
- Supervision of EMMI only

→ No supervision of panel banks
(no extra-territorial effect of the Royal Decree)

Draft Euribor Royal Decree: provisions

- **Authorization conditions = BMR:**
  - Governance & conflicts of interest
  - Oversight function
  - Control framework requirements
  - Accountability framework
  - Outsourcing provisions

Draft Euribor Royal Decree: provisions

- Authorization conditions ≠ BMR:
  - Fit and proper character of the management body and the oversight committee
  - General obligations on input data and BM methodology

  → Taking into account the fact that after the transition to Euribor + the BMR provisions on input data and methodology will be complied with
  - Code of conduct: must be established by EMMI
- Absence of provision on mandatory contributions but:

  → Meetings between the FSMA and a sample of panel banks in order to identify their concerns

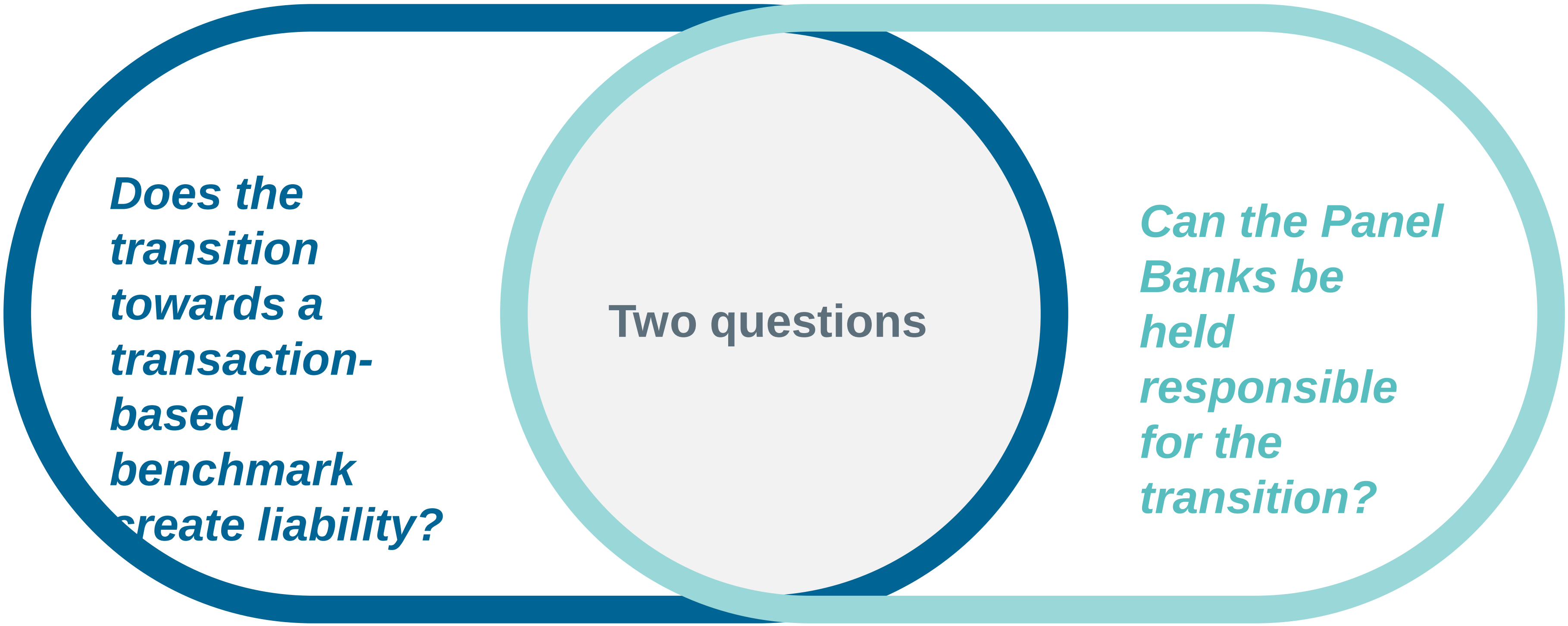
Questions?

Regulatory backing for transition

- Discussion on further suggestions for initiatives regarding regulatory backing?

Liability of Panel Banks

Does the transition towards a transaction based benchmark create liability for Panel Banks



Applicable Legal Framework

– No binding regulation
  – Relevant clauses of Benchmark Regulation enter into force 18 months after publication
  – IOSCO Principles are soft law

– General liability principles apply: three elements need to be proven:
  1. Wrongdoing
  2. Causal Link
  3. Damages

Wrongdoing

- Legal test for wrongdoing
  - Normal prudent person in same circumstances
  - Benchmark Regulation / IOSCO principles will play important role

- Article 7b Benchmark Regulation and IOSCO Principle 12 have specific requirements when benchmark administrator wants to make material changes
  → making a material change does not in itself create liability

Changes to the Euribor methodology

– Five changes:

1. Definition of Euribor
2. Euribor reflects a borrowing rate
3. Eligible types of transactions and counterparties
4. Concept of prime bank
5. Transaction-based methodology

1. Changes to the definition of Euribor (1/2)

- Current definition: *Euribor® is the rate at which Euro interbank term deposits are being offered within the EMU zone by one prime bank to another at 11.00 a.m. Brussels time*

- The current definition does not distinguish between the Underlying Interest and the methodology

- EMMI wishes to clarify the Underlying Interest

1. Changes to the definition of Euribor (2/2)

- New definition will only focus on Underlying Interest: *the rate at which banks of sound financial standing could borrow funds in the EU and EFTA countries in the wholesale, unsecured money markets in euro*

- We understand from EMMI that Underlying Interest itself does not change

  → unlikely to be considered an action a normal, reasonable benchmark administrator would not take

2. Euribor reflects a borrowing rate (1/2)

- Current definition: *Euribor® is the rate at which Euro interbank term **deposits** are **being offered** within the EMU zone **by one prime bank to another** at 11.00 a.m. Brussels time*
- Not very clear that Euribor is the rate at which the second prime bank could borrow the funds offered by the first prime bank
- Mixed reliance by the panel banks on borrowing and lending rates in the determination of Euribor
- EMMI wishes to re-emphasise that Euribor reflects a borrowing rate

2. Euribor reflects a borrowing rate (2/2)

– We understand that original intent for Euribor was to reflect a borrowing rate because the family of –IBOR benchmarks are based upon and aimed at representing funding markets

– The second change does bring the determination methodology in line with the unchanged Underlying Interest.

– Unlikely that a court would rule that this change as such would constitute a wrongdoing provided that it can be shown that Euribor has always sought to measure a borrowing rate

3. Eligible types of transactions and counterparties (1/3)

– The term "interbank transactions" in the Euribor specification reflects the structure of the money markets in the 1980s and 1990s

– We understand that in the last decade a significant shift in banks' funding sources has occurred and there has been a steady decline of interbank activity

– With the third change EMMI wishes to clarify:

1. that Euribor's Underlying Interest needs to be understood as a wholesale funding rate
2. to expand the eligible types of transactions and counterparties to update the methodology to reflect the changed market circumstances

3. Eligible types of transactions and counterparties (2/3)

– Making it explicit that the Underlying Interest of Euribor needs to be understood as a wholesale funding rate:

= analysis of change of the definition: Provided that it can be shown that the Underlying Interest has not changed, we do not think that a court would rule that this constitutes a wrongdoing

3. Eligible types of transactions and counterparties (3/3)

– expand the eligible types of transactions and counterparties :

– article 7.1 (4) Benchmark Regulation and IOSCO Principle 10 provide that benchmark administrators should periodically review whether the market their benchmark intends to measure has undergone changes that require changes to the methodology.

– Article 7a (2) Benchmark Regulation and IOSCO Principle 6 provide that the distribution of trading among market participants (market concentration) and the market dynamics need to be taken into account in the benchmark design.

– If the situation on the money markets has changed, it is unlikely that a court would decide that this change is a wrongdoing, as EMMI is adapting the methodology to changing market situation

4. The concept of Prime Bank (1/2)

– The concept of “prime bank” historically represented both:
  - a concept of the financial standing of the party borrowing the funds (a concept related to the Underlying Interest)
  - a substantial party supplying funds (a concept related to the determination methodology).

– The second concept is related to the structure of the money markets the 1980s and 1990s when bank-to-bank activity was a predominant source of bank wholesale funding. This second concept will be replaced by the broader sources of wholesale funds.
  - Analysis = analysis of expanding the eligible types of transactions and counterparties

4. The concept of Prime Bank (2/2)

– The first concept of prime bank as the financial standing of the party borrowing funds will be incorporated in the definition of the Underlying Interest: "*the rate at which banks of sound financial standing could borrow funds in the EU and EFTA countries in the wholesale, unsecured money markets in euro*".

– prime bank is currently defined as "*a credit institution of high creditworthiness for short term liabilities, which lends at competitive market related interest rates and is recognised as active in euro-denominated money market instruments while having access to the Eurosystem's (open) market operations*."

– This current definition already implies the concept of sound financial standing, so the proposed changes are in our opinion more of a rephrasing than an actual change

5. The introduction of a transaction based methodology (1/3)

– The fifth change is replacing the current quote-based methodology with a transaction-based methodology that is described in the Consultative Position Paper on the Evolution of Euribor

– Given the clear preference for a transaction based methodology, we think that it is unlikely that a court would hold that a transition towards a transaction-based benchmark would constitute a wrongdoing as it is likely that a normal, reasonable benchmark administrator in the same circumstances would make the same transition

5. The introduction of a transaction based methodology (2/3)

- Clear preference for transaction-based benchmarks in Benchmark Regulation and IOSCO principles

- Article 7.1 (a) Benchmark Regulation: "*The input data shall be transaction data, if available and appropriate. If transaction data is not sufficient or is not appropriate to represent accurately and reliably the market or economic reality that the benchmark is intended to measure, input data which is not transaction data may be used, including committed quotes, indicative quotes and estimates;*"

- IOSCO Principle 7 : "*The data used to construct a Benchmark determination should be sufficient to accurately and reliably represent the Interest measured by the Benchmark and should: (…) be anchored by observable transactions entered into at arm's length between buyers and sellers in the market for the Interest the Benchmark measures in order for it to function as a credible indicator of prices, rates, indices or values*. (…)"

5. The introduction of a transaction based methodology (3/3)

- The proposed changes are a material change to the methodology of Euribor:
  - EMMI is allowed to make material changes to the methodology
  - articles 7b 1 (iii) Benchmark Regulation requires the benchmark administrator to give the stakeholders advance notice of the proposed material change and
  - Article 7b 2 (a) Benchmark Regulation requires that the stakeholders should be consulted on the proposed material changes

- Important to (continue to) respect information and consultation obligations

- Transition process must be done in line with Benchmark Regulation and EMMI's own policies

Can the Panel Banks be held responsible for a wrongdoing by EMMI?

- Article 6.2 Euribor Code of Conduct: "*Amendments to this Code are not subject to the approval of the Panel Banks*"

- Consequently, we think it is highly unlikely that Panel Banks could be held responsible

Damage and Causal Link

- Even if a wrongdoing could be proven, users will still need prove damage and causal link

- Users will be faced with significant evidentiary problems:
  - Difficult to prove what the rate of the Euribor would have been if the changes were not implemented (rate variations due to changing market circumstances? Changes to methodology?)
  - Claimants need to show that they would not have referred to Euribor in their agreement if they would have known that the proposed changes would be made

- Analogy with rating agencies confirms evidentiary issues

Liability risk of not transitioning (1/2)

- Article 15 Benchmark Regulation and IOSCO Principle 11: benchmark statement shall clearly and unambiguously defines the market or economic reality measured by the benchmark
  - The methodology could be clearer on the fact that Euribor represents a borrowing rate

- article 7.1 (4) Benchmark Regulation and IOSCO Principle 10: periodic review of the market thebenchmark intends to measure to see whether it has undergone changes that require adaptation of the methodology
  - last decade there has been a significant shift in banks' funding sources

Liability risk of not transitioning (2/2)

- Article 7.1 (a) Benchmark Regulation and IOSCO Principle: clear preference for transaction based benchmark
  - Risky to continue with quote-based benchmark
- Continuing with the current quote based methodology also creates liability risks
  - Article 6.2 limits risks for Panel Banks
- Liability risk of not transitioning > liability risk of transitioning

Comparison of legal risks between both Contribution models

- Traditional Model: each Panel Bank calculates internally its volume-weighted average rate and total volume for each tenor and sends that data to EMMI

- Transactional Data Model: each Panel Bank sends its raw transaction data files to EMMI, which will then select the relevant transactions and calculate volume-weighted average rate and total volume

Comparison of legal risks between both Contribution models

– Applicable legal rules are identical:

  – Input data = "*the data in respect of the value of one or more underlying assets, or prices, including estimated prices, quotes, committed quotes or other values, used by the administrator to determine the benchmark*"

  – Contribution of input data = "*providing any input data not readily available to an administrator, or to another person for the purposes of passing to an administrator, that is required in connection with the determination of a benchmark, and is provided for that purpose*"

Comparison of legal risks between both Contribution Models

– Applicable legal rules are identical:

  – In principle no difference in responsibility

  – In practice: role of Panel Banks more limited under Transactional Data Model, so overall risks are lower:
    - Obligation is limited to compile the raw transaction data and transfer that data to EMMI
    - No need to determine/filter which transactions specifically qualify for Euribor
    - No need to calculate the VWAR and total volume for each tenor

Q&A

Next steps

Questions?

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