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PROPOSAL

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To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
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Subject:	Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) 2016/1011 as regards the exemption of certain third country foreign exchange benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation

Delegations will find attached document COM(2020) 337 final.

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2020/0154 (COD)

Proposal for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Regulation (EU) 2016/1011 as regards the exemption of certain third country foreign exchange benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation

(Text with EEA relevance)

{SEC(2020) 284 final} - {SWD(2020) 142 final} - {SWD(2020) 143 final}

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

1.1. Reasons for and objectives of the proposal

Under the heading "An Economy that Works for People", the Commission Work Programme for 2020 provides for a review of its regulation on financial benchmarks, the "Benchmark Regulation" ("BMR"). Financial benchmarks are indices by reference to which the amount payable under a financial instrument or a financial contract or the value of a financial instrument is determined. By setting out governance and data quality standards for benchmarks that are referenced in financial contracts, the Benchmark Regulation aims to strengthen the trust of capital market participants in indices used as benchmarks in the Union. It contributes to the Commission' efforts in favour of a Capital Markets Union (CMU).

The BMR introduces an authorisation requirement for administrators of financial benchmarks as well as requirements for contributors of input data used to calculate the financial benchmark. The BMR also regulates the use of financial benchmarks[1]. In particular, the BMR rules require EU supervised entities (such as banks, investment firms, insurance undertakings, UCITS[2]) to use only indices whose administrator has been authorised. Benchmarks administered in third countries can only be used in the EU following an equivalence, recognition or endorsement procedure.

The Benchmark Regulation applies since January 2018[3]. However, EU market participants can continue to use benchmarks administered in a country outside the Union - regardless of whether an equivalence decision is in place, the index has been recognised or endorsed for use in the Union[4] – until the transitional regime expires at the end of December 2021.

1.1.1. The orderly cessation of financial benchmarks

Due to concerns about whether the London Interbank Offered Rate (LIBOR) adequately represents an underlying market or economic reality reflective of interbank borrowing, the national competent authority for LIBOR (the UK Financial Conduct Authority or "FCA") has announced the likely cessation of LIBOR after the end of 2021. The FCA, in all its public statements, has been clear that, where a benchmark loses representativeness and its representativeness will not be restored, use of the benchmark by supervised entities must cease. Relying on a very small number of panel banks such that LIBOR was no longer representative of the underlying market or economic reality that LIBOR sought to measure, means that its value could deviate significantly from that economic reality, as well as becoming more volatile.

As documented in the Commission's impact assessment, many financial instruments and contracts that reference LIBOR will not have reached maturity by the expected cessation date after the end of 2021. Many of these contracts involve debt issued by supervised entities, debt instruments held on the balance sheet by supervised entities, the loan portfolio of supervised entities and derivative contracts that these entities have concluded to hedge their positions. As mentioned above, supervised entities within the scope of the EU Benchmark Regulation may only use indices that are authorised as compliant with the BMR.

The disappearance of LIBOR will have significant economic impacts that EU supervised entities could not have anticipated when concluding these often longer maturity contracts. Many of these contracts, especially those concluded before adoption of the BMR in 2016, often lack any contractual "fall-back" provisions that deal with the permanent discontinuation of the LIBOR rate. Amending the terms of thousands of contracts that currently contain references to LIBOR will not always be possible in the short period remaining until the expected end of the LIBOR at the end of 2021.

Many currently existing debt, loan, deposit and many of the derivative contracts would, upon a permanent cessation of an interest rate benchmark, such as LIBOR, lack a contractual fall-back rate that allows parties to continue to comply with their contractual obligations.

If no remedies were envisaged, the discontinuation of a widely used interest rate benchmark will have negative consequences for EU supervised entities and their contractual counterparts from whom these entities either borrow or to whom they lend funds. All counterparts in contracts referencing such a benchmark that are still pending at the date of cessation will face legal uncertainty as to the validity and enforcement of their contractual obligations. The range of contracts that will be affected by the cessation of a widely used interest rate benchmark includes: (1) debt issuances by supervised entities; (2) debt held on the balance sheet of supervised entities; (3) loans; (4) deposits and (5) derivative contracts. A large part of the financial contracts that reference widely used interest rate benchmarks involve supervised entities within the scope of the BMR. The legal uncertainty and potentially adverse economic impact that may result from difficulties in the ability to enforce contractual obligations will pose a risk for financial stability in the Union.

To mitigate the risk of contract frustration and the ensuing risk to financial stability, central banks in various currency areas have set up working groups to recommend fall-back rates that would apply to the legacy stock of contracts that reference interest rate benchmarks in cessation and that could not be renegotiated by the date of the permanent cessation of this benchmark. For example, the Alternative Reference Rate Committee (ARRC) in the United State has recommended a waterfall that includes a replacement rate calculation based on a risk-free overnight rate (SOFR) plus a spread adjustment to make the replacement rate resemble, as close as possible, the economic properties of the discontinued benchmark. The aim of these replacement rates would therefore be to mimic, to the extent possible, what the contract parties intended to achieve by references to the benchmark in cessation.

It is a deliberate policy choice underpinning all recommendations for a replacement rate for legacy contracts that no new contracts (defined as contracts concluded after cessation of the benchmark) may reference the replacement rate. This is because the replacement rate is most likely a synthetic version of the benchmark in cessation and is meant to ease the transition to a new rate. For example, a replacement rate for USD LIBOR will most likely be calculated based on a risk-free overnight rate in borrowing (SOFR) plus a spread adjustment to reflect the historical spread between the risk-free overnight rate and the replaced LIBOR rate. While a synthetic version of a benchmark should be stable enough to accompany the wind-down of legacy portfolios, it is not a permanent solution, reflective of a supervised entity's forward looking financing cost.

However, even once these replacement rates are available, it will be difficult to amend all existing legacy contracts given the scale of the LIBOR references and the short period of time before LIBOR is expected to be discontinued.

A reform of the BMR is therefore the right tool to establish a statutory replacement rate that mitigates the adverse consequences for legal certainty and financial stability that might ensue if LIBOR, or any other benchmark whose cessation would result in significant disruption in the functioning of financial markets in the Union, was discontinued without such a replacement rate being both available and integrated into legacy contracts that involve a supervised entity within the scope of the BMR.

1.1.2. Spot foreign exchange rates

While spot foreign exchange rates play a crucial role for the international economy, for several currencies, the rates that are available are largely unregulated and are often reflective of central bank monetary policies. In some countries, central banks have implemented controls to restrict the publication of spot foreign exchange rates outside their local jurisdiction. In addition to preventing publication of off-shore foreign exchange rates, certain countries have in place capital controls that limit the convertibility of their currencies.

Since their currencies are not freely convertible, the availability of on-shore currency hedging tools, such as currency forwards, swaps or options, is limited. Demand for hedging tools against currency volatility in these countries outstrips the shallow liquidity offered by the on-shore market. In consequence, European financial institutions have developed off-shore derivatives markets that, due to the convertibility restrictions in place, settle into the base currency of the hedging entity, albeit by reference to the foreign exchange rate published at the moment of the hedging contract's expiry. Therefore, hedging against movements in currencies subject to such convertibility restrictions is done with off-shore derivative contracts. These include financial instruments such as non-deliverable currency forwards and non-deliverable swaps.

Where these forwards and swaps are offered by an EU supervised entity (a dealer bank)[1] and traded on an EU trading venue or via an EU systematic internaliser, the spot currency rate that is used to determine the pay-out due under the forward or swap agreement constitutes a "use" of the spot exchange rate which brings the offer of forwards and swaps by a supervised entity within the scope of the BMR.

At the end of the current transitional period set out in Article 51 of the BMR the reference to foreign exchange spot rates in EU-traded currency forwards or swaps will no longer be allowed. This means that, at the beginning of 2022, EU supervised entities are at risk of losing access to many public policy rates administered outside the EU, including spot foreign exchange rates that they reference in derivative contracts that they offer corporate counterparts to help them manage their day-to-day hedging of currency risk.

The urgency of the issue arises as almost no other jurisdiction apart from the EU regulates spot exchange rates. Due to the absence of regulation, currency spot rates could not, therefore, be the subject of an equivalence assessment under the BMR. Neither can they be recognised or endorsed for use in the Union under the BMR, as both of these mechanisms, in turn, require some form of regulation and oversight. In conclusion, foreign exchange spot rates are not suitable candidates for equivalence, endorsement or recognition by the end of the transition period.

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1 A supervised entity pursuant to the definition in Article 3(1)(17)(b) of the BMR. Note also that it is only the dealer bank offering the derivative instrument which is considered to be using the benchmark, not the corporate end client seeking to hedge its foreign exchange exposure.

This proposal, therefore, makes targeted modification of the scope of the BMR in order to ensure that European companies retain access to hedging tools against volatility of currencies that are not freely convertible into their base currency, ensuring seamless continuation of their business activities abroad after the expiry of the transitional period at the end of 2021.

1.2. Consistency with existing policy provisions in the policy area

The European Union's financial services policy encourages legal certainty and financial stability. This policy goal extends to contracts that are essential for the financing of its banking sector. As part of the Capital Markets Union action plan, the Union strives to create legal framework that ensures stability for corporate loans, debt issuances by its banking sector and for securitizations.

In light of the anticipated cessation of LIBOR after the end of 2021, supervised entities in the European Union will be faced with legal uncertainty for hundreds of thousands of financial contracts. In order to avoid adverse consequences for the lending capacity of the European banking sector, early clarification as to the availability of a statutory replacement rate for use by supervised entities in all LIBOR referencing contracts that mature beyond the end of 2021 is necessary. The planned amendments to the BMR are therefore a corollary to both the CMU and more recent initiatives aimed at spurring the recovery from economic repercussion of the Covid 19 pandemic.

1.3. Consistency with other Union policies

In line with the recommendations of the Financial Stability Board, the reform of critical benchmarks, such as the IBOR rates, is a top priority of the Commission's Capital Market Union (CMU) Action Plan. Preparing for the orderly phase out of a major benchmark supports one of the principal objectives set by the CMU Mid Term Review, namely to strengthen bank lending and stable financing of the corporate sector through capital markets.

Interbank borrowing rates are important indices used to calculate the interest due for corporate loans, but also in issuing short and medium term debt and in hedging debt positions. Therefore, the availability of and the legal certainty around interbank rates affects the capacity of banks to lend to the real economy and perform their core functions.

This proposal introduces various tools to make sure that the phase out of a widely used interbank rate does not unduly affect the banking sector's capacity to provide funding to EU companies and therefore jeopardize a key objective of the CMU. Finally, the measures proposed are to be viewed as supporting "an EU economy that works for people", which is one of the headline ambitions set out in the 2020 Commission Work Programme. Bank lending to retail customers is an important element of an economy that serves the needs of the people. Retail loans reference IBOR rates, whose movement determines loan repayment amounts, which is a key consideration in managing personal finances for many citizens. By providing the tools for a legally sound transition from IBOR rates, this initiative benefits retail customers holding loans referencing those rates.

2. LEGAL BASIS, SUBSIDIARITY AND PROPORTIONALITY

2.1. Legal basis

The legal basis for the adoption of the Benchmark Regulation is Article 114 of the Treaty on the Functioning of the European Union (TFEU). Adoption of amendments aimed at enhancing the efficiency of this regulation by providing powers to ensure contract continuity in the context of the cessation of a benchmark with systemic relevance in the Union and de-scoping certain benchmarks should also fall under the same legal basis.

In particular, Article 114 TFEU confers the European Parliament and the Council the competence to adopt measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market. Article 114 TFEU allows the EU to take measures not only to eliminate current obstacles to the exercise of the fundamental freedoms, but also to prevent, if they are sufficiently concretely foreseeable, the emergence of such obstacles, including those which make it difficult for economic operators, including investors, to take full advantage of the benefits of the internal market. Thus, Article 114 TFEU gives the EU the right to act to (1) address contract continuity issues that arise in the context of the very likely cessation of a benchmark with systemic relevance in the Union in the near future; and (2) ensure continued availability of spot foreign exchange rates for use in hedging tools issued in the European Union after the end of the BMR transition period in December 2021.

More specifically, the lack of mechanisms in the BMR to organise the orderly cessation of a benchmark with systemic relevance in the Union would be likely to result in heterogeneous implementing or legislative solutions by Member States. This would create confusion among benchmark users and end-investors, resulting in disruptions to the internal market, preventing them from fully benefiting from the single market. Therefore, the use of Article 114 TFEU appears as the most appropriate legal basis to tackle these problems comprehensively and uniformly and to avoid fragmentation.

As regards the continued access to third-country foreign exchange spot rate for EU users, this action is aimed to avoid harming the competitiveness of certain EU stakeholders and the effectiveness of the financial system, for the Union economy, its citizens and businesses, that would otherwise occur should those rates remain subject to the BMR. This action is also aimed at avoiding obstacles to the single market which could be caused by the impediments to cross border exchanges due to impossibility to continue reference the third-country foreign exchange spot rate. Article 114 TFEU is therefore the appropriate legal base to achieve this coordinated deregulation objective.

Therefore, the establishment of an EU mechanism to deal with legacy contracts and of an exemption regime to ensure continued reference of foreign currencies spot rates would fall under the competence of the EU according to Article 114 TFEU.

2.2. Subsidiarity (for non-exclusive competence)

According to the principle of subsidiarity (Article 5.3 of the TEU), action at EU level should be taken only when the aims envisaged cannot be achieved sufficiently by Member States alone and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the EU. While some benchmarks are national, the benchmark industry as a whole is international in both production and use. Issues concerning the use by supervised entities of benchmarks having systemic relevance in the Union as well the use of non-EU benchmarks have by definition a European dimension.

The issues that this legislative proposal aims to address could not be addressed through individual un-coordinated action by Member States. As to the issue of the orderly winding down of benchmarks whose cessation would result in significant disruption in the functioning of financial markets in the Union, Member States could intervene introducing legislation indicating the national replacement rate in contracts referencing the benchmark in cessation. Nevertheless, individual action by Member States is likely to address only partially the identified issues (notably because some Member States may legislate, while others would not). Furthermore, different approaches to replacement rates for legacy contracts across the Member States would introduce fragmentation in the single market. Action at EU level as regards a harmonised orderly transition regime for benchmarks with systemic relevance that works for legacy contracts entered into by supervised entities across the Union is thus needed in order to ensure coherence and to further improve the functioning of the single market. More specifically, un-coordinated action at national level in relation to benchmarks whose cessation would result in significant disruption in the functioning of financial markets in the Union may lead to a patchwork of divergent rules, could create an un-level playing field within the internal market and result in an inconsistent and un-coordinated approach. A patchwork of national rules would impede the opportunity to treat benchmarks in cessation that are used in many cross-border debt, loan or derivatives transactions in the same manner and therefore make such transactions more complex to manage.

Equally, action at EU level is also needed for ensuring the continuous use of foreign currency spot rates as they are already covered by regulation adopted at European level (the BMR) and action at national level would not be sufficient to reach the aim.

2.3. Proportionality

The proposed amendments to the Benchmark Regulation are proportionate, as required by Article 5(4) of TEU. The proposal follows a proportionate approach making sure that limited new obligations are imposed on supervised entities using systemic benchmarks who already are subject to requirements under the Benchmarks Regulation.

Furthermore, the procedure accompanying the wind-down of benchmarks with systemic relevance aims to provide visibility and legal certainty for users of those benchmarks who might not be in a position to amend or renegotiate their stock legacy contracts. The financial sector as well as the end clients, both corporates and citizens, should therefore benefit significantly from the improvements brought forward with this amending Regulation.

2.4. Choice of the instrument

An amendment to the Benchmark Regulation is the most appropriate legal instrument to solve issues arising from the likely disappearance of certain IBORs widely used in EU which are themselves regulated under the Benchmark Regulation.

The use of a Regulation, which is directly applicable without requiring national legislation, will restrict the possibility of divergent measures being taken by competent authorities at national level, and will ensure a consistent approach and greater legal certainty throughout the EU.

3. RESULTS OF EX-POST EVALUATIONS, STAKEHOLDER CONSULTATIONS AND IMPACT ASSESSMENTS

3.1. Stakeholder consultations

The Commission has carried out extensive consultations with various groups of stakeholders in order to obtain a complete picture of the different views market participants may hold with regards to the issues addressed in this regulation.

On 18 March, DG FISMA published an inception impact assessment (IIA) intended to inform stakeholders about the scope of the review of Regulation (EU) 2016/1011 (Benchmark Regulation / BMR) and outlining different policy options considered. The consultation period closed on 15 April 2020. The Commission has received responses from 22 respondents, mostly private companies and business associations.

On 26 November 2019, the Commission organised a workshop around three main topics:

(1) The first panel discussed whether regulators had the necessary tools at hand in order to maintain, sustain and potentially amend the methodologies underpinning critical benchmarks.

(2) The second panel delved into further detail on whether BMR was fit to accompany the transition of existing interbank (IBOR) rates to the new risk free rates, also assessing whether BMR was sufficient to accompany the transition from Eonia to €STR.

(3) The third panel provided for a cross-cutting view on whether the BMR scope as well as the third country provisions should be reassessed.

On 11 October, DG FISMA published a public consultation intended to support its review of the Benchmark Regulation. Stakeholders had until 31 December 2019 to express their views via the online EU Survey portal.

The Commission has also been actively involved in the work of the Euro RFR Working Group, composed of stakeholders from the private sector, including contributors, administrators and users of benchmarks, as well as the ECB, which provides Secretariat, and ESMA and the Belgian FSMA in observer status along with the EC, in order to identify varied stakeholder considerations that should be kept in mind in designing the best policy tools for the orderly cessation of critical benchmarks. Furthermore, the Commission is a member of the Official Sector Steering Group of the Financial Stability Board, which comprises senior officials from central banks and regulatory authorities, thus giving it a good insight into the international public policy perspectives on the transition to risk-free rates. In addition the Commission Services sits as an observer in ESMA Board of Supervisors and in its technical standing groups, among which that on benchmarks, from which it has closely followed the work of ESMA in the context of critical benchmarks. Finally, DG FISMA staff has had many bilateral contacts with a broad spectrum of stakeholders in order to further refine its analysis and policy approach.

3.2. Collection and use of expertise

The proposal builds on the expertise of EU competent authorities that today supervise administrators of critical benchmarks as well as on the expertise of administrators themselves. In addition, the Commission monitors closely developments in other jurisdictions that are similarly preparing the transition to IBOR replacements, in particular in relation to the preparatory work taking place in the Official Sector Steering Group of the Financial Stability Board.

Several jurisdictions have also established private sector working groups to accompany the transition. The Commission has been informed of the various alternatives also considered by these groups and has taken a view on whether these alternatives could be applied to the EU situation.

3.3. Impact assessment

3.3.1. Orderly cessation of a financial benchmark

The Commission conducted an impact assessment on how to best accommodate legacy contracts that contain references to a widely used interest rate benchmark in cessation and that cannot be renegotiated by the end of 2021 ("tough legacy" contracts). After receiving a first negative opinion on 15 May 2020, the impact assessment received a positive opinion by the Regulatory Scrutiny Board on 4 June 2020.

All of the options considered in the impact assessment focused on the creation of a replacement rate in case a widely used interest rate benchmark would be discontinued. The replacement rate would either result from a conversion of the benchmark in cessation into a time-limited replacement rate to accompany the wind-down of legacy contracts, the authorisation of such a replacement rate by the regulator competent for the benchmark in cessation, the publication of a replacement rate under a statutory exemption or the mandating of a permanent replacement for a benchmark in cessation;

The approach chosen in the impact assessment was to amend the BMR to equip the national authority competent for the administrator of a widely used interest rate benchmark in cessation with the regulatory powers to manage the orderly wind-down of such a benchmark, when it is no longer capable of reflecting an underlying market or economic reality. These powers would comprise the power to require an administrator of such a benchmark in cessation to change the methodology that underpins the benchmark in order to ensure that the benchmark remains sufficiently robust and sustainable to accompany the wind-down of legacy contracts that reference this benchmark at the point in time that the competent regulator concludes that the capacity to measure an underlying market or economic reality is lost. The new benchmark "conversion powers" would allow the competent regulator to require a methodology change as long as this was necessary to protect consumers and financial stability in the Union.

However since completion of the impact assessment, a series of more recent caveats made by the LIBOR regulator, the FCA, leaves doubt as to whether conversion powers are effective to cater to all instances that a conversion rate would need to cover. For example, according to the FCA: "… regulatory action to change the LIBOR methodology may not be feasible in all circumstances, for example where the inputs necessary for an alternative methodology are not available in the relevant currency."[2]

There are several effectiveness issues that may make it less efficient to rely on conversion powers:

[2] https://www.fca.org.uk/news/statements/fca-statement-planned-amendments-benchmarks-regulation

First, the use of conversion powers might not be possible in all circumstances or for all LIBOR currencies. For example, the FCA points out that conversion powers could not be exercised where the "inputs" necessary for an alternative methodology are not available in the relevant currency[3].

Second, conversion may not always be feasible for legal or practical reasons. While the FCA cites instances where the administrator may not have access to robust input data in the relevant currency, access issues could include instances where the sourcing and licensing of these inputs might appear too complex or costly to warrant the effort of producing a replacement rate[4]. In this case the publication of the benchmark in cessation would cease without any replacement rate.

Third, even if feasible, conversion powers might lead to heterogeneous results. According to the FCA, some markets such as derivatives, bond and large parts of cash markets prefer transition to overnight interest rates compounded in arrears at the end of a relevant interest period. In contrast, tough legacy consumer or export loan contracts using three, six or twelve month term LIBOR benchmarks use a forward-looking measure of interest rate expectations. Methodology changes inherent in the exercise of conversion powers would therefore not be able to deliver results that are the preferred outcome for all current LIBOR users. As the FCA states, industry-agreed replacement arrangements would therefore be preferable as they are more likely to cover a broader range of contracts.

Fourth, conversion powers rely on the fact that the administrator of a benchmark in cessation and the administrator of the benchmark that results from conversion is the same legal entity. Such a requirement would confine the risk-free rate working groups - that will issue recommendations on the industry-agreed replacement rate - to recommend a replacement rate that is produced by the same administrator as that of the benchmark in cessation. Especially in cross-border situations, where the risk free rate working group operates in a different jurisdiction than that of the administrator of the benchmark in cessation (e.g., LIBOR for USD contracts), this is not necessarily the case. In addition, such a requirement would put unnecessary constraints on the rate that a risk free rate working group could recommend as the most suitable replacement benchmark.

In light of the above, the chosen approach has been modified to ensure that the Commission would have the necessary legal empowerments to ensure that a replacement rate for a benchmark whose cessation would result in significant disruption in the functioning of financial markets in the Union, could be designated with sufficient flexibility to cover all potential circumstances.

The conversion powers have therefore been replaced by the powers for the European Commission to designate a statutory successor for a benchmark whose cessation would result in significant disruption in the functioning of financial markets in the Union. The European Commission, in exercising the designation powers would be able to take into account industry-agreed replacement rates 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. The change of approach is warranted to ensure that a suitable industry-agreed replacement rate is

3 https://www.fca.org.uk/markets/transition-libor/benchmarks-regulation-proposed-new-powers

4 The provision of a conversion rate would include the sourcing new input data, developing a new calculation methodology, and establishing surveillance procedures and publication tools. These changes all require technological and procedural development, and potentially sourcing and agreeing new data provision arrangements with third party providers other than the administrator of the conversion rate.

available for use in all contracts entered into by an EU supervised entity. This replacement rate should be available for all legacy contracts, irrespective of potential use or time restrictions that might be associated with the exercise of a conversion rate mandated by a regulator outside the Union.

3.3.2. Options for avoiding loss of EU-based risk management tools

In order to maintain the possibility of hedging foreign exchange risk for both the EU financial and non-financial sectors, the impact assessment analysed four options, each of which amounted to the targeted BMR exemptions, either for certain spot currency exchange benchmarks or hedging instruments which rely on these benchmarks to calculate the pay-outs.

One option – a general exemption for all third country benchmarks, except those designated as critical for financial stability in the Union, was discarded at an early stage, as it was considered less consistent with the original BMR approach, which is to provide for comprehensive coverage of all third country benchmarks, the "all-in" approach being a specific policy goal at the time the BMR was negotiated.

Out of the three remaining options, the option of creating a statutory exemption for third country foreign exchange spot rates emerged as the preferred option. This approach was deemed the best to enable EU supervised entities to continue referencing third country foreign spot exchange rate for non-convertible currencies on EU based forward contracts. At the same time it would ensure maintaining consistency within the Benchmark Regulation and not require regulators to authorise individual forward contracts. An exemption for public policy rate is already embedded in the BMR philosophy, taking the form of an exemption for policy rates published by central banks. In addition, if the exemption is formulated with the necessary degree of flexibility, it would also be suitable to cater for other policy rates that, for reasons of monetary or other policy goals, are produced in the relevant third countries under the guidance and control of central banks or other policy makers, such as national treasuries. Moreover, this options was more future-proof than the two others. This option would also tackle one of the design flaws of the BMR, which is to require BMR compliance for third country spot exchange rates which are so volatile that an EU-based market for forward contracts has developed precisely with the aim of hedging against the volatility of the relevant spot rate.

3.4. Fundamental rights

The proposal respects the fundamental rights and observes the principles recognised by the Charter of Fundamental Rights of the European Union, in particular the principle establishing a high level of consumer protection for all EU citizens (Article 38). Without an orderly transition to IBOR replacement rates, retail clients would be potentially negatively affected by IBOR cessations, particularly in certain Member states that rely more heavily on mortgages contracts with references to floating rates.

4. BUDGETARY IMPLICATIONS

The initiative does not have any impact on the EU budget.

5. OTHER ELEMENTS

5.1. Implementation plans and monitoring, evaluation and reporting arrangements

The Commission proposes to establish a monitoring programme to evaluate whether the proposed amendments deliver the intended results.

5.1.1. Monitoring with regard to the orderly IBOR transition

This legislative proposal requires competent authorities of supervised entities using the replaced benchmark to monitor whether the replacement has minimised contract frustration or any other detrimental effects on economic growth and investments in the Union. They shall report to that effect to the Commission and to ESMA annually.

5.1.2. Monitoring with regard to the foreign exchange spot rate

This legislative proposal requires competent authorities of supervised entities that use third country foreign exchange benchmarks that are designated by the Commission as excluded from the scope of the BMR to report to the Commission and to ESMA on the number of derivative contracts that use that foreign exchange benchmark for hedging against third country currency volatility at least every two years.

5.2. Detailed explanation of the specific provisions of the proposal

5.2.1. Orderly cessation of a financial benchmark

The proposed amendments to the BMR are designed to reduce legal uncertainty and risks to financial stability. The approach introduces powers to designate a statutory replacement rate that takes the place of all references to a benchmark whose cessation would result in significant disruption in the functioning of financial markets in the Union. The replacement of all references to the "benchmark in cessation" with a statutory replacement rate is designed to avoid, or at least minimise, costly litigation by providing legal certainty for all contracts involving an EU supervised entity. In particular, the proposed statutory replacement powers would: (1) avoid that a party to a contract involving a supervised entity refuses to perform its contractual obligations or declares a breach of contract as a result of the discontinuance of a benchmark whose cessation would result in significant disruption in the functioning of financial markets in the Union; (2) establish that a replacement rate for such a benchmark as recommended by a risk-free rate working group established under the auspices of a central bank in the relevant currency area can serve as a statutory replacement for this benchmark and (3) provide a safe harbour from litigation for supervised entities that use (reference) the statutory replacement rate.

The proposed BMR amendments would achieve these goals by empowering the European Commission to designate a statutory replacement rate that would replace the reference to the benchmark in cessation where: (1) the contract contains no fall-back provisions that cover the permanent cessation; (2) cessation of that benchmark would result in significant disruption in the functioning of financial markets in the Union. For contracts that do not involve a supervised entity within the scope of the BMR, the statutory replacement would not apply. In order to also cover these contracts, Member States are encouraged to provide for statutory replacement rates. These statutory replacement rates would apply to contracts between two non-financial counterparts governed by the laws of their jurisdiction. At the appropriate moment, the European Commission intends to adopt a recommendation encouraging Member States to select the replacement rate chosen for EU supervised entities as the statutory replacement rate in their national statutes.

Since the main goal of these new powers is to ensure legal certainty for the existing contracts referencing the benchmark whose cessation would result in significant disruption in the functioning of financial markets in the Union, it appears coherent that it will be incumbent on the competent authorities of the supervised entity using the relevant benchmark to monitor whether statutory replacement rates for contracts entered into by supervised entities has resulted in reducing litigation or breach of such contracts and report their findings annually to the Commission.

There are the three main pillars to the proposed amendments of the BMR provisions governing the winding down of a benchmark with systemic relevance in the Union.

First, the proposed BMR amendments will introduce a statutory power, whereby the European Commission designates a replacement rate if and when a benchmark whose cessation would result in significant disruption in the functioning of financial markets in the Union ceases to be published. This power can be exercised irrespective of where the benchmark is authorised and published. In designating the statutory replacement rate, the European Commission shall take into account the recommendations of the risk free rate working groups operating under the auspices of the central banks responsible for the currency in which the rates of the benchmark in cessation are denominated.

Second, the statutory replacement rate will, by operation of the law, replace all references to the "benchmark in cessation" in all contracts entered into by an EU supervised entity. In order to benefit from the statutory replacement rate, contracts referencing the benchmark in cessation must be pending at the time of the designation enters into force, while no contracts concluded after entry into force of the implementing act designating the replacement rate will be allowed to reference the statutory replacement rate.

Third, for contracts not involving an EU supervised entity, Member State are encouraged to adopt national statutory replacement rates. At the appropriate time, the European Commission may issue a recommendation that the national statutory replacement rates will be identical to the statutory replacement rate that is designated for contracts involving EU supervised entities.

The following overview provides a description of key components of the proposed statutory replacement rate and its effects on contractual provisions:

Mandatory use of the statutory replacement rate	(1) Legacy contracts that contain no contractual fall-back benchmarks; (2) Legacy contracts that only contain fall-back provisions to accommodate for a temporary suspension of a benchmark whose cessation would result in significant disruption in the functioning of financial markets in the Union; (3) Legacy contracts that contain a fall-back that references the benchmarks mentioned under (2) (e.g., last quoted fixing of the above benchmarks).
Optional use of the statutory replacement rate (opt-in)	Legacy contracts that provide parties with a choice of fall-back rates; Legacy contracts that do not involve a supervised entity within the scope of the BMR.
Mutually agreed opt-outs	Parties that have renegotiated their references to a benchmark and selected another replacement rate.
Trigger events	The statutory replacement rate would become applicable or available upon the occurrence of three trigger events:

	(1) a public statement by or on behalf of the administrator of a benchmark announcing that the administrator has ceased or will cease to provide the benchmark permanently; (2) a public statement by the regulatory authority competent for the authorisation of the administrator of the benchmark announcing that the administrator of a benchmark has ceased or will cease to provide the benchmark permanently; (3) a public statement by the regulatory authority competent for the authorisation of the administrator of the benchmark announcing that the benchmark is no longer representative of an underlying market or economic reality on a permanent and irremediable basis.
Scope of the statutory replacement rate	All contracts referencing a benchmark in cessation that involve an EU supervised entity as a counterpart. Mutually agreed opt out remain available, also for supervised entities
Accompanying measures	The European Commission proposes to issue recommendations inviting Member States to complement the statutory replacement rate for use by supervised entities with national statutes mandating the use of the EU statutory replacement rate for use in contracts between non-financial counterparts that are governed by the laws of their jurisdiction.

The statutory replacement rate would become applicable upon the occurrence of any one of three objective trigger events, as described in the table above.

5.2.2. Exemption of specific foreign exchange benchmarks

The proposed amendments aim at exempting specified third country spot foreign exchange benchmarks from the scope of the Regulation where they fulfil certain criteria. The list of exemptions set out in Article 2 of the BMR would be extended to include spot foreign exchange benchmarks designated by the Commission (new paragraph 1(i)). This would be accompanied by a provision specifying how the Commission may exercise its power and the criteria for exempting qualifying spot foreign exchange benchmarks from the scope of the BMR (new paragraphs 3 and 4 in article 2). In order for the spot foreign exchange benchmark to qualify for exemption, it has to: (1) measure the spot exchange rate of a third-country currency that is not freely convertible and (2) be used by EU supervised entities, on a frequent, systematic and regular basis as settlement rate to calculate the pay-out under a currency forward or swap contract. Furthermore, to enable the Commission to have all the necessary elements to designate exempted benchmarks, ESMA and the ECB are required to provide it with relevant information and views on specific exemption criteria.

Finally, in order to monitor the appropriateness of the newly introduced exemption, competent authorities and supervised entities are required to periodically report to the Commission on the use of the exempted benchmarks by EU businesses and the changes of the balance sheets of supervised entities in terms of exposure to third country currency fluctuation.

2020/0154 (COD)

Proposal for a

REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Regulation (EU) 2016/1011 as regards the exemption of certain third country foreign exchange benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 114 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Economic and Social Committee[5],

Acting in accordance with the ordinary legislative procedure,

Whereas:

(1) In order to hedge against exposure to foreign exchange rate volatility in currencies that are not readily convertible or subject to exchange controls, companies in the Union enter into non-deliverable currency forwards and swaps. Those instruments enable their users to protect against volatility of foreign currencies that are not readily convertible into a base currency, such as the dollar or the euro. The unavailability of foreign currency spot exchange rates to calculate the pay-outs due under currency forwards and swaps would have a negative effect on companies in the Union that export to emerging markets or hold assets in those markets, with consequent exposure to fluctuations of emerging market currencies. Following the expiration of the transitional period set out in paragraphs 4a and 4b of Article 51 of Regulation (EU) 2016/1011 of the European Parliament and of the Council[6], the use of spot foreign exchange rates provided by a third country administrator other than a central bank will no longer be possible.

5 OJ C , , p. .

6 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).

(2) In order to enable companies in the Union to continue their business activities while mitigating foreign exchange risk, spot exchange rates referred to in non-deliverable forwards or swaps to calculate contractual pay-outs should be excluded from the scope of Regulation (EU) 2016/1011.

(3) In order to designate certain third country spot exchange rates as being excluded from the scope of Regulation (EU) 2016/1011, the power to adopt acts in accordance with Article 290 of the Treaty on the Functioning of the European Union should be delegated to the Commission in respect of the exemption of foreign spot exchange rate for non-convertible currencies when that the spot exchange rate is used for calculating the pay-outs that arise under non-deliverable currency forwards or swaps. It is of particular importance that the Commission carry out appropriate consultations during its preparatory work, including at expert level, and that those consultations be conducted in accordance with the principles laid down in the Interinstitutional Agreement of 13 April 2016 on Better Law-Making. In particular, to ensure equal participation in the preparation of delegated acts, the European Parliament and the Council receive all documents at the same time as Member States' experts, and their experts systematically have access to meetings of Commission expert groups dealing with the preparation of delegated acts.

(4) The UK Financial Conduct Authority (FCA) has announced it will stop supporting the production of one of the most important interest rate benchmarks, the London Interbank Offered Rate (LIBOR) by the end of 2021. As of the end of the transition period for the United Kingdom's withdrawal from the Union on 31 December 2021, LIBOR will no longer qualify as a critical benchmark. The cessation of LIBOR may nevertheless result in negative consequences that produce significant disruption in the functioning of financial markets in the Union. In the Union there is a stock of contracts in the areas of debt, loans, term deposits and derivatives that reference LIBOR, that mature beyond 31 December 2021 and that do not have robust contractual fall-back provisions to cover for the cessation of LIBOR. Many of those contracts cannot be renegotiated to incorporate a contractual fall-back prior to 31 December 2021. The cessation of LIBOR may therefore result in significant disruption in the functioning of financial markets in the Union.

(5) To be able to provide for an orderly wind down of contracts that reference a widely used benchmark the cessation of which may result in negative consequences that produce significant disruption in the functioning of financial markets in the Union and where such contracts cannot be renegotiated to include a contractual fall-back rate by the time of that benchmark's cessation, a framework accompanying the cessation of such benchmarks should be laid down. That framework should comprise a mechanism aimed at transitioning such contracts to suitable replacement benchmarks. Replacement benchmarks should ensure avoiding contract frustration which may result in negative consequences that produce significant disruption in the functioning of financial markets in the Union.

(6) In order to ensure uniform conditions for the implementation of this Regulation, implementing powers should be conferred on the Commission to designate a replacement benchmark to be used for the winding down of contracts that have not been renegotiated by the date the benchmark in cessation is no longer published. Those powers should be exercised in accordance with Regulation (EU) No 182/2011

of the European Parliament and of the Council[7]. Legal certainty requires that the Commission exercises those implementing powers only upon precisely defined trigger events clearly demonstrating that administration and publication of the benchmark to be replaced will cease permanently.

(7) Where necessary, the Commission should, at the appropriate moment, adopt a recommendation encouraging Member States to designate, by virtue of national laws, a replacement rate for the benchmark in cessation for contracts entered into by entities that are not supervised entities subject to Regulation (EU) 2016/1011. In order to account for the interconnectedness of contracts, the Commission should have the possibility to recommend that the national replacement rates should be identical to the replacement rate it designates for contracts entered into by supervised entities.

(8) 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. The Commission should also exercise its implementing powers only where it has become clear that the representativeness of the benchmark concerned cannot be restored or that the benchmark will no longer be published on a permanent basis.

(9) Use of that replacement benchmark should be allowed only for contracts that have not been renegotiated prior to the cessation date of the benchmark concerned. The use of the replacement benchmark designated by the Commission should therefore be restricted to contracts already entered into by supervised entities at the moment of the entry into force of the implementing act designating the replacement benchmark. Furthermore, considering that such implementing act is aimed at ensuring contract continuity, the designation of the replacement benchmark should not affect contracts that already provide a suitable contractual fall back provision.

(10) In exercising its implementing powers to designate a replacement benchmark, the Commission should take into account recommendations by private sector working groups operating under the auspices of the central bank responsible for the currency in which the interest rates of the replacement benchmark are denominated with regard to replacement rates to be used in existing financial instruments and contracts referencing the benchmark in cessation. Those recommendations should be based on extensive public consultations and expert knowledge, and reflect benchmark users' agreement about the most appropriate replacement rate for the interest rate benchmark in cessation.

(11) Since the main objective of those implementing powers is to ensure legal certainty for supervised entities with existing contracts referencing a benchmark in cessation, competent authorities of a supervised entity using the benchmark in cessation should monitor the evolution of the legacy stock between counterparts to such contracts and report their findings annually to the Commission and to the European Securities and Markets Authority ('ESMA').

(12) Regulation (EU) 2016/1011 should therefore be amended accordingly.

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[7] Regulation (EU) No 182/2011 of the European Parliament and of the Council of 16 February 2011 laying down the rules and general principles concerning mechanisms for control by the Member States of the Commission's exercise of implementing powers (OJ L 55, 28.2.2011, p. 13).

(13) In view of the fact that LIBOR will no longer be a critical benchmark within the meaning of Regulation (EU) 2016/1011 as of 1 January 2021, it is appropriate that this Regulation enters into force without delay,

HAVE ADOPTED THIS REGULATION:

Article 1

Amendments to Regulation (EU) 2016/1011

(1) Article 2 is amended as follows:

(a) in paragraph 2, the following point (i) is added:

"(i) a foreign exchange benchmark which has been designated by the Commission in accordance with paragraph 3.";

(b) the following paragraphs 3 and 4 are added:

"3. The Commission can designate foreign exchange benchmarks that are administered by administrators located outside the Union where all of the following criteria are fulfilled:

(a) the foreign exchange benchmark refers to a spot exchange rate of a third-country currency that is not freely convertible;

(b) supervised entities use the foreign exchange benchmark on a frequent, systematic and regular basis in derivative contracts for hedging against third country currency volatility;

(c) the foreign exchange benchmark is used as a settlement rate to calculate the pay-out of the derivative contract referred to in point (b) in a currency other than the currency with limited convertibility referred to in point (a).

4. The Commission shall adopt delegated acts in accordance with Article 49 to create and update as appropriate a list of foreign exchange benchmarks that fulfil the criteria laid down in paragraph 3. Competent authorities of supervised entities that use third country foreign exchange benchmarks that are designated by the Commission in accordance with paragraph 3 shall report to the Commission and to ESMA on the number of derivative contracts that use that foreign exchange benchmark for hedging against third country currency volatility at least every two years.";

(2) the following Article 23a is inserted:

"*Article 23a*

Mandatory replacement of a benchmark

(1) The Commission may designate a replacement benchmark for a benchmark that will cease to be published where the cessation of that publication may result in significant disruption in the functioning of financial markets in the Union and provided that any of the following events has occurred:

(a) the competent authority for the administrator of that benchmark has issued a public statement, or has published information, in which it is announced 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;

(b) the administrator of a benchmark has issued a public statement, or has published information, or such public statement has been made or such information has been published on behalf of that administrator, in which it is announced that that administrator has ceased or will cease to provide the benchmark, permanently or indefinitely, provided that, at the time of the issuance of the statement or the publication of the information, there is no successor administrator that will continue to provide the benchmark;

(c) the competent authority for the administrator of a benchmark or any entity with insolvency or resolution authority over the administrator of that benchmark has issued a public statement or has published information in which it is stated that the administrator of that benchmark has ceased or will cease to provide that benchmark permanently or indefinitely, provided that, at the time of the issuance of the statement or the publication of the information, there is no successor administrator that will continue to provide that benchmark.

(2) The replacement benchmark shall, by operation of law, replace all references to the benchmark that has ceased to be published in financial instruments, financial contracts and measurements of the performance of an investment fund where all of the following conditions are fulfilled:

(a) those financial instruments, contracts and performance measurements reference the benchmark that has ceased to be published on the date the implementing act designating the replacement benchmark enters into force;

(b) those financial instruments, contracts or performance measurements contain no suitable fall back provisions.

(3) The Commission shall adopt implementing acts to designate a replacement benchmark in accordance with the examination procedure referred to in Article 50(2) where one of the conditions laid down in paragraph 1 is fulfilled. When adopting the implementing act referred to in paragraph 1, the Commission shall take into account, where available, the recommendation by an alternative reference rate working group operating under the auspices of the central bank responsible for the currency in which the interest rates of the replacement benchmark are denominated.

(4) Competent authorities of supervised entities using the benchmark designated by the Commission shall monitor whether the implementing acts adopted in accordance with paragraph 1 have minimised contract frustration or any other detrimental effects on economic growth and investments in the Union. They shall report to that effect to the Commission and to ESMA annually.”

Article 2

This Regulation shall enter into force on the day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the European Parliament *The President*	*For the Council* *The President*