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COVER NOTE

From:	Ms Christine LAGARDE, President of the European Central Bank
To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
No. prev. doc.:	9964/20
Subject:	Opinion of the European Central Bank (ECB) on the 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 the opinion of the European Central Bank, and its drafting proposals, in relation to the proposal mentioned above.

Encl.



**OPINION OF THE EUROPEAN CENTRAL BANK
of 18 September 2020**

**on a 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
(CON/2020/20)**

Introduction and legal basis

On 8 September 2020 the European Central Bank (ECB) received a request from the Council of the European Union for an opinion on a 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 cessation¹ (hereinafter the 'proposed regulation').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union, since the proposed regulation contains provisions (a) relevant for the transmission of monetary policy and thus affecting the basic task of the European System of Central Banks (ESCB) of defining and implementing the monetary policy of the Union pursuant to Article 127(2) of the Treaty, and (b) affecting the ESCB's task of contributing to the smooth conduct of policies pursued by the competent authorities relating to the stability of the financial system pursuant to Article 127(5) of the Treaty. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

General observations

1. Objectives of the proposed regulation

1.1 The ECB welcomes the main objective of the proposed regulation to amend Regulation (EU) 2016/1011 of the European Parliament and of the Council² by empowering the European Commission to adopt an implementing act to designate a statutory replacement rate that would replace by operation of law certain benchmarks, which if no longer published would cause significant disruption to the functioning of financial markets in the Union and which are undergoing a supervised process of orderly cessation³. Upon the date of entry into force of the Commission implementing act, the replacement benchmark designated in that act would replace by operation of

¹ COM (2020) 337 final.

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

³ New Article 23a of Regulation (EU) 2016/1011, to be inserted by Article 1(2) of the proposed regulation.

law all references to the benchmark that has ceased to be published in all financial contracts and instruments and measurements of the performance of an investment fund, subject to Regulation (EU) 2016/1011, where these contain no suitable fall-back provisions.

- 1.2 The ECB considers this a helpful additional tool whose utilisation would fill the legal vacuum that would be left in respect of contracts with supervised entities as defined in Article 3(17) of Regulation (EU) 2016/1011⁴ (hereinafter referred to as 'Union supervised entities') that reference a benchmark whose cessation would significantly disrupt the functioning of financial markets in the Union and where the relevant contracts do not provide for or have no suitable fall-back reference rate. This would help to mitigate the risk of contract frustration and the risk to financial stability which might result from the cessation of such a benchmark.
- 1.3 The ECB also supports the proposed exemption from Regulation (EU) 2016/1011 of foreign exchange benchmarks administered from third countries that refer to a spot exchange rate of a third-country currency that is not freely convertible and that fulfil the other criteria set out in the proposed regulation⁵. With the exception of those provided by central banks, the use of such third country foreign exchange benchmarks will not be permitted in the Union beyond 2021⁶ unless they undergo an equivalence, recognition or endorsement procedure. The ECB appreciates that the fulfilment of such condition would be problematic, as these types of benchmarks are not regulated outside the Union. By exempting these benchmarks from Regulation (EU) 2016/1011, Union supervised entities would, however, be able to continue using them.

Specific observations

2. The ECB's interest and role in supporting the market's transition to near risk-free rates

- 2.1 Benchmarks, and particularly interest rate benchmarks, or interbank offered rates, are important for the functioning of financial markets and the transmission of monetary policy. The transmission of monetary policy to the wider economy relies on the ECB being able to monitor changes in benchmarks in money markets as a response to changes in ECB policy interest rates. The absence of robust and reliable benchmarks might therefore trigger financial market disruptions with a possible significant adverse impact on the transmission of ECB monetary policy through its decisions and on the Eurosystem's ability to contribute to the smooth conduct of policies pursued by the competent authorities relating to stability of the financial system.
- 2.2 In view of such risks, the ECB performs a number of roles in supporting the financial market's transition from critical benchmarks in the euro area to near risk-free rates. In 2017, together with the Commission, the European Securities and Markets Authority and the Belgian Financial Services and Markets Authority (FSMA), the ECB set up the working group on euro risk-free rates, for which it provides the secretariat. Since October 2019, the ECB also publishes the euro unsecured overnight interest rate (€STR), based on data already available to the Eurosystem, to complement existing benchmark rates produced by the private sector and serve as a backstop

⁴ Article 3(17) of Regulation (EU) 2016/1011 includes within its definition of supervised entities credit institutions, investment firms and certain other categories of financial institution.

⁵ New Article 2(3) and (4) of Regulation (EU) 2016/1011, to be inserted by Article 1(1)(b) of the proposed regulation.

⁶ Article 51(4a) and (4b) of Regulation (EU) 2016/1011.

reference rate. The working group has recommended the €STR as the risk-free rate for the euro to replace EONIA, which will be discontinued as of 2022. The ECB also participates in the Official Sector Steering Group, which guides the Financial Stability Board in reviewing the progress made in the transition to near risk-free rates globally.

3. Designation of a statutory replacement rate to replace a benchmark other than LIBOR

The ECB notes that the Commission's proposed power to designate a replacement rate is aimed primarily at contracts with Union supervised entities which reference the London Interbank Offered Rate (LIBOR)⁷, as this benchmark may not be sustained after the end of 2021. In this respect, the Government of the United Kingdom (UK) has recently announced its intention to amend its benchmarks regulations to ensure that by end-2021 the UK Financial Conduct Authority has the appropriate regulatory powers to manage and direct any wind-down period prior to eventual LIBOR cessation in a way that, inter alia, ensures market integrity⁸. The ECB notes that as the proposed power of the Commission to designate a replacement rate is neutrally framed in the proposed regulation, it may potentially be applied to contracts referencing other benchmarks – such as, for instance, the Euro Interbank Offered Rate (EURIBOR) – provided that the framework conditions set out in the proposed regulation and the Commission implementing act are met in respect of the relevant benchmark.

4. Contingency planning by Union supervised entities

- 4.1 The ECB notes that Article 28(2) of Regulation (EU) 2016/1011 requires Union supervised entity users of a benchmark (other than benchmark administrators), including credit institutions, to produce and maintain robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided. Union supervised entities are required to nominate in their contingency plans, where feasible and appropriate, one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives. Furthermore, Union supervised entities must, upon request, provide the relevant competent authority with those plans and any updates and reflect them in the contractual relationship with clients⁹. The ECB accordingly understands that the Commission's designation of a statutory replacement rate will be an additional tool that may be applied to a benchmark in cessation under the conditions set out in the proposed regulation, and that it does not affect, and is without prejudice to, Union supervised entities' contingency planning obligations under Article 28(2) of Regulation (EU) 2016/1011.
- 4.2 The ECB has recently published a horizontal assessment of credit institutions' preparedness for benchmark rate reforms¹⁰, following a horizontal stocktaking exercise on the impact of the reforms under Regulation (EU) 2016/1011 on credit institutions supervised within the Single Supervisory

⁷ As LIBOR is issued in different currencies and tenors, references to LIBOR in this opinion are to be read as referring to the particular LIBOR currency and tenor pair(s) whose publication is to be ceased.

⁸ See Financial Services Regulation; House of Commons Written Statement by the Chancellor of the Exchequer, Rishi Sunak, HCWS307, 23 June 2020, available at www.parliament.uk.

⁹ Article 28(2) of Regulation (EU) 2016/1011.

¹⁰ See ECB Banking Supervision, A horizontal assessment of SSM banks' preparedness for benchmark rate reforms, 23 July 2020, available on the ECB's website at www.ecb.europa.eu.

Mechanism. The ECB has also published on its website a separate report on credit institutions' preparations for benchmark rate reforms¹¹, which sets out certain good practices that can help credit institutions in their benchmark transition planning. The conclusions of these reports highlight the importance of credit institutions speeding up their preparations for moving to risk-free rates, in particular by developing and implementing mitigation actions and including robust and suitable fall-back mechanisms in their contractual documentation. Therefore, the ECB does not view the proposed availability of a statutory replacement rate mechanism as an alternative to the transition from EURIBOR or LIBOR where a contract can feasibly be amended.

5. Recommendations of the working group on euro risk-free rates

- 5.1 The ECB notes that, pursuant to the proposed regulation, when adopting the implementing act to designate a replacement benchmark the Commission would be required to 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 denominated¹².
- 5.2 The ECB would like to recall in this connection that the working group on euro risk-free rates was convened by the ECB, the European Securities and Markets Authority, the FSMA and the Commission, and that the ECB provides the secretariat for the working group and has participated as an observer since its launch. Nonetheless, the recommendations issued in this context are entirely those of this private sector working group, and the ECB does not accept any responsibility or liability for their content. Moreover, the fact that the ECB currently provides the secretariat for the working group should not be taken as implying in any way that it shares any of the views expressed in the working group's recommendations¹³.

6. Governing law of affected contracts

The ECB understands that pursuant to the proposed regulation, the designated replacement rate would replace the benchmark in cessation upon it ceasing to be published, in any legacy contract or instrument involving a Union supervised entity covered by Regulation (EU) 2016/1011, regardless of the governing law of the contract or instrument or of where the benchmark was authorised or published. This intention appears to follow from the explanatory memorandum¹⁴, which clarifies that the statutory replacement rate will, by operation of law, replace all references to the benchmark in cessation in all contracts entered into by a Union supervised entity.

¹¹ See ECB Banking Supervision, Report on preparations for benchmark rate reforms, 23 July 2020, available on the ECB's website.

¹² New Article 23a(3) of Regulation (EU) 2016/1011, to be inserted by Article 1(2) of the proposed regulation.

¹³ See recital 10 of the proposed regulation.

¹⁴ See page 12 of the explanatory memorandum to the proposed regulation.

7. Scope of contracts affected

As noted above, under the proposed regulation the Commission's power to designate the replacement rate would apply to legacy contracts covered by Regulation (EU) 2016/1011 to which a Union supervised entity is a party. The consulting authority is invited to give consideration to extending the scope of the contracts which would be subject to this proposed power, so that where the contract referencing the benchmark to be replaced is governed by the law of an EU Member State, the designated replacement rate may be applied to the contract irrespective of whether a Union supervised entity is a party to the contract. This would help to avoid the fragmentation that might otherwise ensue in the Union market so far as concerns relevant contracts - especially cross-border contracts – that reference benchmarks, with certain contracts being potentially subject to the designation of the replacement rate and others not.

8. Determining unsuitability of fall-back provisions

The ECB notes that the proposed regulation does not set out the criteria for determining whether the fall-back provisions in a contract referencing the benchmark in cessation are unsuitable and hence fall into the category of contracts to which the designated replacement rate would be applied should ceasing publication of the benchmark be considered to significantly disrupt the functioning of financial markets in the Union. The ECB understands that this and many other aspects would remain to be clarified, after due public consultation of all stakeholders, in the implementing act to be adopted by the Commission pursuant to the procedure referred to in Article 50 of Regulation (EU) 2016/1011.

Where the ECB recommends that the proposed regulation is amended, specific drafting proposals are set out in a separate technical working document accompanied by an explanatory text to this effect. The technical working document is available in English on EUR-Lex.

Done at Frankfurt am Main, 18 September 2020.



The President of the ECB

Christine LAGARDE



Technical working document

produced in connection with ECB Opinion (CON/2020/20)¹

Drafting proposals in relation to the proposed amendments to the benchmark regulation as regards the exemption of certain third country foreign exchange benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation

Text proposed by the European Commission	Amendments proposed by the ECB ²
Amendment 1 Preamble	
<p>THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,</p> <p>Having regard to the Treaty on the Functioning of the European Union, and in particular Article 114 thereof,</p> <p>Having regard to the proposal from the European Commission,</p> <p>After transmission of the draft legislative act to the national parliaments,</p> <p>Having regard to the opinion of the European Economic and Social Committee,</p> <p>Acting in accordance with the ordinary legislative procedure,</p>	<p>THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,</p> <p>Having regard to the Treaty on the Functioning of the European Union, and in particular Article 114 thereof,</p> <p>Having regard to the proposal from the European Commission,</p> <p>After transmission of the draft legislative act to the national parliaments,</p> <p>Having regard to the opinion of the European Central Bank,</p> <p>Having regard to the opinion of the European Economic and Social Committee,</p> <p>Acting in accordance with the ordinary legislative procedure,.....'</p>
<p><u>Explanation</u></p> <p><i>As the proposed regulation contains provisions relevant for the performance of ESCB tasks pursuant to Article 127 (2) and (5) of the Treaty in view of which the ECB has been consulted on the proposed amendments, the ECB opinion to be issued on the proposed regulation should be referred to in the Preamble.</i></p>	

¹ This technical working document is produced in English only and communicated to the consulting Union institution(s) after adoption of the opinion. It is also published on EUR-Lex alongside the opinion itself.

² Bo'd in the body of the text indicates where the ECB proposes inserting new text. Strikethrough in the body of the text indicates where the ECB proposes deleting text.

Text proposed by the European Commission	Amendments proposed by the ECB ²
Amendment 2 Recital 10	
<p>(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.</p>	<p>'(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 public authorities of 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. Furthermore, they are entirely the recommendations of these private sector working groups, and the public authorities under whose auspices these working groups operate do not accept any responsibility or liability for the contents of the recommendations or necessarily share any of the views expressed in them.'</p>
<p><u>Explanation</u></p> <p><i>In view of the reference in the proposed new Article 23a(3) of Regulation (EU) 2016/1011 to the Commission taking 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, the proposed amendment clarifies, for the avoidance of doubt, that any recommendations issued by the working groups, including the working group on euro risk-free rates, are entirely the recommendations of these industry working groups. The public authorities in question, including the ECB, do not accept any responsibility or liability for the contents of the recommendations or necessarily share any of the views expressed in them.</i></p>	

Text proposed by the European Commission	Amendments proposed by the ECB ²
<u>Amendment 3</u> New Article 23a (3)	
<p>(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.</p>	<p>(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 public authorities of the currency in which the interest rates of the replacement benchmark are denominated.</p>
<u>Explanation</u> See <u>Explanation to Amendment 2</u> .	
