FINANCIAL MARKETS LAW COMMITTEE

12 April 2016

European Money Markets Institute
56 Avenue des Arts
1000 Brussels

Dear Mr Ravoet,

EMMI Consultative Position Paper on the Evolution of EURIBOR

The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

The Committee has actively and regularly engaged with the subject of financial benchmark reform since 2012.[1] In light of its extensive work on this subject, the Committee welcomes the opportunity to respond to the consultative position paper (the "**Position Paper**") published by the European Money Markets Institute (the "**EMMI**") on the evolution of the European Interbank Offered Rate ("**Euribor**"), dated 30 October 2015.

Changes to the Benchmark Methodology

The Position Paper provides proposals for reforming the Euribor calculation methodology. Currently, Euribor is calculated using quote-based submissions provided by panel banks. The EMMI is committed to ensuring that the methodology is brought into line with international regulatory recommendations by anchoring it in transactions to the greatest extent possible.[2]

In briefest summary, the proposals, introduced in section 3 of the Position Paper, set out three phrases in the development of the new transaction-based methodology: a) calculating the benchmark from a sampling of data, supplied by Panel Banks, derived from "eligible transactions"; b) enhancements to guarantee data sufficiency, including the use of appropriately weighted historic data from days prior to the calculation; and c) the further elaboration of calculation methods, including techniques to smooth volatility by discarding outlying rate data. The EMMI also makes detailed proposals for data insufficiency contingency and fallback arrangements. The primary proposed fallback is to make greater use of historic data from prior days; the second is to revert to a quote-based methodology.

In section 4, the Position Paper addresses the question of how a transition to the new methodology can be achieved with minimum market disruption. This question had previously been addressed, in abstract, for key "IBOR" benchmarks as part of a report by the Financial Stability Board (the "**FSB**") on *Reforming Major Interest Rate Benchmarks*.[3] As part of its analysis, the Position Paper refers to various alternative transition pathways identified in the FSB Report and concludes that pursuing a "Seamless Transition"—whereby the identity of the existing benchmark is preserved to the greatest extent possible whilst the methodology is reformed—would be in the interest of the broad majority of Euribor stakeholders. The advantages of such a transition are that it offers reduced legal and operational risks compared to other alternatives. There are, however, some

[1] The FMLC has published several papers on benchmark reform (which can be accessed at www.fmlc.org). Members of the FMLC Secretariat also contributed to the work of a Market Participants Group ("MPG"), established by the Financial Stability Board (the "FSB") and to the MPG's *Final Report of the Market Participants Group on Reforming Interest Rate Benchmarks*, dated 22 July 2014. The report is available at: http://www.fsb.org/wp-content/uploads/r_140722b.pdf. The findings of the MPG Report were considered by the Official Sector Steering Group (the "OSSG") of the FSB. Accordingly, the FSB published its own recommendations on *Reforming Major Interest Rate Benchmarks*, in a report dated 22 July 2014. The FSB Report is available at: http://www.fsb.org/wp-content/uploads/r_140722.pdf.

[2] See for example the recommendations in the FSB Report, *supra* at n.1.

[3] *Supra* n.1.

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disadvantages. As highlighted in the Position Paper, a Seamless Transition is only feasible if the "definition as well as the value and volatility of Euribor under the current and transaction-based determination methodologies are sufficiently similar" (p.21). Accordingly, the EMMI emphasises (p.22) the need "to achieve similarity in the essential characteristics of the benchmark" before and after transition.

In view of this concern to ensure continuity not only with respect to the identity of the benchmark but also with respect to the predicted values, it is noteworthy that the figures provided in Table 6 (p.23) of the Position Paper suggest that the new methodology could lead to a variation spread in values of more than ten basis points (although the Position Paper stresses that the quantitative analysis undertaken is not a prediction of actual changes when the methodology is introduced in 2016). There is good reason to infer that if this degree of divergence in projected values is substantiated, market participants will be apprehensive about the possibility of operational disruption and this may possibly have a negative impact on plans for a Seamless Transition.

Legal Risk and Financial Contracts

It is sometimes said that divergence in predicted values under a reformed benchmark methodology would give rise to legal risk. Those who raise this concern are usually referring to "frustration" risk in relation to existing financial contracts which reference the benchmark. Frustration risk materialises at common law when the subject matter of a contract has been destroyed, or has otherwise become unavailable, and as a result performance by one or both of the parties to the contract is rendered impossible. It is often said that benchmark withdrawal would represent a frustration risk for financial contracts and occasionally the same thing is said of benchmark transition or evolution on the premise that the evolved benchmark no longer shares the identity of the original benchmark.

A similar issue, which is perhaps more prevalent in civil law systems, is the risk of *force majeure*, whereby a party is excused performance under a contract because performance has become impossible or impracticable owing to the intervention of an unpredictable and overwhelming supervening event. In common law systems, although there is no free-standing doctrine of *force majeure*, contracts sometimes include *force majeure* clauses contemplating events that may render performance impossible or impracticable and make provision for the parties to be excused further performance. When a *force majeure* clause is triggered it will normally bring an end to the contract.

It would be wrong to suggest that an increase in projected values is likely to crystallise legal risks of this kind. The FMLC has observed elsewhere that it would be highly unusual for a commercial contract to be frustrated, particularly where the parties have incorporated fallback provisions dealing with the eventuality of benchmark withdrawal.[4] Frustration will only occur where the parties to the contracts can be said to have wholly failed to allocate the risks of benchmark withdrawal. The parties may be taken to have allocated these risks in a number of different ways.[5] A financial contract may make express provision for benchmark withdrawal—as with a fallback clause—or it may be found, at common law, to incorporate an implied term which covers the eventuality: for example, by recognising the parties' obvious, if implicit, intention that a new methodology is to apply in substitution for the original methodology where the latter has been superseded.

The likelihood of contracts governed by English law being frustrated following a change to the methodology of a specific benchmark is, then, very remote. It is not, however, wholly negligible. One reason why frustration risks deserve continued attention is that fallback clauses in market standard contracts typically refer to mechanisms (e.g. "*reference banks*") which are unlikely to prove workable on a market-wide basis over the long term. It is self-evident that, where the contractual fallback is itself unavailable, there is necessarily an increased risk that a financial contract will be frustrated in the event of benchmark withdrawal. This increased risk could conceivably materialise in situations of benchmark

[4] FMLC paper entitled "Benchmark Transition—Observations on Proposal for Benchmark Reform", published 1 December 2012, at paragraph 6.11. The report is available at: http://www.fmlc.org/uploads/2/6/5/8/26584807/011212.pdf.

[5] See FMLC report *ibid*, p.24 to 27, for more detail on the doctrines of frustration and implied terms.

transition or evolution if a case can successfully be made that the evolved benchmark no longer shares the identity of the original benchmark which has, therefore, effectively been withdrawn. (One would expect the threshold to be met in establishing such a case to be a high one.)

The risks may be different under other European legal systems. A report published by a Market Participants Group (the "**MPG**") established under the auspices of the FSB in the context of its work on *Reforming Major Interest Rate Benchmarks* sets out legal risk factors for certain key jurisdictions in the Eurozone and provides that, in those jurisdictions, the doctrine of implied terms is not available.[6] The risk that a contract comes to a disorderly end in the event of benchmark withdrawal or transition may, in light of this, be slightly higher in civil law systems, although fallback provisions will help to mitigate any risk.

Cost of Borrowing and Litigation Risk

The fact that the risks highlighted in the paragraphs above may be, *de jure*, remote does not necessarily mean that a benchmark transition will be an entirely smooth one. Wherever there is a change in market practice, those who perceive themselves to be economically disadvantaged are incentivised to challenge the new arrangements and/or the contracts which tie them to those arrangements. History may suggest that there are grounds to be sanguine about benchmark transition,[7] but examples of a transition involving a benchmark which is the reference rate for over-the-counter derivatives valued at more than a hundred trillion euros (on a notional underlying basis)[8] and a proposed core rate spread of over ten basis points are probably unprecedented.

Concerns regarding potential basis point variation in the context of benchmark transition were documented in the MPG report referred to above. The MPG surveyed market participants and found that, in a situation where a reformed benchmark systematically varied from a current benchmark by more than five basis points, the vast majority of those surveyed were undecided or preferred to transition to a different rate.[9] One of the key concerns emphasised by those who expressed a view was the impact on the cost of borrowing.[10]

This work by the MPG suggests that a perception of economic disadvantage could render benchmark transition arrangements for major interest rate benchmarks contentious and even litigious, despite every indication that the legal risks are remote. This is a possibility which the EMMI will no doubt wish to consider.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,

Joanna Perkins

FMLC Chief Executive

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6 MPG, *Final Report of the Market Participants Group on Reforming Interest Rate Benchmarks*, dated 22 July 2014, *supra* n.1; see p.43 and also the section entitled "Implied Terms" at p.66.

7 See article entitled "Evolving financial benchmarks: The impact on legacy contracts" by Joanna Perkins and Paul Mortby, dated 13 May 2015, Journal of Securities Operations & Custody, Volume Seven, Number Four, Autumn/Fall 2015.

8 EUR interest rate derivatives figures for H1 2015 from the Bank for International Settlements.

9 See, in particular, p.37 of the report.

10 The FMLC also highlighted this issue in its report of 2012 by noting that rates based on actual transaction data may be higher than those determined under a quote-based methodology and, thus, a change may be perceived as economically disadvantageous to Borrowers, in particular. See FMLC report, *supra* n.4, see paragraph 5.12.