



# Report by the working group on euro risk-free rates

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High level recommendations for fallback provisions in contracts for cash products and derivatives transactions referencing EURIBOR

6 November 2019

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# 1 Overview of the euro benchmarks reform

In January 2019 the working group on euro risk-free rates (the “working group”) published a paper containing guiding principles for fallback provisions in new contracts for euro-denominated cash products.<sup>1</sup> The paper provided an overview of the legal frameworks and market practices applicable to cash products, such as mortgages, loans and bonds, that reference EURIBOR and EONIA, with a specific focus on fallback clauses, and it recommended a set of guiding principles promoting the use of effective fallback provisions in new contracts for euro-denominated cash products. This new paper serves to remind market participants of key messages from the paper published in January and, where relevant, it provides updates that reflect market developments and practices related to cash products and derivatives transactions referencing EURIBOR.

Since January 2019 euro benchmark rates have evolved significantly. On 2 October 2019 the European Central Bank started publishing the euro short-term rate (“€STR”). On the same date the European Money Markets Institute (EMMI), as the administrator of EONIA, modified the EONIA methodology such that EONIA is now calculated as €STR plus a fixed spread of 8.5 basis points.

In July 2019 the working group published a set of recommendations, referred to as the EONIA to €STR legal action plan,<sup>2</sup> and in August 2019 it published a report on the impact of the transition from EONIA to €STR from an operational and valuation perspective.<sup>3</sup> In the coming months until the discontinuation of EONIA in December 2021, market participants will need to gradually transition from EONIA to €STR.

A great deal of progress has also been made with regard to EURIBOR:

- On 6 May 2019 EMMI announced<sup>4</sup> that it had applied for authorisation as the administrator of EURIBOR from the Belgian Financial Services and Markets Authority (FSMA) under the EU Benchmarks Regulation (BMR)<sup>5</sup> and had started transitioning from the current EURIBOR methodology to the new hybrid methodology which measures the same underlying interest – namely banks’ costs of borrowing in unsecured money markets.<sup>6</sup> The transition to the new hybrid methodology is expected to be completed in the fourth quarter of 2019.
- On 2 July 2019, following the positive advice of the EURIBOR College of Supervisors, the FSMA granted the requested authorisation to EMMI.<sup>7</sup> This authorisation confirms that EMMI and the EURIBOR hybrid methodology meet the requirements contained in the BMR and that EURIBOR can

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1 <https://www.ecb.europa.eu/pub/pdf/other/ecb.sg3guidingprinciples201901.en.pdf>

2 [https://www.ecb.europa.eu/paym/pdf/cons/euro\\_risk-free\\_rates/ecb.eurostr\\_eonia\\_legal\\_action\\_plan\\_20190716.en.pdf](https://www.ecb.europa.eu/paym/pdf/cons/euro_risk-free_rates/ecb.eurostr_eonia_legal_action_plan_20190716.en.pdf)

3 [https://www.ecb.europa.eu/pub/pdf/other/ecb.wgeurorfr\\_impacttransitioneoniaeurostrcashderivativesproducts~d917dffb84.en.pdf](https://www.ecb.europa.eu/pub/pdf/other/ecb.wgeurorfr_impacttransitioneoniaeurostrcashderivativesproducts~d917dffb84.en.pdf)

4 <https://www.emmi-benchmarks.eu/assets/files/D0156A-2019%20-%20EMMI%20has%20applied%20for%20authorisation%20from%20the%20FSMA.pdf>

5 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.

6 <https://www.emmi-benchmarks.eu/assets/files/D0062A-2019%20-%20EURIBOR%20Questions%20and%20Answers.pdf>

7 <https://www.fsma.be/en/news/fsma-authorises-emmi-administrator-euribor-benchmark>

continue to be used in new and legacy contracts, which allows market participants to continue using EURIBOR for the foreseeable future.<sup>8</sup>

The situation for EURIBOR is different from EONIA, as EURIBOR is not scheduled to be discontinued. As a consequence, contracts and financial instruments referencing EURIBOR do not need to transition to a new rate, but need to incorporate new or improved fallback provisions. This would reduce potential uncertainties in the event of the potential disruption to EURIBOR and would be in line with the recommendations of the International Organization of Securities Commissions (IOSCO). For supervised entities and financial instruments and contracts that fall within the scope of the BMR, introducing robust fallbacks would also contribute to meeting the requirements laid down in the BMR. Market participants may also assess whether €STR could be used as an alternative benchmark for new financial instruments and contracts for certain asset classes.

In Europe, Article 28(2) of the BMR, which applies since January 2018, requires supervised entities 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. Where feasible and appropriate, such plans shall nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives. The supervised entities shall, upon request, provide the relevant competent authority with those plans and any updates and shall reflect them in the contractual relationship with clients.”*

Historically, contractual fallback provisions, where present, generally only contemplated the temporary unavailability of EURIBOR and did not address its permanent cessation and/or any differences between EURIBOR and any applicable replacement rate. As a result, current legacy fallback language may not produce a commercially fair result, as it may affect the pricing and performance of the product in the event of the permanent cessation of EURIBOR. The working group noted that legacy contracts dating from prior to 2018, when the BMR took effect, may be more prone to this issue.

The aim of this report is to provide high level recommendations for fallback provisions in contracts for EURIBOR-referencing cash products and derivative transactions. When establishing their plans to introduce fallback provisions, supervised entities are also advised to check whether further guidance have been provided by the working group and competent authorities, such as the European Commission, ESMA and national competent authorities.

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<sup>8</sup> See the speech by Mr Steven Majoor (European Securities and Markets Authority) on 25 September and the statement by Mr Valdis Dombrovskis (European Commission) in a communication to the European credit sector associations, dated 3 September 2019 ([https://www.esma.europa.eu/sites/default/files/library/esma71-319-141\\_speech\\_esma\\_chair\\_roundtable\\_eur\\_rfr\\_25\\_09\\_19.pdf](https://www.esma.europa.eu/sites/default/files/library/esma71-319-141_speech_esma_chair_roundtable_eur_rfr_25_09_19.pdf) and [https://www.ebf.eu/wp-content/uploads/2019/09/2019-09-03-VP-Dombrovskis-EACB\\_EBF\\_ESBG.pdf](https://www.ebf.eu/wp-content/uploads/2019/09/2019-09-03-VP-Dombrovskis-EACB_EBF_ESBG.pdf)).

## 2 High level recommendations for fallback provisions for products referencing EURIBOR

### 2.1 General recommendations

The working group recommends that market participants should consider incorporating fallback provisions in all new financial instruments and contracts referencing EURIBOR, regardless of whether they fall within the scope of the BMR.<sup>9</sup>

Legacy financial instruments and contracts referencing EURIBOR that were entered into after 1 January 2018 and that fall within the scope of the BMR should be covered by the “robust written plans” prepared by supervised entities in accordance with Article 28(2) of the BMR. For legacy contracts which do not contain fallback provisions or which do not contain appropriately worded fallback provisions, to the extent practicable, market participants should consider including EURIBOR fallback provisions, or enhancing existing provisions, when such financial instruments and contracts are amended or during any scheduled future update.<sup>10</sup>

These recommendations are intended to support compliance with the BMR, where applicable,<sup>11</sup> and to enhance legal and commercial certainty.

The working group recommends that the development of EURIBOR fallback provisions should take into account the characteristics described below.<sup>12</sup> It acknowledges that, for certain asset classes, key aspects of the high level recommendations set out below are already being met under current market practice. Therefore, there should not be any need to develop EURIBOR fallback provisions in such contexts.

- New contracts should include provisions covering both permanent and temporary cessation trigger events. They should be objective and should define the circumstances in which they will apply. Clear fallback provisions which specify the date from which the fallback rate will apply after one or more of the trigger events has occurred will facilitate the smooth operation of the fallback if and when it is invoked. Market participants may wish to avoid disrupting an interest rate which has already been set prior to the occurrence of a trigger event.
- New contracts should include EURIBOR fallback provisions which comply with the BMR, where applicable, and with any other applicable national or European law. In the coming months the working group will conduct analysis and propose recommendations on the most appropriate EURIBOR fallback rates for specific asset classes and/or financial product types. In the absence of recommended specific fallback provisions and pending further guidance from the working group or

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<sup>9</sup> Very short-term contracts are also recommended to include fallback provisions, as they may be exposed to temporary unavailability of EURIBOR.

<sup>10</sup> In the coming months the working group will analyse options and best practices for amending legacy contracts.

<sup>11</sup> The BMR does not apply to all types of financial product and each market participant should perform their own assessment of which of their products fall within the scope of the BMR.

<sup>12</sup> The working group acknowledges that the standard documentation provided by the Loan Market Association for syndicated loans and by the International Swaps and Derivatives Association for derivatives transactions could be considered a convenient way to introduce fallback provisions.

the regulatory authorities, market participants may wish to consider including generic language in their fallback provisions (see below). This could be a convenient option that would enhance transparency, increase contractual robustness and comply with the BMR, where applicable.

- New contracts should contemplate adjustments to address differences between the value of EURIBOR and the value of the fallback rate. The methodology for calculating the fallback rate may differ from that used for EURIBOR and an adjustment would therefore be necessary to address potential differences between EURIBOR and the fallback rate, if the fallback were applied. It is expected that in the coming months the working group will recommend an adjustment methodology to resolve any difference between EURIBOR and the fallback rate that parties are recommended to consider as an appropriate EURIBOR fallback. In the absence of market consensus on a suitable adjustment methodology, it is advisable for documentation to include generic provisions on determining and applying an adjustment to the fallback rate.
- Taking into account the above considerations regarding the fallback rate and the applicable adjustments, a generic EURIBOR fallback provision may take the following form: *“Unless otherwise agreed by the parties, the EURIBOR replacement rate will be the rate (inclusive of any spreads or adjustments) formally recommended by (i) the working group on euro risk-free rates established by the European Central Bank (ECB), the Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission, or (ii) the European Money Market Institute, as the administrator of EURIBOR, or (iii) the competent authority responsible under Regulation (EU) 2016/1011 for supervising the European Money Market Institute, as the administrator of the EURIBOR, or (iv) the national competent authority designated by each Member State under Regulation (EU) 2016/1011, or (v) the European Central Bank.”*<sup>13, 14</sup> The selection of a replacement benchmark rate by a nominating body should, to the extent feasible, be objective and clearly defined. This would reduce the risk of any potential legal challenge.
- The working group notes that some market participants, particularly households and small and medium-sized enterprises, may not be comfortable with referring to *“a rate formally recommended by the working group on the euro risk-free rate, [...]”* as per the proposed generic language, since no formal recommendations have yet been made and market participants are consequently not able to assess whether such rates will be appropriate. However, all recommendations by the working group are promptly published on the ECB’s website and it is proposed that extensive efforts should be made by private and public institutions to inform and educate market participants (see below for further guidance).
- Where possible and applicable, new contracts should include flexible provisions to facilitate the application of new fallback provisions and/or should amend the consent levels required for future amendments to the agreements. One option in certain circumstances could be to give prior consent in a transparent and fair manner at the time of signing, and include it in the terms and conditions of

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13 This wording would be a feasible option where asset classes and/or local law and regulatory requirements permit prior consent to be given for future amendments.

14 This is an example of a wording that could be considered as a starting point in the discussion with parties. It would need to be tailored to take account of the specific nature of the contract, the product type, the applicable laws and any applicable market conventions. For example, for transferrable securities with multiple potential investors the requirements will differ from those for bilateral contracts. Further optionality may also be required by way of a “waterfall” procedure to provide for the possibility that there is no formal recommendation, in order to allow for the party (or parties) to select a rate that is customarily applied in the relevant market or under the industry standard for derivatives, for example. The package of fallbacks as a whole needs to be robust enough to meet the requirements of the BMR.

the agreement, so that any future amendments related to a specified and agreed replacement rate would not require any additional consent (this may not be possible for certain products and the applicable laws may require counterparty agreement to be obtained on a case by case basis). Another option is for parties to consider lowering the consent thresholds, which would facilitate the amendment of the terms and conditions of the relevant agreement in cases in which prior consent is not considered feasible or appropriate.<sup>15</sup>

When implementing these recommendations, the specific features of the product, contractual documentation and market practice, as well as any applicable local laws relating to frustration or discontinuation of agreements, will need to be considered. The risk of legal challenges resulting from a substantial change in rates owing to the application of a fallback should be considered on a jurisdiction-by-jurisdiction basis.

## 2.2 Derivatives transactions

For derivatives transactions, at the request of the Financial Stability Board's Official Sector Steering Group, the International Swaps and Derivatives Association, Inc. (ISDA) is developing fallbacks for derivatives referencing LIBOR, EURIBOR and other key interest rate benchmarks (the ISDA IBOR fallbacks) to address the event of permanent cessation. In addition, ISDA has published the ISDA Benchmarks Supplement which market participants may incorporate into their documentation to provide primary fallbacks for derivatives in the event of the cessation of an index, which the working group considers a convenient way to include fallback provisions. Supplementary consultations on EURIBOR and pre-cessation trigger events will be held by ISDA in the coming months.

For derivatives transactions executed under European master agreements,<sup>16</sup> the sponsors of European master agreements should consider amending these agreements to include EURIBOR fallback provisions for addressing the permanent cessation of EURIBOR in line with ISDA's work, if possible.

## 2.3 Contracts with consumers

EURIBOR is widely referenced in contracts entered into by consumers and less sophisticated counterparties. Therefore, the incorporation of fallback provisions into contracts referencing EURIBOR may involve consumer protection issues, including the need for consumers to be informed and educated, where possible in a timely manner, by private and public institutions. To this end,

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15 For example, in the case of syndicated loans, the Loan Market Association published a revised version of its "replacement of screen rate" clause, which can be incorporated into new loan agreements where the parties would like to have the flexibility to make changes to the documentation to include replacement benchmark rate(s) and related changes with a lower consent threshold than may otherwise be required. This may make the process of amending agreements to incorporate any new benchmark rate(s) and related changes easier than if a higher consent threshold were required.

16 These are: the Master Agreement for Financial Transactions, commonly known as the European Master Agreement (EMA) sponsored by the European Banking Federation, in cooperation with the European Savings Bank Group and the European Association of Cooperative Banks; the French Master Agreement relating to transactions on forward financial instruments sponsored by the French Banking Federation (Fédération Bancaire Française – FBF); the Spanish Master Agreement (Contrato Marco de Operaciones Financieras – CMOF) sponsored by the Spanish Banking Association (Asociación Española de Banca) and the German Master Agreement for Financial Derivatives Transactions (Deutscher Rahmenvertrag für Finanztermingeschäfte – DRV) developed by German banks with the support of the Association of German Banks (Bundesverband Deutscher Banken).

market participants should carefully consider their marketing practices and the applicable laws, particularly when interacting with consumers and less sophisticated counterparties. In particular, market participants introducing fallback clauses in their new contracts should consider introducing adequate training on this topic for their sale forces and should ensure that customers are properly informed about the rationale for and operation of fallback clauses (including adjustment mechanisms), in accordance with the applicable law.

## 2.4 Differences between asset classes and currencies

The working group highlights the risk management implications of inconsistencies in fallback provisions and triggers and of incorporating different fallback trigger language for different asset classes and currencies. In particular, side effects could arise from the lack of concordant language for the commonly used hedging product combinations. Market participants are recommended to consider these risks when developing trigger events and fallback provisions, assessing the feasibility and appropriateness of aligning them across asset classes and currencies.

## 2.5 Voluntary nature of high level recommendations

Finally, the extent to which market participants adopt and use any of the high level recommendations discussed in this paper is left to their discretion. Each market participant will need to make their own independent decision about whether and, if so, to what extent any recommendations are adopted and used in their financial instruments and contracts.



## Disclaimer

This paper has been prepared for recommendation purposes only, as required in the context of the work being performed within the working group. It has been prepared for this specific purpose and must not be used for any other.

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