Deutsches Aktieninstitut

Reform of EU Benchmark Regulation: Missed Opportunity, but in Step in the Right Direction

Exemptions for non-EU interest rate benchmarks and broader scope of the statutory replacement regime neeeded

Response of Deutsches Aktieninstitut to 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 benchmarks in cessation, 21 September 2020

Introduction

This position paper summarizes the view of German non-financial companies on the issues raised in the Proposal of the EU-Commission to amend 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.

Our view is based on discussions in the corporate finance/corporate treasury working group of Deutsches Aktieninstitut which is the central forum of opinion building for the treasury departments of the largest German NFCs.

Financial benchmarks play a key role in global financial markets and day-to-day activities of treasury departments of non-financial companies (NFC). They are an important part of the risk management strategies, for example to protect NFCs from exchange rate risks, commodity price risks or interest rates fluctuations.

Deutsches Aktieninstitut[1] therefore welcomes the initiative of the EU Commission to improve the Benchmark Regulation (BMR), on two key points: (1) the exemption of specific foreign exchange benchmarks and (2) the introduction of statutory replacements for discontinued or unrepresentative financial benchmarks. The proposed amendments are both a step in the right direction, although from the perspective of NFCs they both require further refinement and extension. In particular, the proposal to exempt certain Non-EU-benchmarks should be extended to other classes of benchmarks (most notably interest rate benchmarks).

However, the proposal has missed the opportunity for a comprehensive reform of the BMR. Just as other jurisdictions have limited their regulatory regimes to the most critical or systemic benchmarks, the BMR should employ a risked based approach and focus its efforts on critical benchmarks only. This would solve a number of problems that currently arise with the BMR without jeopardizing the ultimate objective of ensuring reliability of financial benchmarks and protecting the EU economy from systemic risks. We therefore encourage policy makers to envisage such a comprehensive reform as soon as possible.

[1] Deutsches Aktieninstitut (EU transparency register: 38064081304-25) represents the entire German economy interested in the capital markets. The about 200 members of Deutsches Aktieninstitut are listed companies, banks, stock exchanges, investors and other important market participants.

1 Exemption of designated FX rates

Extending the scope of the proposal

Financial benchmarks play a key role in global financial markets and day to day activates of treasury departments of non-financial companies (NFC). They are a part of the risk management strategy as derivatives are used to hedge against exchange rate, commodity price risks or interest rates fluctuations reference to financial benchmarks. The aim of the EU Benchmarks Regulation (BMR) was to ensure the reliability of benchmarks and to protect the European financial market from the risks and disruption of failing benchmarks.

However, the BMR in its broad scope, combined with an inefficient third country benchmark regime and the automatic prohibition of non-qualifying benchmarks may have negative impact on non-financial end-users from the real economy. This is particularly relevant with regard to Non-EU-Benchmarks. If those Benchmarks cannot be used in EU because administrators fail to comply with the EU provisions or non-EU-governments do not implement an equivalent legal framework, EU companies will lose key components of their risk management strategies and face a competitive disadvantage vis-à-vis international competitors who operate in a less strict benchmark regime.

The new EU Commission Proposal therefore rightly picks up this very important issue with respect to non-EU FX benchmarks rates. An important motivation behind the Propsal is to ensure that so-called Non-Deliverable Forwards (NDFs), which reference to non-EU FX benchmarks, remain available in the EU after 2021. NDFs are used by non-financial companies to hedge against foreign exchange risks in currencies that are not freely convertible into Euro. Examples for such jurisdictions are India, South Korea, Argentina or Russia. As most of the NDFs are based on FX spot rates issued/calculated by organisations located in the respective third countries there are regularly no broadly used alternative rates.

According to Art. 2 of the Proposal the EU COM will be empowered to exempt non-EU FX benchmarks on a case-by-case basis. Without such an exemption, EU supervised entities will no longer be permitted to reference non-EU FX benchmarks in certain contracts after 31 December 2021, unless the rates have been authorised via the "equivalence, "endorsement" or "recognition" routes available under the BMR.

We therefore welcome the proposal as a step in the right direction. However, the proposal has two significant shortcomings that definitely need to be addressed:

1. The third country issue is not limited to FX benchmarks alone but also relevant for interest rate, equity and other benchmarks administrated outside the EU. **The proposal should therefore be extened to other classes of benchmarks (in particular interest rate benchmarks**). We therefore propose to add a further possible exemption to Art. 2 para. 2 which could read "(ii) „an interest rate benchmark administrated outside the EU which has been designated by the EU Commission in accordance with para 3a". In addition to that a para 3a should be added to specify potential reasons for using the discretionary power in relation to interest rate benchmarks.

   A problem relating to Non-FX-benchmarks may, for example, be internal finance for corporate subsidiaries which is often provided by the central treasury unit in the EU. To convert Euro funds into the respective local currency the central treasury uses cross-currency-swaps referencing a local interest rate benchmark, e.g. from EUR to Renminbi (SHIBOR), Rubel (MOIBOR) or the Australien reference rates (BBSW, BBSY). The inherent interest rate risk will be hedged by the central treasury unit also using hedging instruments referencing to that third country benchmark. Rendering these benchmarks unavailable would counteract the central treasury logic by requiring local subsidiaries to finance themselves externally.

2. As the EU COM will have discretionary power it remains unclear which FX benchmarks are going to be exempted from the BMR. Market participants are therefore confronted with a high degree of uncertainty as to whether and which financial instruments and services referencing to non-EU benchmarks will be possible in the future. From the perspective of an non-financial end-user of this situation is likely to lead to uncertainties in operative business and interfering with existing treasury activities**. In order to reduce legal uncertainty, the EU Commission should commit itself to transparency**. The selection procedure for the derogations must be clarified.. In addition, if the exemption from a third country benchmark is withdrawn, companies **should be granted a sufficiently long transitional period, and legacy contracts should be granted grandfather rights.**

Missed opportunity

Notwithstanding necessary improvements to the existing proposal, the current proposal misses the opportunity of broader reform of the BMR base it on new principles and abandon the "all-in" approach of the regime. We therefore

encourage policy makers to address in particular the third country issue in a more suitable and less complex way then in the current proposal. A broader a reform should take the following direction.

From our perspective many of the problems of the BMR result from an overaly broad scope. We therefore believe that the BMR should take a proportionate and risk based approach as certain benchmarks pose a far greater risk to the financial system than others. Just as other jurisdictions have limited their benchmark regulatory regimes to the most critical or systemic financial benchmarks, the BMR should focus its efforts on critical benchmarks only. This would also solve the third country issue as we expect that only a very small subset of third country benchmarks will have the significance to pose a systemic risk to the EU market as a whole.

More concretely:

- EU non-significant benchmarks and their equivalent third country benchmarks should be exempt of the BMR and allowed to be used in the Union unless specifically prohibited (i.e. a reversal of the current general prohibition of benchmarks unless specifically authorised, see point 3.).

- Public policy benchmarks (e.g., FX rates used in NDFs and certain interest rate swaps) should be exempt in general because their prohibition would be disproportionately disadvantageous to end users. Non-significant EU and equivalent third country benchmarks as well as public policy pose little risk of systemic disruption.

- ESMA or the EU Comission could be empowered to analyse significant EU and third country benchmarks based on their use or potential impact on EU financial markets. On this basis, the authorities could decide whether individual benchmark providers need to fulfil additional obligations

Such a regime would ensure the continued availability of benchmarks from third countries for which there is no suitable alternative in the Union and improve the user-friendliness of the system for benchmark users. In addition, it would relieve EU and non-EU administrators of regulatory hurdles alike and level the playing field. It would be up to the competent authorities to identify Non-EU-benchmarks, which are considered critical, and prone to manipulation that extraterritorial jurisdiction might be justified.

2 Mandatory replacements for discontinued IBOR rates

The unorderly discontinuation LIBOR or other widely used interest rate benchmarks may pose a significant risk for financial stability in the Union.

We therefore welcome the proposal to give the Commission the power to mandate the use of a statutory replacement rate (SRR) in relevant contracts if a major benchmark used in the EU is discontinued or becomes unrepresentative of its underlying market.

We also welcome, that a statutory replacement will only overrule existing contracts when there is no suitable fallback provision (Art. 23 para 2 sub b)). However, it appears to be unclear in which case a fall-back provision will be regarded as not suitable. In particular it is unclear whether the fall back provision would also apply if the contractual parties have agreed to negotiate a suitable rate when necessary but this negotiation has not come to a final result at the time of the publication of the statuary replacement rate. We therefore propose to clarify that the statutory replacement only applies, if parties fail to find a consensus in negotiatons. A wording could be "„… only apply if parties to a contract within the scope of the BMR failed to individually agree on a successor rate until the next given fixing date." or "a required consent on a fallback rate cannot be achieved between parties until the replacement rate applies".

The Propsal is, however, too limited in its scope. Under the new regime, the relevant SRR would automatically replace the outgoing benchmark by operation of law in all contracts which are (i) in scope of the BMR and (ii) entered into by one or more BMR "supervised entities". With its overly specific focus on supervised entities the proposal does not fully address the needs of non-financial entities of the real economy.

Both intercompany contracts of non-financials companies and contracts with other non-financial-companies would not fall under the SRR mechanism An example are the numerous leasing or commercial contracts that still refer to LIBOR, for example in the case of interest on overdue payments. Since it may not be possible to renegotiate all these contracts individually, the discontinuation of LIBOR or other important benchmarks presents companies with legal uncertainties.We therefore advocate extending the scope of the SSR regime to all contracts, while at the same time ensuring that non-financial companies must not meet stricter BMR requirements in general

Although the proposal envisions that the application of an SRR for NFCs could be extended through the enactment of domestic legislation by each EU member state and the EU Commision might issue a respective recommandation, this solution gives rise to the possibility of a patchwork of legislation across the EU. Differing rules would spark confusion and legal uncertainty as firms seek to plan their legacy strategies. We therefore would prefer a binding EU mechanism. However, this mechanism must be well designed in order to avoid that other provisions of the BMR are applied to non-financial companies.

In addition, non-EU law governed instruments and contracts, need further consideration. The Proposal appears to cover also contracts governed by non-EU laws, for example US or UK-Law. This could give rise to conflicts scenarios where market participants are subject to different LIBOR legacy regimes with the consequence that extensive legal advice may be necessary in order to address potential legal risks.

Deutsches Aktieninstitut therefore proposes the following changes

1. Legal certainty should be improved on when there is “no suitable fall-back”. In particular, it should be accepted if parties have agreed to freely negotiate a replacement rate in case of cessation or lack of representativeness.

2. Non-financial companies should be able to benefit from statutory replacement rates for all contracts and not only for those where at least on contractual partner is a “supervised entity”. The new rules should apply EU-wide to avoid a patchwork of divergent rules. However, this mechanism must be well designed in order to avoid that other provisions of the BMR are applied to non-financial companies.

3. Instruments and contracts that are not governed by EU law should generally be excluded from the SSR mechanism.

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