

# Working Group on Euro Risk-Free Rate

## Understanding EURIBOR Fallbacks



# Table of contents

1. Purpose and use of this pack
2. EURIBOR context with regard to the introduction of fallback clauses
3. Fallback provision and their main elements
4. The need for fallback clauses
5. Regulatory requirements in relation to EURIBOR fallback clauses
6. Historical market practice in relation to EURIBOR fallback provisions
7. High level recommendations on EURIBOR fallback
8. Market associations' work on fallbacks
9. Risk management and accounting considerations

**Annex: Brief description of market associations' work on EURIBOR Fallbacks**

# 1. Purpose and use of this pack



## Purpose

- The purpose of this presentation is to inform about EURIBOR fallbacks in the context of the interest rate benchmark reform and the recommendations made by the Working Group on Euro Risk Free Rates, as well as to address the need for fallbacks from a regulatory perspective and the work performed by market associations.



## Uses

- This documentation has been prepared by the Working Group on Euro Risk Free Rates to be used by its members when engaging with internal and external stakeholders on this topic.



## Scope

- The presentation covers the following areas:
  - EURIBOR fallback context
  - What a fallback provision is and its main elements
  - The need for the use of fallbacks
  - Regulatory requirements regarding the fallback provision
  - Recommendations of the Working Group
  - Risk management and accounting considerations
  - Other work performed by market associations

## 2. Euribor context with regard to the introduction of fallback clauses

- **European Benchmark rates are currently undergoing significant reforms** derived from the Financial Stability Board report “Reforming major interest rate benchmarks” in 2014. In the EU, **this reform process is supported by the introduction of the EU Benchmark Regulation (BMR)** which was published in 2016 and came into force in January 2018.
- **EURIBOR is a critical interest rate benchmark** administered by the European Money Markets Institute (EMMI), see EMMI website for definition and governance details ([about EURIBOR](#)).
- **BMR requires that critical benchmarks, such as EURIBOR, receive authorization** in order to be used as a valid benchmark in financial contracts.
- In order to be authorized, **EMMI**, the administrator, **reformed the EURIBOR governance and methodology** to comply with BMR requirements. **Authorization was granted on July 2<sup>nd</sup> 2019** by the Financial Services Market Authority (FSMA) under art. 34 of BMR.
- This authorization **allows EU supervised entities to continue using EURIBOR after January 1<sup>st</sup> 2020**.
- However, **benchmarks are subject to the risk of disruption or future discontinuation**, therefore, **BMR** and the recommendations of the International Organization of Securities Commission (IOSCO) **foresee the introduction of robust fallbacks in contracts referencing benchmark rates** (see also: [ESMA Chairman, Mr Steven Maijor, Speech](#))

### 3. Fallback provisions and their main elements

#### What is a fallback provision?

- A fallback provision is a clause in a contract that determines what rate parties should use in the event that the initially agreed upon benchmark rate (like EURIBOR) is not available.



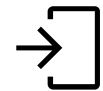
Without a fallback, a party tied to a contract could potentially dispute actions taken in response to the unavailability of the referenced benchmark rate.



Robust fallback provisions reduce uncertainty and the risk of legal disputes in the event that the initially agreed upon benchmark rate is no longer available.

#### Key elements of a fallback provision:

- Fallback provisions are defined by 3 key elements which determine the application and the conditions applicable to the provision:



Trigger event: Defines events and future date when the fallback will be applied.



Fallback rate: Identifies the new reference rate.



Spread adjustment: If the new fallback rate provides an economically different outcome to the original rate, a spread is included to avoid or minimise the transfer of value.

## 4. The need for a EURIBOR fallback provision

- There are several reasons to introduce EURIBOR fallback provisions:

1

EURIBOR fallback provisions serve as insurance against the temporary or permanent cessation of EURIBOR.

2

EURIBOR fallback provisions help to reduce uncertainty and the risk of legal disputes in case of unavailability of EURIBOR.

3

The EU Benchmarks Regulation (BMR) contains regulatory requirements in relation to fallback provisions. International Securities Commission (IOSCO) recommends the inclusion of fallback provisions.



## 5. Regulatory requirements in relation to EURIBOR fallback provisions

Regulatory requirements in relation to EURIBOR fallback provision are contained in the EU Benchmark Regulation (BMR)

BMR is applicable since January 1<sup>st</sup> 2018

BMR's main objectives are, among others to:

- Ensure accuracy and integrity of benchmarks
- Protect consumers and investors through greater transparency
- Provide adequate rights of redress requiring, for example, a number of actions in the event of changes to or cessation of a benchmark.

BMR is applicable to:

- Supervised entities
- Financial instruments and contracts



Firms that provide EU investment services, loans to consumers, insurance, asset management products



See MiFid annex for financial instruments definitions  
See Directive 2008/48/EC and 2014/17/EU for financial contracts

**The requirements for fallback provisions are laid out in Article 28(2))\***

**Supervised entities are required:**

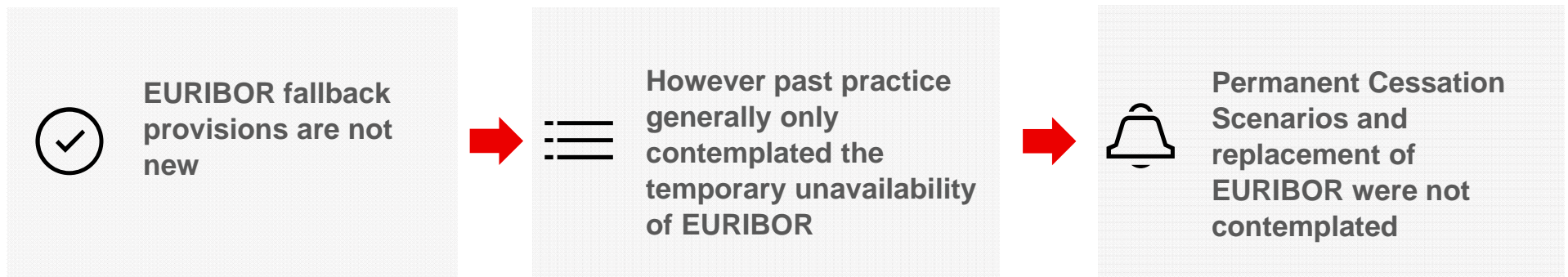
- to produce and maintain **robust written plans** setting out the actions they would take in the event that a benchmark they are using materially changes or ceases to be provided, including, where, feasible and appropriate, the nomination of alternative benchmark(s) that could be referenced to substitute the benchmarks no longer provided
- **to provide** their written plans, upon request, **to the relevant competent authority**
- to reflect the written plans **in the contractual relationships with clients.**

\* ESMA published a Q&A that provides guidance on the implementation of Article 28(2) of BMR.



## 6. Historical Market Practice in relation with EURIBOR fallback provisions

- Before BMR, the market practice did not generally contemplate the permanent cessation of a benchmark

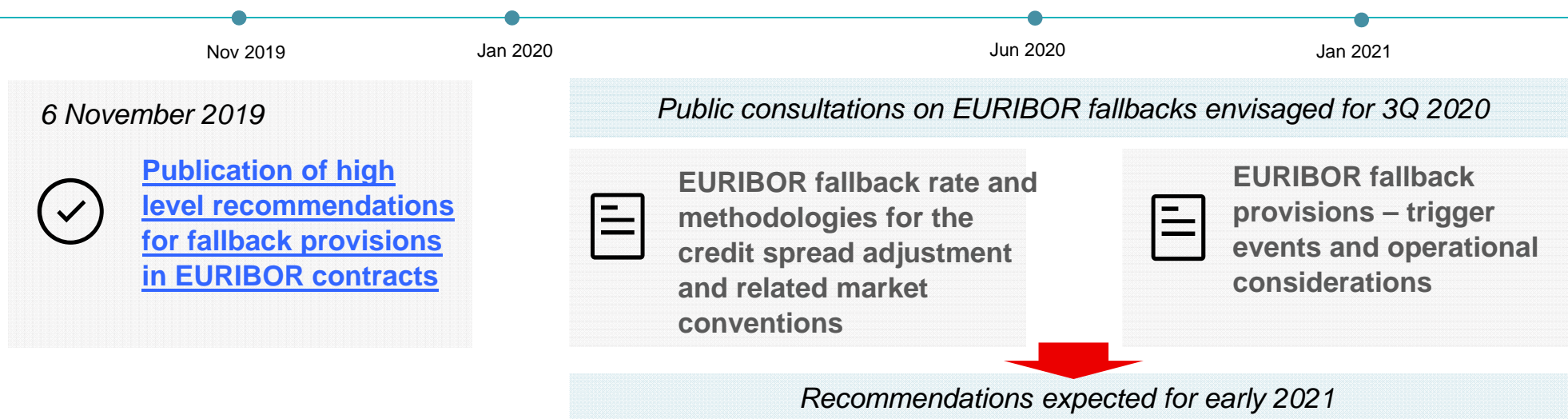


The use of current (historical) legacy fallback language may not produce a commercially fair result, as it may affect the pricing and performance of the product in the event of permanent cessation of EURIBOR.



## 7. High level recommendations on EURIBOR fallback provisions (1/5)

- The Working Group on Euro Risk-Free Rates is engaged in activities to identify and recommend EURIBOR fallback provisions.



- Guidance on how to amend existing contracts envisaged to be published in early 2021

The Working Group is also in the process of developing a set of guidelines for how to amend existing legacy contracts and financial instruments referencing EURIBOR to embed fallback provisions in existing documentation for different asset classes.

## 7. High level recommendations on EURIBOR fallback provisions (2/5)

### *Topic*

#### 1. New contracts

### *Working Group high level 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 BMR.

#### 2. Legacy Contracts

- **Legacy financial instruments and contracts referencing EURIBOR that were entered into after 1 January 2018 should be covered by the “robust written plans”** prepared by supervised entities in accordance with art. 28(2) of 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.

## 7. High level recommendations on EURIBOR fallback provisions (3/5)

### Topic

#### 3. Fallback expected characteristics

### Working Group high level recommendations

- **EURIBOR fallback provision should cover both permanent and temporary cessation trigger events.** They should be objective, should define the circumstances in which they occur, and should specify the date from which the fallback rate will apply after one or more of the trigger events has occurred.
- EURIBOR fallback provisions **should comply with the BMR, where applicable, and with any other applicable national or European law.**
- **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.
- **EURIBOR fallback provisions should contemplate adjustments** to address differences between the value of EURIBOR and the value of the fallback rate. The fallback rate may differ economically from that used for EURIBOR and an adjustment would therefore be necessary to address potential differences between EURIBOR and the fallback rate.

## 7. High level recommendations on EURIBOR fallback provisions (4/5)

### Topic

#### 4. Generic fallback provisions

### Working Group recommendations

- While market participants await recommendations for specific fallback provisions, **a generic fallback provision, as per below, may be considered for inclusion in contracts:**

*“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.”*

- **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.

## 7. High level recommendations on EURIBOR fallback provisions (5/5)

<i>Topic</i>	<i>Working Group recommendations</i>
5. Flexibility in contracts	<ul style="list-style-type: none"><li>• Where possible and applicable, <b>new contracts should include flexible provisions to facilitate the application of new fallback provisions</b> and/or should amend the consent levels required for future amendments to the agreements.</li></ul>
6. Specific considerations	<ul style="list-style-type: none"><li>• When introducing fallback provisions into contracts referencing EURIBOR, <b>entities should also consider:</b><ol style="list-style-type: none"><li>i. <b>whether they wish or need to apply consistency across products and/or currencies</b></li><li>ii. <b>the consistency between the definition of triggers and their timing</b> when two contracts are linked (eg: a hedged item and its hedging instrument)</li><li>iii. <b>consumer protection issues and requirements</b>, including the need for customers to be informed and educated, where possible in a timely manner, by private and public institutions</li></ol></li></ul>
7. Voluntary nature of recommendations	<ul style="list-style-type: none"><li>• 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.</li></ul>



## 8. Market associations' work on fallbacks

- Several market associations are working on fallback provisions.
- Below is a **non exhaustive list** of some major market associations involved in this work.
- Please **review the annex for a brief detail of their work**.
- **Market participants are advised to check the relevant websites** for more and regularly updated details on this work.

### *List of main market associations:*

- AEB
- AFME
- BDB
- EBF
- FBF
- ICMA
- ISDA
- LMA
- Others



Market associations are working on fallback languages and provisions in order to update their reference contracts and master agreements, which helps to improve terminology and standardization among users.

## 9. Risk management and accounting considerations

- The Working Group highlights that users and supervised entities should consider risk management and accounting implications when they incorporate fallback language for different assets and currencies. (\*)

### Risk and accounting considerations on hedging and inconsistencies in fallback provisions

- Inconsistencies could arise in relation to:
  1. Fallback rate definition
  2. Triggers –timing of fallback transition
- Timing inconsistency can add to the discrepancy between different fallback rate definitions, increasing potential risks to hedging, hedge accounting and asset and liability management.



***Market participants are recommended to reduce variability in fallbacks between different product classes (including derivatives) to a minimum as this would reduce technical implementation challenges as well as risk management and accounting complexity.***

\* For further implications and background information see WG euro RFR reports [on risk management](#) and [accounting](#)

## 9. Accounting considerations (1/2)

### Accounting implications

- The impact of €STR-based fallbacks for EURIBOR on accounting is twofold:

**First**, inserting fallback clauses to existing contracts could affect the relevant IFRS modification requirements.

- This mainly affects legacy contract.
- If this modification were considered substantial, it would probably result in derecognition and re-recognition of the modified financial instrument.

**Second**, triggering existing fallbacks could cause valuation shifts that have a potentially greater impact on hedge accounting.

- This could cause issues for both legacy contracts and new contracts
- The triggering of an existing contractual fallback clause should not be considered a contractual modification, as the original contract already anticipated that a replacement could occur. Nevertheless, in some situations, applying such a contractual clause could imply a change in the instrument's value as a result of the shift from the old benchmark to the new one.

- The working group believes that owing to the general goal of equivalence when (i) introducing a fallback rate in an existing contract, or (ii) shifting from a benchmark rate to its fallback rate, this change should be considered a substantial modification only when such equivalence is not fulfilled. However, this view would have to be supported by the IASB.

- For further implications and background information see WG euro RFR reports [on risk management](#) and [accounting](#)
- [See structure of the accounting recommendations report](#)

## 9. Accounting considerations (2/2)

### Accounting implications



*The WG recommends to analyse hedging implications following these actions.*

- a) *Analyse whether there might be fallback scenarios under which hedge relationships would need to be discontinued.*
- b) *Consider incorporating a provision for replacing benchmark interest rates in their hedge documentations for new contracts. Consequently, the risk of hedge de-designations resulting from documentation adjustments could be reduced for new business.*
- c) *Consider the risk of inconsistency when developing fallback provision triggers when amending or setting up new contracts.*
- d) *To consider the risk of hedge ineffectiveness and potential discontinuation of hedge relationships in the event of:*
  - *having timing inconsistencies in fallback provision triggers,*
  - *incorporating different fallback trigger language for hedged items and hedging instruments.*



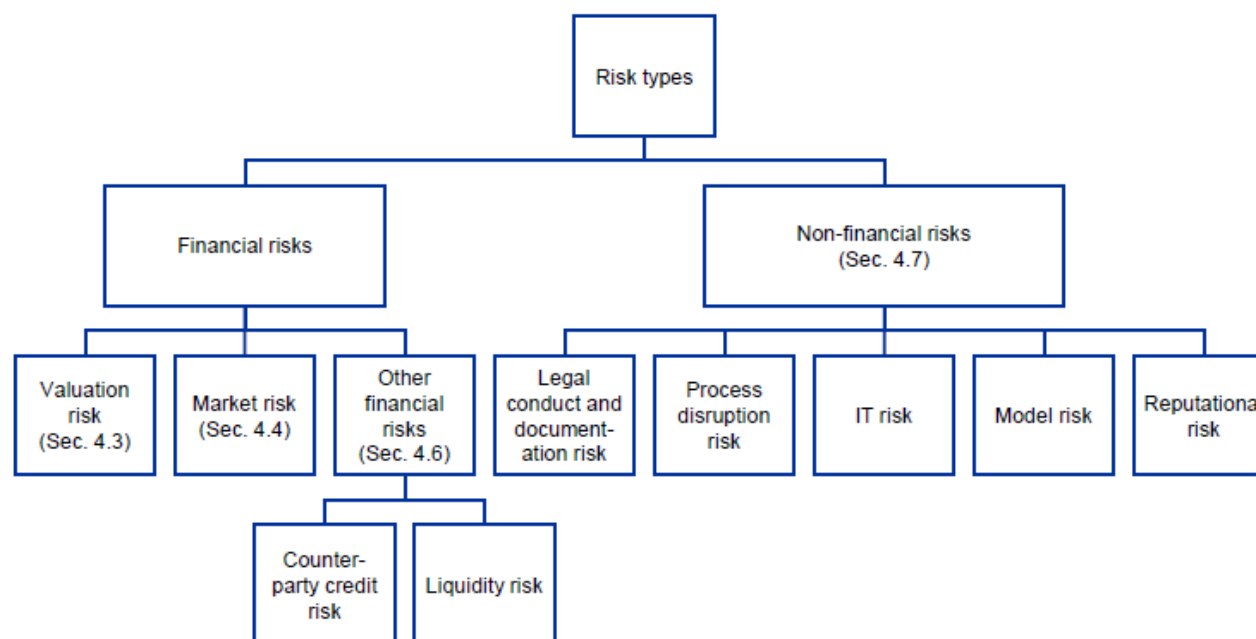
***Working group recommends that preparers of financial statements closely monitor the IASB project on IBOR reforms and any amendments or clarifications to the standards resulting from it.***

\* For further implications and background information see WG euro RFR reports [on risk management](#) and [accounting](#)

## 9. Risk considerations (1/3)

### Major risk types that the working group has identified as affected by the introduction of risk-free rates resulting from the benchmark reform

- Valuation and market risk are expected to be the most affected. While the risk types mentioned serve as first guidance on possible areas of focus for financial institutions and their assessment
- The WG highlights that the severity of individual impacts strongly depends on the individual business and technical circumstances.



For more detail, see section 4.3. to 4.7 of the WG euro RFR on [risk management](#)

\* For further implications and background information see WG euro RFR reports [on risk management](#) and [accounting](#)



## 9. Risk considerations (2/3)

### Risk management implications on fallbacks



The working group recommends that market participants:

- (i) gain an **overview of the quantity of basis risk exposure from fallbacks in their current EURIBOR-indexed** contracts by assessing the exposure amount and estimating the magnitude and volatility range of the spread;
- (ii) gain an overview of **and develop a clear plan for current and future hedging instruments and strategies for the relevant basis risks, including associated costs**;
- (iii) **set up corresponding market observations and possible warning indicators** for market liquidity in the relevant hedging instruments.

- Market participants should consider establishing a governance framework involving front office and risk functions to monitor the benchmark and contractual fallback exposures at a sufficiently differentiated level on an ongoing basis
- With respect to fallback data, it would be particularly useful to have a consistent source for the publication of fallback rate values, including the respective spread adjustments, i.e. a vendor could publish it ensuring compliance with BMR and IOSCO principles.

\* For further implications and background information see WG euro RFR reports [on risk management](#) and [accounting](#)

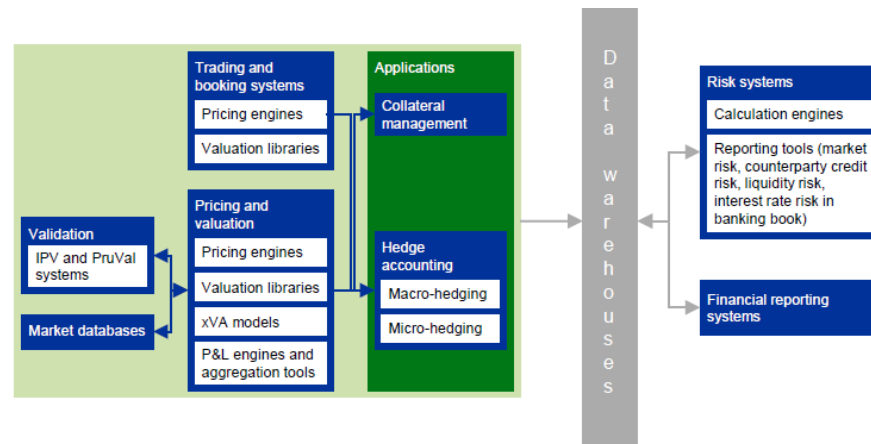
## 9. Risk considerations (3/3)

### Technical Implications

#### Impact on the full front-to-back IT system landscape: Products

- **Models**
- **Market data systems**
- **Valuation infrastructure: pricing engines and valuation libraries, VA models and P&L engines.**
- **Processes.**

#### Overview of affected risk management IT systems



#### Implications for data

- **Market data set-up:** New interest rate curves need to be introduced as part of the market data, including data quality processes and the calculation of new projection and yield curves.
- **Historical data:** The calibration of internal models to measure market and counterparty credit risk, requires time series of historical market data, including historical stress periods.



The working group recommends that market participants carefully assess potential impacts on their IT system landscape and processes related to risk management implications, including an analysis of the technical ability to switch from one valuation curve to another when required.

\* For further implications and background information see WG euro RFR reports [on risk management](#) and [accounting](#)

## Useful links

### Website



[ECB Website](#)



[Terms of reference for the Working Group on Euro Risk-Free Rates](#)



[Meetings of the Working Group on Euro Risk-Free Rates](#)

### Link to other jurisdictions



[FSB progress report](#)

### WG Recommendations



1. [Report by the WG on EONIA to €STR transition](#)



2. [Recommendations of the WG on the EONIA to €STR legal action plan](#)



3. [Report by the WG on the impact of the transition from EONIA to the €STR on cash and derivatives products](#)



4. [Report by the WG on the risk management implications of the transition from EONIA to the €STR and the introduction of €STR-based fallbacks for EURIBOR](#)



5. [Report by the WG on the financial accounting implications of the transition from EONIA to the €STR and the introduction of €STR-based fallbacks for EURIBOR](#)



6. [Report on Fallback provisions in contracts for cash products and derivatives transactions referencing EURIBOR](#)



7. [Report on €STR fallback arrangements](#)



## Disclaimer

This presentation has been prepared for information and education purposes only, it has been prepared for this specific purpose and must not be used for any other. *The authors recommend to read the applicable rules and regulation, Q&As and the consultations and reports published by the Working Group.*

It is not intended to provide and should not be construed, or relied on in any manner, as legal, regulatory or other advice. The information (of a legal, factual or any other nature) included in the presentation has not been independently verified and such information is not comprehensive and may be subject to change. The authors disclaim any obligation or undertaking to release any update of, correct, keep current or otherwise revise the content of this paper.

This presentations discusses a variety of options to address the cessation of a benchmark. Each recipient of this paper is responsible for performing their own assessment as to the suitability of the various options discussed herein. Each recipient must continue to operate in an independent and competitive manner and they shall not use the content of this paper to coordinate their activities, either with respect to the commercially sensitive terms of each recipient's business or with regard to any other independent business.

The authors or any of their respective directors, officers, advisers, affiliates or representatives, shall not be deemed to have made any representation, warranty or undertaking, express or implied, as to, and no reliance should be placed on, the truthfulness, fairness, accuracy, completeness or correctness of the information and opinions contained in this document. The authors or any of their respective directors, officers, advisers, affiliates or representatives, expressly disclaim any and all liability, whether direct or indirect, express or implied, contractual, tortious, statutory or otherwise, in connection with the accuracy, completeness or correctness of the information, for any of the opinions or factual information contained herein, any errors, omissions or misstatements contained in this document or otherwise for any direct, indirect or consequential loss, damages, costs or prejudices whatsoever arising from the use of this document.

The authors of this presentation may provide to any third party (including, but not limited to, authorities, clients, associations or counterparties) opinions or advice that may differ from the content of this document.

SG#7 Communication and Education | February 2020

# Annex

## Understanding Euribor Fallbacks



## Annex 1: Brief description of market association work on EURIBOR Fallbacks

<b>Association</b>	<b>Description</b>
1. AEB	<ul style="list-style-type: none"><li>The Spanish Banking Association (AEB) together with the Savings Bank Association (CECA), both sponsors of the Spanish Master Agreement for Financial Transactions (CMOF), started last year the necessary work to adapt the Spanish documentation to the European Benchmark Regulation, specifically to facilitate the transition from the EONIA to the STR and to include the necessary fallbacks for the interest rate and currency benchmarks used. This work is expected to be completed by spring 2020 (<a href="https://www.aebanca.es/contrato-marco-de-operaciones-financieras/">https://www.aebanca.es/contrato-marco-de-operaciones-financieras/</a>)</li></ul>
2. AFME	<ul style="list-style-type: none"><li>The Association for Financial Markets in Europe (AFME) published model wording for new issues of securitization bonds to help facilitate the transition from IBORs to new risk-free rates. The model wording provides an easier mechanism for the transition to an alternative rate when EURIBOR would no longer be available. It does not identify a new rate but makes the procedure for moving to such a rate (once identified) easier, by avoiding the need to undertake a consent solicitation.</li></ul>
3. BDB	<ul style="list-style-type: none"><li>The Association of German Banks/Bundesverband deutscher Banken e.V. (BdB) have already developed some templates addressing certain benchmark/RFR related aspects:<ol style="list-style-type: none"><li>Incorporated into the new German Master Agreement for Derivatives Transactions 2018 (DRV 2018): A general fallback provision in Clause 5 (2) addressing the case that a benchmark may no longer be available or may no longer be used – the fallback provision is described in more detail in the (English language) background paper: <a href="https://bankenverband.de/media/files/drv_2018_annotated_version_04_09_2018.pdf">https://bankenverband.de/media/files/drv_2018_annotated_version_04_09_2018.pdf</a></li><li>A proposed wording (which the parties to a German master agreement can include as a special provision) for an agreement for the avoidance of doubt regarding changes to EONIA methodology and time of publication (no material change)</li></ol></li></ul>

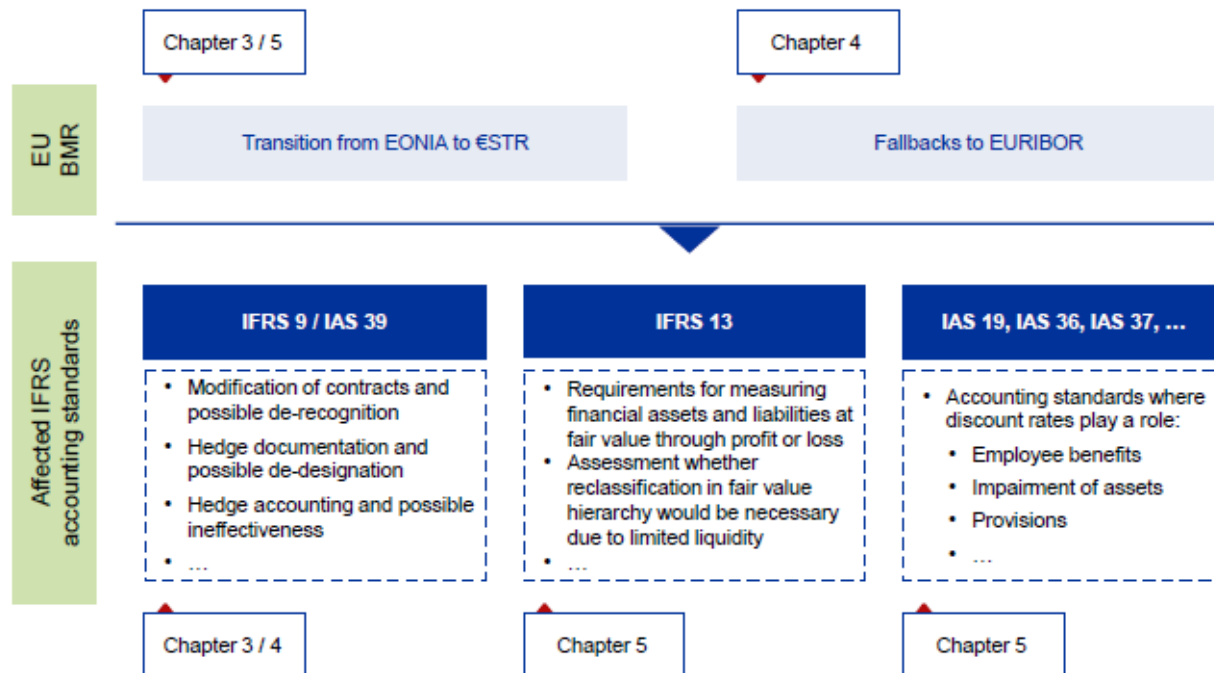
## Annex 1: Brief description of market association work on EURIBOR Fallbacks

Association	Description
3. BDB (continues)	<p>3. A proposed wording regarding Clause 5 (2) of the DRV 2018 (which the parties to a DRV 2018 can include as a special provision) with a clarification regarding immaterial changes and additional provisions establishing a procedure for raising objections.</p> <p>BdB is currently developing a supplemental agreement for German Master Agreements addressing the replacement of the EONIA and related issues, including specific EONIA fallback provisions (which in the case of the DRV 2018 would take precedence over the general fallback-provision in Clause 5 (2)). In a next step IBOR-related issues will be addressed. Please refer to the following link: <a href="#">bankenverband</a></p>
4. EBF	<ul style="list-style-type: none"><li>• The European Banking Federation (EBF) is very much engaged in ensuring the awareness on the reform of EURIBOR and the transition from EONIA to €STR is a smooth process, providing the required legal certainty for banks and their clients in order to avoid any possible disruption threatening the European financial stability and proper functioning of key EU markets while safeguarding the continuity of contracts. Having conveyed the message to relevant European authorities about the need to ensure such legal certainty, the EBF released a <a href="#">public statement</a> on 30 September 2019, with supporting statements from the European Commission and ESMA, to aid institutions in understanding how to prepare for the forthcoming migrations.</li><li>• The EBF will continue working to ensure no disruption in the transition takes place affecting markets and consumers.</li></ul>
5. FBF	<ul style="list-style-type: none"><li>• The French Banking Federation is currently updating the FBF master agreements for derivatives to be compliant with the European Benchmarks Regulation. The master agreement should be finalized beginning of 2020. Work to update the interest rates' definition and fallback will be launched in 2020. This task is expected to be achieved in 2020 and will be made available to the members of the FBF on its extranet site (<a href="https://extranet.fbf.fr">https://extranet.fbf.fr</a>).</li></ul>

## Annex 1: Brief description of market association work on EURIBOR Fallbacks

<i>Association</i>	<i>Description</i>
6. ICMA	<ul style="list-style-type: none"><li>• ICMA has taken steps to raise awareness of the need to consider fallbacks to IBORs among its members, and vanilla bond market participants have developed alternative fallbacks which are now included in most bond documentation. This document summarises the position: <a href="#">Fallbacks for LIBOR floating rate notes</a>. There is no ICMA “standard language” for vanilla bond fallbacks.</li></ul>
7. ISDA	<ul style="list-style-type: none"><li>• 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. A supplementary consultation on fallbacks for EURIBOR was launched in December 2019. On 24 February, ISDA published a statement summarizing responses to a supplemental consultation that would apply to fallbacks for derivatives referencing euro LIBOR and EURIBOR. Additionally, ISDA published a consultation on pre-cessation trigger events will be held by ISDA in the coming months.</li></ul>
8. LMA	<ul style="list-style-type: none"><li>• Since November 2014, LMA facility documentation has included an optional "replacement of screen rate" clause, which can be helpful in terms of any discontinuation of EURIBOR. This clause qualifies the "All Lender matters" clause by providing that if a Screen Rate is unavailable any amendment replacing that Screen Rate may be made with Majority Lender and Obligor consent. In order to facilitate further flexibility than the November 2014 clause allows, the LMA published a Revised Replacement of Screen Rate Clause in May 2018 which permits amendments to be made to documents with Majority Lender and Obligor consent in a wider range of circumstances than the November 2014 clause (i.e. not just in the case of an unavailability of a Screen Rate).</li></ul>

## Structure of the report and specific accounting standards affected by the Benchmarks Regulation



For more detail please see the [WG euro RFR report on financial accounting](#) implications of the transition from EONIA to the €STR and the introduction of €STR-based fallbacks for EURIBOR

