Svensk Värdepappersmarknad
Swedish Securities Markets Association

EU Commission
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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

The Swedish Securities Markets Association (SSMA) welcomes the opportunity to provide comments on the proposal for amending the Benchmark Regulation 2016/1011 (BMR) as regards the exemption of certain third country foreign exchange benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation. We are generally in favor of the proposal for a statutory transition and a replacement rate that mitigates the adverse consequences for legal certainty and financial stability in cases where the parties to a contract have not agreed on a suitable fallback provision in time. In principle, there may be objections to an EU institution making amendments to civil law contracts; however, we still see that there are practical reasons why such solution is appropriate in this case.

We believe that it is crucial that any legislation amending bilaterally concluded agreements is as clear and precise as possible. The wording of the agreement and the intention of the parties must be respected to the greatest extent possible and any statutory designation of replacement benchmarks by the Commission must be done with due care. We have identified the following issues that are too vaguely addressed in the Commission's proposal and therefore need to be clarified:

i. What benchmarks are affected by the proposal?
ii. How do you ensure that the chosen interest rate does not give rise to value transfers between the parties?
iii. What is meant by “suitable replacements benchmarks” and ”suitable fallback provisions”?
iv. The use of the replacement benchmark in new contracts.
v. The territorial scope of the proposed change.
vi. The exemption of certain third country foreign exchange benchmarks

What benchmarks are affected by the proposal?

It is unclear what benchmarks are covered by the proposal. It could be any of the following:

1. The proposal applies only to Libor and all its currencies (GBP, USD, EUR, CHF, YEN). In the proposal, the Commission solely mentions “Libor”.

2. The proposal applies to all benchmarks that are critical in the Union. This would be justified by the Commission's wording in Section 5.2.1, i.e. that the proposal shall be applied to "all references to a benchmark whose cessation would result in significant disruption in the functioning of financial markets in the Union". Since Stibor and Wibor are only critical in their home countries, they would not be included in this definition. ESMA's critical benchmark register does not yet indicate whether the reference value is

critical nationally or across the Union. It needs to be clarified what is meant by significant disruption and how significant disruption relates to the definition of critical benchmarks in the BMR. Furthermore, it should be clarified who is responsible for making the assessment of what causes significant disruption within the EU and how this is communicated with the market in advance.

3. <u>The proposal refers to all benchmarks.</u> As the proposal in its current form is vaguely drafted, it could mean the cessation of any benchmark that the Commission currently considers could cause a significant disruption to the financial markets of the Union. In this case it is also important to clarify what causes significant disruption within the EU and how this is communicated with the market in advance.

In summary, it needs to be clarified which benchmarks are covered by the proposal so that it is possible to predict what agreements will be affected.

As for benchmarks that have been determined as critical pursuant to Article 20(1)(b) in the BMR – national critical benchmarks – we believe that it would be best if the competent authority for the national critical reference benchmark designates the compensation reference benchmark, in cases where the parties have not agreed on a fallback solution in time since:

i. The national authority has better knowledge of the market where the national reference value is used.
ii. It is easier for the national authority to consult parties who use the reference rate.
iii. The national authority will have better knowledge of the effects of any changes in the reference rate, including the volume of relevant agreements.

It is, however, important that the new reference rate will be recognized and approved in the international market, which is one of the reasons for further clarifications.

How to ensure that the chosen interest rate does not give rise to value transfers between the parties

The SSMA finds it a bit peculiar that the Commission makes a proposal without emphasizing the importance of minimizing the risk of value transfers in connection with the change of reference rate. If you change from e.g. LIBOR to SONIA plus an historical adjustment spread it could mean that the value of the relevant contracts change, even if the ambition is that the fallback interest rate should be equal to the original interest rate.

In all working groups that work with alternative reference rates, there have been a strong focus on minimizing the risk of creating value transfer when changing reference rates. Thus, it is important to ensure that the chosen interest rate does not give rise to value transfers between the parties. In addition to the new reference rate, the Commission may also set out principles for calculating credit spread adjustments in order to avoid value transfers between the parties. The principles announced by ISDA and other trade associations and working groups should be followed.

What is meant by “suitable replacements benchmarks” and “suitable fallback provisions”?

The reference to "suitable replacement benchmarks", under Recital (5) is too vague and it is unclear who should decide whether a replacement benchmark is suitable or not and under what circumstances. Furthermore, the reference to"a suitable contractual fallback provision", under Recital (9) and Article 23a (2)(b), also needs further clarifications.

Hence, it should be clarified what types of replacement benchmarks (and/or fallback provisions) are considered acceptable and that this only includes the designation of a fallback reference rate that is available in the long term. For example, Article 23a(2)(b) could also include a clarification of what fallback provisions are considered acceptable. Although covering all fallback provisions would be challenging given the vast variety in the market, we still believe that the most frequently used fallback provisions, such as those referring to historical interest rates when a screen rate is temporarily unavailable, or when the applicable fallback rate is referring to "cost of funds", should be clarified in relation to what should be considered acceptable fallbacks as they are not suitable for long-term use.

Regarding the design of the new reference rate, it would be preferable if the Commission limits the alternative interest rates to the agreed market standard for each currency and type of contract. If the Commission were to state that their replacement interest rates would consist of adjusted O/N rates with the addition of a spread adjustment, including principles for calculating spread adjustments, based on historical differences in line with what the market has proposed, it would be more clear to market participants.

The use of the replacement benchmark in new contracts

The wording in Recital (9) – *The use of the replacement benchmark designated by the Commission should therefore be restricted to contracts already entered into by supervised entities at the moment of the entry into force of the implementing act designating the replacement benchmark* – that the statutory replacement rate may not be used in new contracts, could cause practical problems as it will make normal routines for hedging activities very difficult. We assume that this is an error which should be corrected.

The territorial scope of the proposed change

The Regulation needs to be clarified in relation to how the laws of different jurisdictions relate to each other. Will the Commission's proposal apply only to contracts agreed under the law of an EU member state or does it also apply to agreements entered into under third country law? If the intention is that it should apply to agreements that are regulated by the law of a third country, then how should e.g. EU banks act in relation to these agreements (and their third country branches)? Another relevant question is how potential legal conflicts should be resolved and in which forum?

The United Kingdom has produced a divergent proposal on how the problems with "tough legacy" agreements should be handled when Libor ceases, and in New York, proposals have been made on how to deal with these issues. Coordination between the legislative authorities of the major economies would be appropriate. If coordination cannot be achieved, the law chosen by the parties should take precedence and that must be clarified in BMR. It is also very important that the proposed provision is clear and possible to apply from a practical practice and that any legal uncertainty is removed.

The exemption of certain third country foreign exchange benchmarks

The SSMA agrees that foreign exchange benchmarks administered by administrators located outside of the EU should be exempted from the BMR. However, the proposed exemption of certain third country foreign exchange benchmarks is quite specific and therefore too restrictive.

According to Art 2, para 3, (a)-(c) of the proposal, certain conditions need to be met in order for a foreign exchange benchmark to be covered by the exemption. In addition to the foreign exchange benchmark referring to a spot exchange rate of a third-country currency that is not freely convertible (sub-para (a)), supervised entities should use the foreign exchange benchmark on a frequent, systematic and regular basis in derivative contracts for hedging against third country currency volatility (sub-para (b)), and be used as a settlement rate to calculate the pay-out of the derivative contract in a currency other than the currency with limited convertibility (sub-para (c)).

Since this type of benchmarks can be used in contracts for purposes that deviate from this description, it is difficult to understand why the scope of the exemption should be limited to the above situations.

The proposal will also lead to interpretation problems due to the uncertainty surrounding terms such as “frequent, systematic and regular basis”. The proposal should therefore be extended to cover other situations/third country benchmarks as well.

As for the Competent authorities’ reporting obligation set out in Art 2, para 4, we have difficulties understanding the purpose of this type of reporting obligation and how the information should be collected. Most likely, it will involve an extensive administrative burden for both the national Competent authorities and the supervised entities while the benefits can be questioned.

Concluding remarks

Given the far-reaching powers that would be handed to the Commission, it is important that the proposed regulation is as clear and precise as possible. Further clarification is needed, inter alia, as to which benchmarks are to be included in the proposal, when and how the statutory fallback interest rate should be applied and the principles for minimizing the risk of value transfer when changing reference rates.

The process of moving from Ibors to alternative risk-free rates varies between Member States and when designating a statutory fallback rate it is necessary to take into account the work of other market led working groups and not only those that work under the auspice of a central bank. In addition, national market characteristics should be taken into account.

The SSMA would also like to highlight the importance that the statutory fallback solution follows agreed market practice for each currency and contract type. This is essential to ensure a widespread acceptance on the market and a harmonized and credible designation of replacement benchmarks.

SWEDISH SECURITIES MARKETS ASSOCIATION

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