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EUROPEAN COMMISSION
Regulatory Scrutiny Board

Brussels,
RSB/

Opinion

Title: Impact assessment /

Overall 2nd opinion: POSITIVE WITH RESERVATIONS

(A) Policy context

Financial contracts worth trillions of euros refer to interest rates such as LIBOR and EURIBOR. These rates reflect what panels of banks report having to pay to borrow in dollars and euros. During the financial crisis, some bank employees managed to manipulate both of these reference rates. The EU passed the 2016 Benchmark Regulation in part to ensure the integrity of rates that can affect financial stability. Starting in 2022, new procedures will also apply to benchmarks administered in third countries.

Bank participation in rate panels is voluntary and confers limited benefit. Wary of legal exposure, many banks no longer want to take part. This weakens panel reference rates further. International efforts are underway to replace panel rates with risk free rates, and LIBOR is likely to cease to exist at the end of 2021. At that point, there will still be many outstanding contracts that reference LIBOR. This report considers alternative ways to prevent a disruptive transition when IBORs, including LIBOR, end.

This report also looks at ways to allow EU banks to continue using certain spot foreign exchange rates as benchmarks for hedging foreign exchange risks after the new requirements for third country benchmarks start to apply.

(B) Summary of findings

The Board notes substantial revisions to the draft report.

However, the report still contains significant shortcomings. The Board gives a positive opinion with reservations because it expects the DG to rectify the following aspects:

(1) The report does not integrate the way it intends to future-proof the Benchmark Regulation into the options for the IBOR transition. It does not analyse the consequences of granting more decision-making authority to the regulator, and does not include this in its discussion of the preferred option.

(2) The report does not adequately present the context of the exchange rate benchmarks issue.

(3) The report does not adequately analyse impacts on SMEs and possible social

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This opinion concerns a draft impact assessment which may differ from the final version.

impacts.

(C) What to improve

(1) For the IBOR transition, the report explains that only a collection of options, left to the competent authority to choose from, can provide a long-run solution for similar cases in the future. The report should consequently assess the impacts of an option that lets the competent authority decide the method for triggering the rate replacement rate. It should clarify which methods this option would include. The report should clarify whether the preferred option for the IBOR transition is a single option (mandated temporary legacy rate) or whether it wants to authorise the competent regulator to select the best approach. It should incorporate stakeholder groups' views into the analysis of the options.

(2) The report should concisely present a more complete context of the reasons and considerations that have led the Commission to reconsider the provisions of the original Benchmark Regulation with respect to spot foreign exchange rates. The report points to a need to hedge growing EU trade and FDI flows through EU banks, but this represents only a fraction of those banks' current non-deliverable forwards trading volume.

(3) The report should ensure that all relevant objectives are identified. Missing objectives seem to include, for example, banks' competitiveness if they are no longer able to use some spot foreign exchange rates, and the need to find a solution for all possible future discontinued critical benchmarks, beyond IBOR.

(4) The report should complete the analysis of impacts, including social aspects for mortgage holders, operating costs for users from the change of methodology, and impacts on SMEs. In doing so, the report should be transparent about any issues that will remain outstanding after a newly calculated LIBOR replacement rate, including where the duration of continuation of the mandated LIBOR is not sufficiently long to cover all contracts with long maturities.

(5) The draft report requires further editing to fix references, spelling and numbering errors, remove minor factual inaccuracies and improve style consistency. Annexes should not contain references to a baseline which no longer features in the report.

The Board notes the estimated costs and benefits of the preferred option in this initiative, as summarised in the attached quantification tables.

(D) Conclusion

The DG may proceed with the initiative.

The DG must revise the report in accordance with the Board's findings before launching the interservice consultation.

If there are any changes in the choice or design of the preferred option in the final version of the report, DG FISMA may need to further adjust the attached quantification tables to reflect this.

Full title	Benchmark Regulation Review
Reference number	PLAN/2020/7130

Submitted to RSB on	26 May 2020
Date of RSB meeting	Written procedure

ANNEX: Quantification tables extracted from the draft impact assessment report

The following tables contain information on the costs and benefits of the initiative on which the Board has given its opinion, as presented above.

If the draft report has been revised in line with the Board's recommendations, the content of these tables may be different from those in the final version of the impact assessment report, as published by the Commission.

Summary of costs and benefits

	I. Overview of Benefits (total for all provisions) – Preferred Option		
	Description	***Amount***	***Comments***
	Direct benefits		
Mandating the publication of a time-limited legacy rate	Continuity for SME financing	In the European Union, SMEs are an important group of corporate borrowers and their loan payments are often based on LIBOR plus a spread reflecting their own credit rating. It is fair to say that LIBOR plays a crucial role in SME financing, also for debt issued by SMEs. Many of the financing instruments used by SMEs are "priced" off a LIBOR rate (either three, six or one year LIBOR). A universally agreed legacy rate would therefore give legal certainty for SME contracts that are still in course at the end of December 2021.	Legal certainty as to the applicable financing rate would be beneficial for SME financing and the continued availability of such financing, especially in current circumstances when the COVID 19 crisis is putting at risk the very survival of many SMEs.
	Avoided litigation cost	It is difficult to give an accurate quantitative assessment of the cost savings resulting from avoiding legal disputes relating to tough legacy contracts for the no agreed fall-back rate scenario (baseline). However, we could make a very rough "ballpark" estimate based on the number of legacy contracts pending in 2021 and the cost of litigation if these contracts risk being considered void due to the absence of a mutually accepted fall-back rate. Conversations with major EU corporate lenders reveal that the "big five" banks have in excess of 1000 contractual counterparts, roughly 600 of them corporations. But each of these counterparts has, naturally, several loans or other LIBOR	The main beneficiaries of litigation cost-savings will be the benchmark users (and the national court system as an indirect beneficiary, see below). The continuity option implies a *de jure* switch to the reformed IBOR rate for tough legacy contracts, which would provide legal certainty for parties to those contracts. Therefore, this approach would avoid litigation costs that would otherwise arise in a number of cases due to the legal uncertainty about the contract reference rate following the discontinuation of the rate in the baseline scenario.

		related transactions pending after December 2021, a conservative estimate would be that LIBOR loans and debt, end 2021, will comprise more than 50.000 contracts per lending institution. Should the parties wish to renegotiate/litigate this entire legacy stock on account of the absence of a LIBOR replacement, costs would reach millions per institution and probably in excess of 1 billion for the EU banking sector.	
	Avoided renegotiation cost	In the absence of any action, the (consensual) repapering of contracts linked to a disappearing IBOR is considered a huge burden for European banks. According to estimates conducted by the private sector, a Global Systemically Important Bank (GSIB) may have more than 250,000 contracts with references to IBORs that are likely to mature post-2021, in addition to several thousand other contracts with indirect IBOR exposure (e.g., a penalty clause in supplier agreements). The volume of documents can increase significantly when considering activities such as servicing, where firms may not have direct financial exposure but play an important operational role in IBOR contracts. According to FISMA Services informal contacts, in terms of cost and complexity of renegotiation of USD LIBOR legacy contracts, the cash market (loans and debt) is more challenging than derivatives (where agreements are often covered by standardised contracts which can be amended via accepted protocols – like the ISDA's ones). In the cash markets, counterparties have varying degrees of sophistication and	Legal and contract remediation for IBOR transition may cost more than USD 50 million and would require enterprise-wide contract discovery, digitization, term extraction, repapering, client outreach and communication capabilities [Source: Ernst & Young analysis].

		individual negotiations are required for each agreement. According to the estimates received, there are thousands of contracts that banks' would need to renegotiate (because they mature after the end of 2021). The legal cost associated with renegotiating "tough legacy" contracts is expected to vary, driven by the following key variables: (i) Complexity, (ii) client sophistication and (iii) lawyer time required. According to estimates by a major corporate lender, renegotiating loan agreements with relatively more standardized terms would likely cost, on average, EUR 55,000 per transaction, with variations depending on jurisdiction, governing laws and whether there are contractual securities involved or not. More complex and bespoke loan or debt re-negotiations could see costs rise significantly, possibly exceeding EUR 100,000 per transaction. Cost also increases if parties engage in extended negotiations, because of a lack of borrower or lender cooperation	
	Indirect benefits		
	Smooth transition away from an IBOR rate ensures international competitiveness, notably with the United States	In order to demonstrate the indirect benefits in ensuring a smooth IBOR transition, the following extracts from the ARRC proposal to adopt a statutory fall-back rate for USD LIBOR[1] is illustrative: "The proposed statute is designed to minimize costly and disruptive litigation by providing legal certainty for the issues that are likely to arise under New York law. Notably, the proposed statute	The indirect benefit of an agreed legacy rate for LIBOR have been described by the ARRC as follows: "Although the notes could theoretically be amended to resolve this problem, they typically require consent from each holder to change the interest rate. So while it may be possible to obtain consent in isolated cases, it is unlikely to be workable for many securities

[1] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Proposed-Legislative-Solution.pdf

		would: (1) prohibit a party from refusing to perform its contractual obligations or declaring a breach of contract as a result of the discontinuance of LIBOR or the use of the statute's recommended benchmark replacement; (2) definitively establish that the recommended benchmark replacement is a commercially reasonable substitute for and a commercially substantial equivalent to LIBOR; and (3) provide a safe harbour from litigation for the use of the recommended benchmark replacement. The proposed legislation would achieve these goals by requiring the use of the recommended benchmark replacement where the contract language is silent or the fall-back provisions prescribe the use of LIBOR".	with a large number of holders, especially if held by retail investors. The administrative burden and potentially high costs of reaching these investors will be significant, particularly when unanimous consent of security holders would be required".
	Contractual robustness leads to business continuity	The benefits of business continuity are not only evident or businesses and banks that have loan or debt arrangements referencing LIBOR at the end of 2021, contractual robustness is also in the public interest. The ARRC proposal described these indirect benefits as follows: "The proposed legislation would [instead] uniformly implement a fall-back to the statute's recommended benchmark replacement for securities. This outcome would avoid the use of a rate (last quoted LIBOR) that is no longer representative of a market rate, reduce uncertainty about the replacement rate, and minimize market disruption, potential disputes and the costs and burdens of litigation on New York courts, residents and commercial participants."	Not overloading the EU Member State's court system with LIBOR related litigation is an important aspect of the proposed reform, notably in current circumstances where physical courtroom based litigation is a scarce resource, due to the COVID 19 pandemic.
	Direct benefits		

Exemption of third country foreign exchange spot rates			
	Avoid increase of cost or limited offer of hedging contracts for EU investors	The possibility for EU banks to continue reference FX spot rate in listed derivatives will maintain the current level of transparency on those contracts and avoid an increase of their costs for EU investors due to diminished offer. It will also avoid that investors have to seek their usual financial counterparty for hedging their business risk.	
	Indirect benefits		
	EU Banks do not lose a business sector ensures international competitiveness of EU banks in this FX hedging	If European banks are allowed to continue the business of hedging from currency risk they will not lose their market stake and maintain competitiveness vis-à-vis third country financial sectors players.	

(1) Estimates are relative to the baseline for the preferred option as a whole (i.e. the impact of individual actions/obligations of the preferred option are aggregated together); (2) Please indicate which stakeholder group is the main recipient of the benefit in the comment section;(3) For reductions in regulatory costs, please describe details as to how the saving arises (e.g. reductions in compliance costs, administrative costs, regulatory charges, enforcement costs, etc.; see section 6 of the attached guidance).

II. Overview of costs – Preferred option							
		Citizens/Consumers		Businesses		Administrations	
		One-off	Recurrent	One-off	Recurrent	One-off	Recurrent
Mandating the publication of a time-limited legacy rate	Direct costs	There are no direct costs for citizens and consumers	There are no recurrent costs for citizens and consumers	Banks will cease submissions to the old LIBOR and will, in consequence save the cost of submitting transaction data or exercising expert judgment as to their wholesale funding cost	There is no recurrent cost for business benefiting from a formula-based legacy rate, published by the administrator of the old LIBOR rate	The legacy rate is sourced from a central bank publication (the risk free rare) with a fixed spread added; this is a simple formula implying essentially no extra cost to the original LIBOR administrator	Publication of the LIBOR successor rate is based on a formula, hence cheaper to produce than the “old” LIBOR
	Indirect	There are no	There are no	Banks will save	Personnel that	The cost of daily	The recurrent

	costs	indirect costs	indirect costs	indirect costs of having to employ staff that prepare and verify the daily rate submissions	was previously engaged in administering the daily LIBOR submissions will need to be redeployed elsewhere in the bank, this could result in a small cost of redeployment	publications of a formula-based legacy rate will be lower than assembling a panel bank rate each day	cost of publishing a formula-based replacement rate is expected to cease after a period of 5 years, when the majority of the legacy stock has matured
Exemption of third country foreign exchange spot rates	Direct costs	There are no costs for citizens and consumers	There are no recurrent costs for citizens and consumers.	Businesses and their banks will have no extra cost when the foreign exchange spot rates remain available for use in hedging contracts	An exemption does not cause recurrent cost, as it avoids the cost of any alternatives, such as contract authorisations or rate endorsements	Third country administrators of spot rates do this in pursuit of a public mandate. The fact that these rates are used in EU-based hedging contracts neither causes nor reduces their cost base.	As in the previous column, usage of third country spot rates in EU-based hedging contracts has no incidence on the cost that these administrators incur. The rates are not licensed, so there is no benefit either.
	Indirect costs	There are no indirect costs for citizens and consumers		There are no indirect cost for business, only the benefit to be able to hedge volatility of foreign exchange spot rates	Same as previous column	Usage of foreign exchange spot rates in EU based hedging contracts has no incidence on the cost of producing the spot rates	Same as previous column

(1) Estimates to be provided with respect to the baseline; (2) costs are provided for each identifiable action/obligation of the preferred option otherwise for all retained options when no preferred option is specified; (3) If relevant and available, please present information on costs according to the standard typology of costs (compliance costs, regulatory charges, hassle costs, administrative costs, enforcement costs, indirect costs; see section 6 of the attached guidance).

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EUROPEAN COMMISSION
Regulatory Scrutiny Board

Brussels,
RSB/

Opinion

Title: Impact assessment /Benchmark Regulation Review

Overall opinion: NEGATIVE

(A) Policy context

Financial contracts worth trillions of euros refer to interest rates such as LIBOR and EURIBOR. These rates reflect what panels of banks report having to pay to borrow in dollars and euros. During the financial crisis, some bank employees managed to manipulate both of these reference rates. The EU passed the 2016 Benchmark Regulation in part to ensure the integrity of rates that can affect financial stability. Starting in 2022, new procedures will also apply to benchmarks administered in third countries.

Bank participation in rate panels is voluntary and confers limited benefit. Wary of legal exposure, many banks no longer want to take part. This weakens panel reference rates further. International efforts are underway to replace panel rates with risk free rates, and LIBOR is likely to cease to exist at the end of 2021. At that point, there will still be many outstanding contracts that reference LIBOR. This report considers alternative ways to prevent a disruptive transition when IBORs, including LIBOR, end.

This report also looks at ways to allow EU banks to continue using certain spot foreign exchange rates as benchmarks for hedging foreign exchange risks after the new requirements for third country benchmarks start to apply.

(B) Summary of findings

The Board notes useful additional written information provided in advance of the meeting.

However, the Board gives a negative opinion, because the report contains the following significant shortcomings:

(1) The report does not adequately present the context for the IBOR transition issue or the exchange rate benchmarks issue.

(2) The report is not transparent about the limits of the information base with regard to the scope, nature and risks surrounding the two issues.

(3) The baseline does not appropriately present how the situation will evolve without regulatory intervention. The report does not explain the options in a comprehensive and coherent way.

(4) The report does not adequately discuss the impacts of the options. It does not sufficiently consider the long-term impacts on financial stability.

(C) What to improve

(1) The report should concisely present a more complete context of the initiatives. On LIBOR, this includes current best estimates of the size and composition of tough legacy assets, and relevant parallel measures to manage the transition that are in place or anticipated. The report should account for regulators' views, in particular those of ESMA. On spot foreign exchange rates, the report should explain the reasons why the original Benchmark Regulation prohibited certain rates, and why this rationale is now outweighed by other considerations. If a permanent exemption was not considered when the Regulation was originally proposed, the report should explain why.

(2) The problem definition could be further developed, in order for instance to distinguish between the availability of a legacy rate (determined by the relevant entities), and the possibility to make this rate a mandatory replacement rate in the EU.

(3) The report should be transparent about what is known and what is not known. It should explain why quantification is not possible or not proportionate in some areas. It should better include the known and relevant information in relation to the size of the problem, its evolution over time, the steps taken and planned to prevent use of discontinued IBORs in new contracts, and any issues that will remain outstanding after a newly calculated LIBOR replacement rate.

(4) The report should simplify and clarify the baselines it uses for the two topics it analyses.

(5) The description of options should be comprehensive and coherent. The report should clarify to what extent options provide solutions for any future possible benchmark discontinuation. It should provide more details about the role of regulators in mandating the use of a legacy-rate for LIBOR in the EU and the possible impact of Brexit. The report should also clarify the extent to which a mandated legacy rate would apply to all contracts concluded with EU counterparties, including contracts under UK law.

(6) The report should explain to what extent the options are viable and reasonably future-proof solutions beyond the near term, or if additional amendments to this Regulation are likely.

(7) The report should analyse impacts in a more comprehensive way. It should discuss all relevant costs resulting from the options and wider impacts, including impacts on SMEs and possible social impacts. The report should clarify how it defines and analyses the efficiency of options.

(8) For foreign exchange, the report should analyse impacts of the preferred option on financial stability. This includes risk considerations in terms of the derivatives exposure of EU banks to certain foreign exchange risk that proposed exemptions from the Regulation would permit them to accumulate, and ability of regulators to monitor those risks.

(9) The report needs careful editing to make it clearer, more concise and more reader-friendly for non-experts. The presentation of impacts relies too heavily on a tabular presentation. The accompanying text should guide the reader through the information that is in the tables and discuss the main conclusions.

Some more technical comments have been sent directly to the author DG.

(D) Conclusion **DG FISMA must revise the report in accordance with the Board's findings and resubmit it for a final RSB opinion.**	
Full title	Benchmark Regulation Review
Reference number	PLAN/2020/7130
Submitted to RSB on	16 April 2020
Date of RSB meeting	13 May 2020

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