



EUROPEAN CENTRAL BANK

EUROSYSTEM

Working Group on euro risk-free rates

Guiding principles for fallback
provisions in new contracts for
euro-denominated cash products

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1 Introduction

1. Major reference interest rates play a pivotal role in the global financial system. They are widely used in contracts for derivatives, loans and securities. They are also used by market participants to value financial instruments and by investment funds as benchmarks for assessing their performance, among other things. As benchmark rates provide an accurate reflection of relevant factors and have a governance framework which ensures their integrity, their use decreases negotiation costs, enhances transparency and improves market liquidity. Declining activity in the underlying interbank unsecured funding markets and challenges to the sustainability of panels contributing to these benchmark rates pose potentially serious risks to individual users of the rates and to the financial system more broadly.
2. In 2014, the Financial Stability Board (FSB) published its report “[Reforming major interest rate benchmarks](#)”, which sets out a series of recommendations to strengthen existing benchmarks by underpinning them, to the greatest extent possible, with real transaction data and to develop alternative, nearly risk-free reference rates. The FSB has asked key global central banks to work with the private sector to identify more appropriate nearly risk-free rates that could provide robust alternatives to existing interest rate benchmarks, with a view to mitigating known risks. In addition, Principle 13 of the “[Principles for Financial Benchmarks](#)” published by the International Organization of Securities Commission (IOSCO), states that users should be encouraged to “take steps to make sure that contracts or other financial instruments that reference a benchmark have robust fallback provisions in the event of material change to, or cessation of, the referenced benchmark”. Moreover, IOSCO has also published a statement on matters to consider in the use of financial benchmarks, including contingency planning, particularly for scenarios in which a benchmark is no longer available.¹ In Europe, the Benchmarks Regulation² recently introduced new requirements for benchmark administrators, supervised contributors and supervised entities using benchmarks, including requirements for the use of fallback provisions in contracts.
3. Against this backdrop, in September 2017, the ECB, the Belgian Financial Services and Markets Authority (FSMA), the European Securities and Markets Authority (ESMA) and the European Commission announced the launch of a private sector working group on euro risk-free rates (RFRs). The working group was tasked with the identification and adoption of RFRs to serve as a basis for an

¹ “[Statement on Matters to Consider in the Use of Financial Benchmarks](#)”, IOSCO, 5 January 2018.

² 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 (OJ L 171, 29.6.2016, p.1).

alternative to the current benchmarks used in a variety of financial instruments and contracts in the euro area. In addition, the working group will consider best practices for contracts so as to ensure that new contracts are robust and resilient to the possible material alteration or cessation of the underlying benchmark.

4. At the request of the FSB's Official Sector Steering Group, the International Swaps and Derivatives Association, Inc. (ISDA) is considering fallbacks for derivatives referencing EUR LIBOR, EURIBOR and other key interest rate benchmarks (ISDA IBOR fallbacks). In addition, ISDA has recently published the ISDA Benchmarks Supplement³ which market participants may incorporate to provide primary fallbacks for derivatives in the event of cessation of an index until such time as the ISDA IBOR fallbacks are incorporated into the terms of transactions (upon which the ISDA Benchmarks Supplement provisions will be subordinated to the ISDA IBOR fallbacks in relation to the relevant IBOR). The ISDA Benchmarks Supplement also provides primary fallbacks in the event that a benchmark is not authorised or fails to maintain authorisation under the EU Benchmarks Regulation, resulting in the parties to the relevant transaction (or the calculation agent, if different) being prohibited from performing their obligations under that transaction. Additionally, local master agreements, which are out of the scope of the ISDA protocol, are expected to be amended to incorporate robust fallback provisions in line with those of the ISDA Benchmarks Supplement.
5. In view of the above, this paper focuses on non-derivatives, or "cash products", as set out in Figure 1. The paper (i) considers some main features of the legal frameworks and market practices for retail and wholesale cash products with contracts referencing euro benchmarks, (ii) outlines, at a high level, the main characteristics of existing fallbacks for typical, euro-denominated cash products, and (iii) proposes a set of guiding principles for fallback provisions in new contracts for such products that market participants may wish to consider.
6. The extent to which market participants adopt and use any of the guiding principles discussed in this paper is left to their own discretion. Each market participant will need to make their own independent decision about whether and, if so, to what extent any suggested principles are adopted and used in their contracts.

³ "ISDA Benchmarks Supplement", 19 September 2018.

2 Current legal frameworks and market practices for euro-denominated cash products

7. Cash products referencing the two most critical euro benchmarks, EURIBOR and EONIA, have different characteristics which, among other factors, contribute to the legal risks associated with a potential permanent alteration or cessation of EURIBOR and/or EONIA. These characteristics are outlined below.

Figure 1
Contractual Robustness

	Retail	Non-retail		Maturity on issuance	
	Subject to EU/ local law	Subject to EU/ local law	Subject to UK/ US law	Long-term (>12 months)	Short-term (<12 months)
Retail mortgages	✓			✓	
Other retail loans	✓			✓	✓
Business loans	✓	✓		✓	
Commercial real estate mort.		✓		✓	
Syndicated loans		✓	✓	✓	
Floating rate notes/Capital sec.	✓	✓	✓	✓	
Certificate Deposits/Com. paper		✓	✓		✓
Securitizations		✓	✓	✓	
Covered bonds		✓		✓	
Secured financing transactions		✓	✓		✓
Deposits	✓	✓			

Notes: Yellow ticks mean retail exposure in certain cases.
Source: Working Group on euro risk-free rates, Work Stream #3.

8. Current euro benchmarks, in particular EURIBOR, are widely referenced in contracts entered into by households, natural persons and small and medium-sized enterprises. As a consequence, ensuring consumer protection is a main priority for contracts referencing EURIBOR, such as some retail mortgages and retail loans. Moreover, the European legal framework for assets held by retail customers is composed of a mix of European and national laws. Despite the existence of a common European legislative framework, there are still major

differences between retail contracts in different Member States⁴ as such contracts are predominantly governed by local law.

9. Wholesale customers mainly use benchmarks for syndicated loans, bonds and derivatives. As contracts for these products are often based on master agreements and other standardised documents (produced by ISDA or the Loan Market Association (LMA), for example), the level of harmonisation among them is high. Additionally, given the cross-border nature of many euro-denominated syndicated loans and bonds, contracts are often governed by English law. On the other hand, certain cash projects are governed by Member States' local law, particularly in project finance, and to a lesser extent, where most parties to a transaction are domestic or related to one Member State.

⁴ For example, mortgages in the euro area are covered by the European Mortgage Credit Directive (2014/17/EU) and the Consumer Credit Directive (2008/48/EC). Although these directives have achieved some level of harmonisation across Europe, particularly in pre-contractual agreements, they only set *di minimis* principles and, therefore, leave Member States with a high degree of discretion when transposing them into their national laws in order to cater for national differences (e.g. differences in terms of property markets, consumer behaviors and cultural factors.)

3 Current fallback provisions in euro-denominated cash contracts

10. The use of fallback provisions in contracts was generally not required under EU law until January 2018, when the Benchmarks Regulation came into effect. Article 28(2) of the Benchmarks Regulation 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.”⁵
11. Fallback provisions, where present, were often originally intended to address the temporary unavailability of EURIBOR or EONIA, such as a computer failure affecting the designated screen page or a temporary market disruption, instead of their permanent cessation. As a result, fallback language in many legacy contracts⁶ for cash products may not produce a commercially acceptable result for all parties as it may affect the economics of the product in the event of a permanent cessation of the relevant benchmark. For example, typical fallback provisions in some legacy contracts for cash products may result in the interest rate becoming fixed at the most recently determined rate while, in other cases, the interest rate could increase substantially in the event of a permanent cessation of the relevant benchmark (e.g. where a fallback rate in a corporate loan is calculated on a cost of funds basis).
12. Amending legacy contracts for cash products to embed new fallback provisions is likely to be a very challenging task in many cases. For cash products held by retail customers, Member States’ consumer protection laws may place constraints on the ability of parties to modify the contract and may stipulate that any change to existing fallback provisions or the inclusion of a new fallback provision in legacy contracts requires the prior explicit consent of customers. Obtaining such consent may be very challenging, would be a very costly exercise and would represent a major operational burden.

⁵ In its Q&A, ESMA further clarified that : “...supervised entities, other than administrators, are required to reflect such plans in the contractual relationship with clients in contracts entered into after 1 January 2018. In relation to contracts entered into prior to 1 January 2018 and still existing at that date, ESMA expects supervised entities, other than administrators to amend them where practicable and on a best-effort basis”. ESMA Question and answers on the Benchmarks Regulation, Question 8.1, added on 14 December 2017.

⁶ The term legacy contracts in this context relates to contracts containing traditional fallback provisions, rather than alternative fallback provisions which are typically included in new contracts for cash products and which attempt to cater for a permanent cessation of the relevant benchmark.

13. For cash products held by wholesale and sophisticated counterparties, it is likely that any material amendment to legacy contracts will need to be agreed either among all the parties to the contract or in accordance with the terms of the contract, for example with the consent of the obligors and a certain proportion of holders or lenders, as the case may be. Such consent thresholds may vary and, in some cases, may be set at 100%.
14. In view of these considerations, the development of more robust fallback language that deals with the permanent discontinuation of the benchmark for new cash product contracts which reference EURIBOR or EONIA can help to enhance legal certainty and reduce the risks stemming from the use of existing euro benchmarks. While the guiding principles set out below are intended to assist parties in this endeavour in new contracts, parties may also take them into account when amending fallback provisions in legacy contracts, when applicable and appropriate.

4 New fallback provisions – guiding principles

15. On 13 September 2018 the working group recommended ESTER as the overnight euro rate. ESTER will be based entirely on transactions in euro that are reported by banks in the ECB's money market statistical reporting and will be made available by the ECB by October 2019 at the latest. The ECB already publishes preliminary figures, referred to as pre-ESTER⁷, with the aim of reducing market uncertainty, allowing market participants to assess the suitability of the new rate and familiarise themselves with its statistical properties and enabling them to adjust processes and procedures adequately to ensure a seamless transition to the new rate.
16. Although ESTER will not be available until October 2019 at the latest, market participants may wish to consider including a reference to ESTER and/or potentially to a term structure based on ESTER as an alternative fallback in their new contracts for cash products that reference EONIA and EURIBOR.
17. Market participants should enhance the robustness of fallback language in new contracts for cash products at this stage, before ESTER is published and before the working group finalises its recommendation for an ESTER term structure. This may require willingness to change the language used in new contracts over time in light of market and other developments. Continuing to enter into new contracts referencing EONIA or EURIBOR without more robust fallback provisions may increase the risk to the financial system.⁸
18. Given that euro benchmarks, and in particular EURIBOR, are widely referenced in contracts entered into by households, natural persons and small and medium sized-enterprises and so involve consumer protection issues, consumers need to be properly informed.⁹ To this end, market participants should carefully consider their marketing practices, especially in a retail context. 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 customers are properly informed about the rationale and operation of fallback clauses.
19. New fallback language should take into account the specific principles set out below.

⁷ ["Euro short-term rate \(ESTER\)"](#) ECB website.

⁸ It should be noted that the LMA and AFME have each produced recommended forms of wording in respect of a benchmark discontinuation for the purpose of syndicated loans and securitisations respectively. These new forms do not make explicit reference to ESTER. ["Syndicated loan replacement of screen rate clause"](#) LMA, October 2018.

⁹ Moreover, the Benchmarks Regulation (Article 28.2) requires that, where feasible and appropriate, fallback plans should be reflected in the contractual relationship with clients.

New fallback provisions should include a permanent cessation trigger event

20. New contracts should include permanent cessation triggers, covering at least the following scenarios:
 - (a) A public statement by the EURIBOR/EONIA administrator that it will cease publishing EURIBOR/EONIA or will not be included in the register under Article 36 of the Benchmarks Regulation permanently or indefinitely (in circumstances where no successor administrator has been appointed or where there is no mandatory administration).
 - (b) A public statement by the FSMA that EURIBOR/EONIA has been or will be permanently or indefinitely discontinued.
21. Where appropriate in light of any applicable regulatory regime, consideration should be given to including a scenario where it is unlawful for certain relevant parties to the agreement (such as the issuer in the case of a bond) to use EURIBOR/EONIA.
22. Consideration should also be given to including a scenario where the competent authority states that the EONIA and/or EURIBOR methodology have materially changed.
23. The trigger events should be objective, so it is clear when they apply. The date from which the fallback rate will apply after one or more of the trigger events has occurred should also be specified clearly in fallback provisions. The date should be the discontinuation of publication of EURIBOR/EONIA, or any other (factual or legal) impossibility of use of EURIBOR/EONIA under the relevant cash product and not the date of the publication of the public statement. The fallback provisions should apply to the calculation of the interest rates to be fixed on or after such specific date. Interest periods where the interest rate has been fixed before such specific date should not be disrupted.¹⁰

The new RFR as a potential fallback rate.

24. Market participants should seek to use ESTER as the primary basis for a fallback rate, where this is considered appropriate and feasible.
25. While ESTER is not yet operational and necessary term structures have not yet been defined, market participants may wish to consider including alternative fallback provisions that reference ESTER in contracts for cash products that currently reference EONIA, while keeping the usual waterfall of fallbacks to cater for a permanent cessation of EONIA before the publication of ESTER.

¹⁰ For example, the term of floating-rate cash products is usually set in interest periods. The application of the new fallback rate in the course of an interest period may be challenging, so consideration should be given to apply the new fallback rates once the interest period has ended.

26. In relation to contracts for cash products that reference EURIBOR, market participants may wish to consider the extent to which fallback provisions may reference ESTER and/or a term rate derived from ESTER that is recommended as an alternative fallback by a relevant body (e.g., the ECB, the ESMA, the FSMA, or the working group). It should be noted that the working group recently issued a consultation paper¹¹ focusing on the identification of an ESTER-based term-structure methodology as a fallback in EURIBOR-linked contracts.

The introduction of an adjustment spread should be considered.

27. ESTER is a near risk-free rate which will be derived and set following a methodology which differs from the ones used for EONIA and EURIBOR, thus giving rise to inherent differences between the values of these benchmarks.¹² Thus, fallback provisions should seek to minimise any potential transfer of value between parties when the fallback is applied, by including a provision for an adjustment spread to be applied to the fallback rate.
28. Market participants may wish to consider referring to an adjustment spread that is recommended by a relevant body, as described above.
29. As a general principle, any adjustment spread should be designed to eliminate or minimise any potential transfer of value between parties when the fallback is applied and eliminate or minimise the risk of manipulation.
30. Additionally, market participants may wish to consider consistency with any provision for an adjustment spread that is used in contract language in other jurisdictions and in other products, where feasible and appropriate.

Consider flexibility to facilitate future amendments

31. Parties could also consider including provisions in agreements for new cash products which may make it easier to make amendments to the benchmark rate in the future.
32. An option in certain circumstances and where feasible could be to express consent in a transparent and fair manner, at the time of signing and in the terms and conditions of the agreement, that any future amendments in relation to a replacement rate would not require further consent. In addition, lowering the consent thresholds required in agreements would also make it much easier to amend the benchmark rate in the future.

¹¹ “Second public consultation by the working group on euro risk-free rates”, ECB, December 2018.

¹² “Second public consultation on the publication by the ECB of an unsecured overnight rate”, ECB, March 2018.

33. For example, in syndicated loans, the LMA has 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.

Consistency between financial products

34. Fallback provisions should be consistent, where feasible and appropriate, across asset classes and/or product types, in particular in the case of related contracts (e.g., derivatives and cash products, or loans, securitisations and derivatives). Additionally, market participants may wish to consider consistency with contract language recommended in other non-EU jurisdictions.
35. There are substantial benefits to consistency across products. For example, aligning trigger events across different types of products would help to reduce operational, legal, and basis risk.
36. These guiding principles for alternative fallback provisions in euro-denominated cash products and securities are intended to be consistent, in certain respects, with the ISDA’s intended approach for derivatives. However, as cash products differ from derivatives in various ways, it may not always be appropriate to follow the derivatives approach for them. Market participants are encouraged to develop tailored fallback provisions to each specific product, while seeking general consistency in key principles.

5 Disclaimer

37. 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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