

31 August 2021

ISDA response to the European Commission’s consultation on the draft Implementing Regulation on the designation of a replacement for the benchmark European overnight index average in contracts and financial instruments as referred to in Article 23a of Regulation (EU) 2016/1011 of the European Parliament and of the Council¹ (the “Draft Implementing Regulation”).

1. Introduction

ISDA welcomes the opportunity to comment on the European Commission’s consultation with respect to the Draft Implementing Regulation designating the replacement rate for EONIA.

ISDA has consistently supported efforts to make markets safer and more efficient through the incorporation of robust fallbacks. On August 18, 2021 ISDA launched the ISDA 2021 EONIA Collateral Agreement Fallbacks Protocol² which market participants can use to incorporate a fallback to €STR+8.5 basis points into their ISDA published collateral agreements. In addition, ISDA has published two bilateral amendment templates parties to derivatives contracts can use to incorporate the same fallback into their derivatives-related documentation.

These industry-led documentation initiatives are designed to promote contractual certainty upon the cessation of EONIA on January 3rd, 2022.

It is against this background that the comments below are made.

Please note that we have provided drafting comments on the Draft Implementing Regulation in the annex to this submission.

2. Limited scope of the power to designate a statutory replacement

It is very important that market participants are aware that Article 23a of BMR limits the effect of designation of a statutory replacement to:

- (a) any contract, or any financial instrument as defined in Directive 2014/65/EU, that references a benchmark and is subject to the law of one of the Member States; and

¹ https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13120-Interest-rates-Statutory-replacement-rate-for-the-EONIA-benchmark_en

² <https://www.isda.org/protocol/isda-2021-eonia-collateral-agreement-fallbacks-protocol/>

(b) any contract, the parties to which are all established in the Union, that references a benchmark and that is subject to the law of a third country and where that law does not provide for the orderly wind-down of a benchmark.

The statutory designation will not, therefore, provide a universal solution to the issues which the power is designed to address.

This importance of this point was made clear in the recently published minutes³ of the Working Group on Euro Risk-free Rates from a meeting held July 1, 2021, when Tilman Lueder of the European Commission stated that:

“the statutory replacement rate of the EU will not cover contracts under English (and New York) law, so this must be considered before taking any decision”

On this basis and in terms of derivatives contracts, the amount of exposure to EONIA within contracts which would therefore fall out of scope of the statutory designation is therefore very significant and is likely to greatly exceed the amount of exposure contained in contracts which would fall into scope.

Even for contracts, the parties to which are all established in the Union, that reference a benchmark and that is subject to the law of a third country where that law does not provide for the orderly wind-down of a benchmark, the question of whether or not the statutory designation will be effective under that third country law may vary from jurisdiction to jurisdiction, party to party and contract to contract.

In order to avoid a situation in which parties to contracts do not take advantage of initiatives such as ISDA’s EONIA protocol or bilateral amendment templates in the mistaken belief that their out-of-scope contracts will benefit from the European Commission’s designation, this limitation on scope should be clearly flagged in the Implementing Act. This concern is behind a number of the drafting suggestions made in the Appendix and should also be clearly messaged in the European Commission’s outreach.

3. Avoiding a presumption of contractual frustration

The current wording of the Draft Implementing Regulation could facilitate an argument that contracts which do not have a fallback face a serious risk of contractual frustration. Whether or not this is factually accurate will vary on a jurisdiction by jurisdiction, party by party and contract by contract basis but regardless of the merits of the argument, saying as much in an Implementing Regulation may make it easier for litigants to argue that contracts outside the scope of this power should be held to

³ https://www.esma.europa.eu/sites/default/files/library/esma81-391-72_minutes_eur_rfr_wg_meeting_01072021.pdf

be frustrated. Even if these arguments are defeated in court, the disruption posed by such disputes could be significant.

In order to reduce this risk, several drafting changes have been suggested to the text of the Draft Implementing Regulation in the Annex to this submission.

4. Importance of early adoption

Given the time left until the cessation of EONIA it would be helpful to market participants to implement the proposed Implementing Regulation as soon as possible so that they are able to analyze whether their contracts are in-scope of the power and implement alternative arrangements where necessary.

Annex: Blackline showing suggested amendments to the Draft Implementing Regulation

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to 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, and in particular Article 23b(8) thereof,

1 OJ L 171, 29.6.2016, p. 1.

Whereas:

(1) The European overnight index average (EONIA) is a critical benchmark representing the interest rates on unsecured overnight lending transactions denominated in euros. EONIA is used in the context of overnight index swaps, and a wide range of other products. It is essential for cash settlement and highly relevant for other purposes such as different valuation procedures as applied as part of collateral and risk management processes or accounting.

(2) The original methodology for the calculation of EONIA was based on submissions provided by contributing panel banks. In February 2018, the European Money Market Institute (EMMI), acting as administrator of EONIA, announced that compliance of EONIA with the obligations of Regulation (EU) 2016/1011 could not be warranted by the time such obligations would apply. Work on EONIA's orderly wind-down was therefore initiated. On 13 September 2018, the Working group on euro risk-free rates recommended the euro short-term rate (€STR) as the euro-denominated risk-free rate as a replacement for EONIA. On 14 March 2019, the working group also published recommendations on a transition from EONIA to €STR, which included a phase during which the methodology for calculating EONIA would be modified and based on €STR, as well as the method to determine the spread adjustment between €STR and EONIA.

(3) Following those recommendations, on 31 May 2019 the European Central Bank (ECB) calculated a one-off spread between EONIA and €STR, set at 8,5 basis points. On the same day, EMMI announced the discontinuation of EONIA as of 3 January 2022. During the transition, EMMI published a reformed methodology for EONIA under which EONIA is equal to €STR as published by

the ECB plus the one-off spread adjustment of 8,5 basis points. That reformed methodology applies to EONIA from 2 October 2019 until its cessation on 3 January 2022.

(4) Despite the early announcement of the discontinuation of the EONIA rate as of 3 January 2022 and the early industry recommendations to replace any EONIA references by €STR especially for contracts maturing after 2022, a large volume of contracts and financial instruments referencing EONIA are still outstanding in a number of Member States of the Union. EONIA therefore continues to play a crucial role for financial markets in the European Union. Furthermore, because of the process of reaching expert and industry-wide consensus over the appropriate transition pathway, such “legacy” contracts and financial instruments generally do not contain suitable fall-back provisions covering the permanent cessation of EONIA. The cessation of EONIA is therefore likely to have a significantly disruptive impact on the remaining legacy contracts and financial instruments.

(5) EONIA has been designated as a critical benchmark pursuant to Commission Implementing Regulation (EU) 2019/4822. Regulation (EU) 2021/168 of the European Parliament and of the Council³, which introduced into Regulation (EU) 2016/1011 Article 23b, has conferred on the European Commission the power to designate one or more replacements for a critical benchmark where all conditions laid down in Article 23b of Regulation (EU) 2016/1011 are met into (a) any contract, or any financial instrument as defined in Directive 2014/65/EU, that references a benchmark and is subject to the law of one of the Member States; and (b) any contract, the parties to which are all established in the Union, that references a benchmark and that is subject to the law of a third country and where that law does not provide for the orderly wind-down of a benchmark. A replacement for EONIA should, by operation of law, replace all references to that benchmark in in-scope contracts and financial instruments, provided that such contracts do not contain fall-back provisions or suitable fall-back provisions.

(6) Furthermore, data reported by members of the Working group on euro risk-free rates suggests that, as of 9 July 2021, several thousands of derivative contracts with direct EONIA exposures and Credit Support Annexes referencing EONIA as the interest rate covering collateral are still in course across all Member States of the Union. Both references already account for a total notional amount of several trillion euros. The same members also indicated that their contractual renegotiation efforts are complete in, on average, less than half of contracts that contain EONIA references. While market participants are expected to continue bilateral and industry-led efforts to ensure contractual certainty, those completion rates point to the fact that individual renegotiation of all remaining EONIA references will cause a major challenge for Union contracting parties, especially supervised entities. Without transitioning such contracts to a designated replacement for a benchmark, there is a serious risk of contract frustration. A replacement for EONIA references should therefore ensure that the materialisation of such risk, which might particularly affect clients engaging in overnight index swaps to hedge interest rate risk, is avoided.

(7) The result of expert working group consultations has established the preliminary assessment on the important role of EONIA in Union financial markets. It appeared from those expert working group consultations that the lack of a harmonised approach would give rise to legal uncertainty, which may trigger disputes and disruption litigation and frustration. The Working group on euro risk-free rates has also addressed, on 15 July 2021, a formal letter calling for action from the Commission

to swiftly designate a statutory replacement for EONIA. It is therefore appropriate for the Commission to designate a statutory replacement for EONIA to be used in all in-scope legacy contracts that do not contain fall-back provisions or suitable fall-back provisions.

(8) Consultations in the context of the Working group on euro risk-free rates also pointed out that replacing references to EONIA in legacy contracts by means of contractual renegotiation has often been hampered by the volume of such contracts that do not reach maturity before EONIA's end date of 3 January 2022, and by the difficulty of obtaining consent in each and every case. That explains the amount of pending legacy contracts that still reference EONIA. Considering that situation, and considering the data reported by members of the Working group on euro risk-free rates, it should be ensured that any in-scope contract or financial instrument still referencing EONIA as of the date of its cessation is considered a "legacy contract" under this implementing regulation, and therefore falls under the scope of subject to the statutory replacement measure.

(9) Along with the announcement, on 31 May 2019, of the cessation of the publication of EONIA as of 3 January 2022, EMMI announced changes to the methodology of EONIA to ensure continued compliance with Regulation (EU) 2016/1011 and to ensure a smooth transition until final discontinuation of EONIA. Those changes apply to the EONIA methodology since 2 October 2019, and directly link the EONIA calculation to the development of €STR, by stating that EONIA is equal to €STR plus a fixed spread adjustment based on the spread provided by the ECB. That fixed spread adjustment limits the economic impact of designating €STR as the statutory replacement for EONIA in all contracts that mature beyond the EONIA end date of 3 January 2022.

(10) The formal letter from the Working group on euro risk-free rate dated 15 July 2021 specifically requested that the statutory replacement of EONIA be based on €STR, plus the existing fixed spread adjustment between EONIA and €STR, thus avoiding value transfer in the transition. It is appropriate that the statutory replacement for EONIA reflects recommendations from the relevant risk-free rate working group, and therefore be based on €STR plus the fixed spread adjustment provided by the ECB.

(11) Considering that EONIA will cease to be published on 3 January 2022, the designated replacement rate should replace references to EONIA from that date.

(12) The Belgian Financial Services and Markets Authority (FSMA), as supervisor of the EONIA administrator, and the European Central Bank, as central bank responsible for the currency area of EONIA, were duly consulted to determine the measures provided for in this Regulation.

(13) The measures provided for in this Regulation are in accordance with the opinion of the European Securities Committee,

HAS ADOPTED THIS REGULATION:

Article 1 Replacement of EONIA

1. The Euro short-term rate (€STR) as published by the European Central Bank is designated as replacement for the European overnight index average (EONIA) in references to EONIA in contracts and financial instruments as defined in Directive 2014/65/EU, that reference a benchmark and are subject to the law of one of the Member States; and any contract, the parties to which are all established in the Union, that references a benchmark and that is subject to the law of a third

country where that law does not provide for the orderly wind-down of a benchmark, as referred to in Article 23a of Regulation (EU) 2016/1011.

2. The fixed spread adjustment that shall be added to the replacement rate designated pursuant to paragraph 1 shall be equal to 8,5 basis points.

3. The replacement rate for EONIA shall be designated in accordance with the following table:

Replaced benchmark	Replacement Rate	Spread Adjustment Value (%)
EONIA	Euro short-term rate (€STR)	0.085
ISIN EU0009659945	ISIN EU000A2X2A25	

About ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on [Twitter](#), [LinkedIn](#), [Facebook](#) and [YouTube](#).