

ZBP FALLBACKS CLAUSES

In July 2019 the Polish Bank Association (*Związek Banków Polskich, ZBP*) published its take on the fallback clauses relating to the European benchmark regulation¹. The project aims to propose model clauses for the entire banking sector regardless of whether specific banking procedures are covered by the BMR or not.

BACKGROUND

In accordance with the requirements of Article 28 section 2 of BMR supervised entities that use a benchmark are obliged to create 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. Reasonably, one of the elements of these plans should be an introduction of fallback clauses in relevant agreements that will nominate one or several alternative benchmarks where feasible and appropriate and specify other fallback mechanisms.

Compliance with the BMR obligations is one of the main interests of the Polish Financial Supervisory Authority (*KNF*). According to the latest report², in 2020, *KNF* plans to closely monitor the implementation of fallback clauses by all of the Polish supervised entities.

For the Polish banking sector, it is the Polish Banking Association (*ZBP*) that plays a key role in setting BMR standards. Currently, *ZBP* is conducting consultations with banks and is working on a set of communications to customers (especially retail) and recommended interpretations of BMR, should an event referred to in BMR occur. In the meantime, we set out the rules that were adopted in July 2019.

ZBP FALLBACK CLAUSES

In July 2019 *ZBP* published its take on fallback clauses – "Model emergency clauses prepared by a working group operating at the *ZBP* to support the development of emergency plans in individual banks in connection with the implementation of the obligation under Article 28 section 2 BMR".

General information

- Published in July 2019.
- Created by the Polish Bank Association.
- Consulted with the Polish Financial Supervisory Authority (*KNF*), the National Bank of Poland (*NBP*), the Polish Competition Authority (*UOKiK*) and the Ministry of Finance.

Main guidelines

- Three variants of clauses for different market segments: the interbank market, corporate clients and consumers.
- Different fallback mechanisms in all of the three variants.
- The clauses cover all of fallback triggers – permanent and temporary cessation, non-registration of the administrator and a material change of a benchmark.
- Incorporation of important definitions.
- *ZBP* recommends applying the clauses to instruments which go beyond the ambit of the BMR.

¹ 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 (hereinafter referred to as "**BMR**")

² Activity report of the Polish Financial Supervisory Authority in 2019 (*Sprawozdanie z działalności Urzędu Komisji Nadzoru Finansowego oraz Komisji Nadzoru Finansowego w 2019 roku*).

The project was consulted with the authorities supervising the Polish financial market, including the Polish Financial Supervisory Authority (*KNF*), the National Bank of Poland (*NBP*), the Polish Competition Authority (*UOKiK*) and the Ministry of Finance.

There are three variants of fallback clauses that cover three market segments: the interbank market, corporate clients and consumers. Each variant takes into account the differences between these relations and appropriately modifies the proposed fallback mechanisms and related definitions and drafting.

The clauses provide for all of types of fallback triggers – cessation (both permanent and temporary), non-registration of the administrator and a material change of a benchmark.

Moreover, ZBP recommends applying the clauses to instruments which go beyond the ambit of the BMR. This way a general standard for all contracts that make use of benchmarks can be developed, which will surely encourage the creation of a more transparent and resilient banking sector.

IMPORTANT DEFINITIONS

Triggering events

Regarding the clauses for interbank market and corporate clients fallback triggering events are grouped into two categories: Regulatory Events and Non-Regulatory Events.

Regulatory Events

Within the meaning of the ZBP clauses a Regulatory Event can occur in three situations:

- when an official statement is issued by the Appointing Entity stating that the benchmark ceased or will cease to be calculated or published permanently and there is no successor appointed who will continue to calculate or publish the benchmark ("Event of the cessation of publication of the benchmark");
- when, on the basis of official and publicly available information, a party notifies the other party that the benchmark they use will not be registered or considered equivalent³, or the administrator of such benchmark was denied authorisation or registration⁴ to calculate the benchmark by a relevant supervisory authority, as a result of which the parties will not be able to continue to use such benchmark ("Administrator/ Benchmark Event"); and
- when the benchmark's administrator announces a material change of the benchmark within the meaning of Article 13 of BMR ("Material Change").

³ In the meaning of Article 30 of BMR.

⁴ Or if the authorisation or registration was withdrawn.

Non-Regulatory Events

Non-Regulatory Events cover any other event when a benchmark is not published. Thus may happen when the benchmark is not being published temporarily or was unofficially discontinued. This could be for example, due to technical problems or lack of quotations from contributors of input data.

Consumers clauses

In relation to fallback clauses for consumers there is no such differentiation of triggering events. Any cessation of a benchmark or its material change will activate a uniform fallback procedure.

Appointing Entity

In the current situation, finding an appropriate alternative benchmark is often very difficult or even not possible. That is why, as one of the fallback solutions in case of a Regulatory Event for interbank and corporate clients agreements, ZBP proposes using an alternative benchmark designated by the Appointing Entity⁵.

Under the ZBP clauses, an Appointing Entity is the benchmark's administrator or the central bank for the currency applicable for the benchmark or an authorized public administration body or a working group, an association or an organization that has been officially managing the benchmark or another entity developing the index.

Adjustment

An alternative benchmark agreed upon by the parties or designated by the Appointing Entity may not match the value or parameters of the previous benchmark. For this reason, the parties should apply some kind of adjustment to the new benchmark to ensure that the transaction will continue to work.

The clauses for the interbank market and corporate clients define the Adjustment as a value determined by the parties or by the bank necessary to be applied to the transaction in order to reduce or to eliminate the economic impact of cessation of publication or a Regulatory Event on the parties to the transaction. The adjustment may be made in the form of a one-off payment or a value included in the terms and conditions of the transaction as the spread. The adjustment should, in particular, account for the changes in the economic value of the transaction arising out of the difference between the benchmark to which the Regulatory Event or the cessation of publication pertains and the benchmark that replaced it. The adjustment value may be a positive or negative value or may amount to zero, and it may also be determined by presenting a calculation method or formula. The parties or the bank, is required to take into account available information which may affect the determination of the Adjustment, including the recommendations of the relevant authorities.

⁵ In consumers' version of the clauses the definition an Appointing Entity does not exist. The clauses reference only the benchmark's administrator.

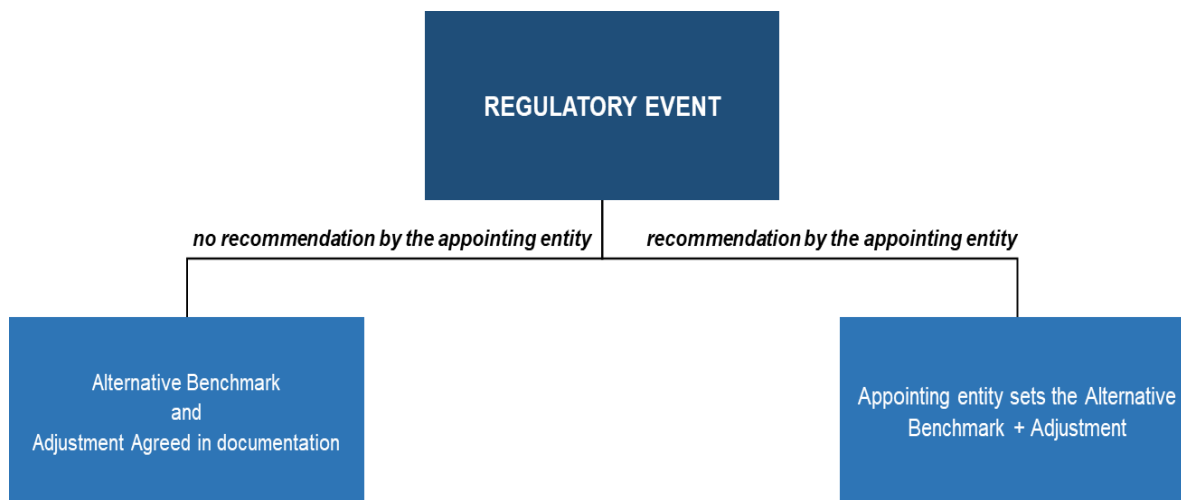
HOW ZBP FALLBACK CLAUSES WORK

Interbank market

Regulatory Event

If a Regulatory Event occurs, the parties shall use an alternative benchmark and Adjustment that they have agreed on in the agreement or set out an alternative benchmark and Adjustment after the Regulatory Event.

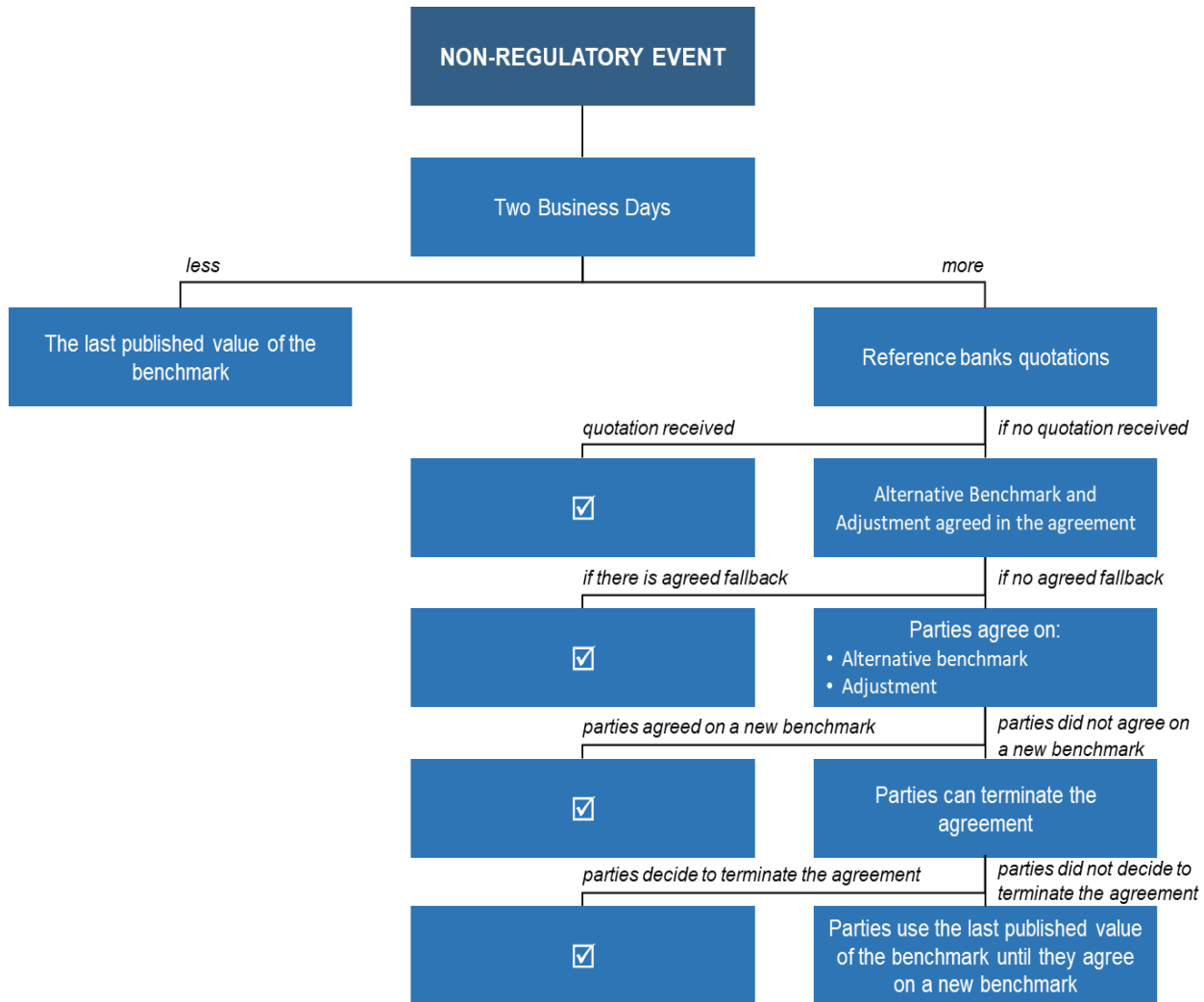
In the event that an Appointing Entity appoints or recommends the use of a specific alternative benchmark, the parties must use that benchmark.



Scheme 1 Simplified diagram of Regulatory Event fallback procedure

Non-Regulatory Event

In the first phase when the benchmark is not published due to a Non-Regulatory Event, the parties should use the last value of the benchmark that was published. It is proposed that this first phase lasts two Business Days, however, the ZBP leaves more precise arrangements open to the parties. If the cessation lasts longer than the agreed period for the first phase, the clauses introduce a mechanism for collecting bank quotations. Each of the banks is to apply to at least three other banks with a request a quotation. Then, the parties will use the arithmetic average of the quotations received as the new benchmark. If the quotations have not been obtained the parties should follow the procedure set out for a Regulatory Event.



Scheme 2 Simplified diagram of a Non-Regulatory Event fallback procedure

Termination of the agreement

The cessation or change of the benchmark will generally not be a reason to terminate the agreement, although the parties may withdraw from the agreement if the benchmark is not agreed upon or is not appointed by the Appointing Entity. If the contract is not terminated, the value of the benchmark from the last day it was published shall apply. The parties will be able to set an appropriate alternative benchmark and Adjustment at any later time.

Corporate clients

The clauses for corporate clients have a lot of similarities to the model proposed for the interbank market, therefore only the main differences will be outlined below:

- As only one bank is party to such an agreement, this bank will collect bank quotations when a Non-Regulatory Event lasts longer than the agreed period of time.
- In the absence of an nominated alternative benchmark or if an alternative benchmark is not indicated or recommended by the Appointing Entity, the bank can unilaterally impose the benchmark of its choice. The bank should present the decision to the other party with justification of the choice. The other party can object and the bank will have to review these reservations and make a decision.

Consumers

The consumers' version of clauses should meet the requirements of clarity, comprehensibility and transparency. In addition, the bank should diligently comply with its disclosure obligations. Before applying any fallback procedures, the bank should inform the consumer that the bank is beginning to follow the fallback procedure and it is possible for the consumer to terminate the contract without additional cost.

Consumers' clauses provide for a uniform fallback procedure in case of any type of cessation of publication of the benchmark. This procedure is divided into four stages:

- In the first few days⁶ after of cessation of the publication of the benchmark the last value of the benchmark that was published should be used.
- After this period, the bank should start using an alternative benchmark given by the law or use an alternative benchmark that is agreed on in the agreement.
- If there is no such alternative benchmark – the bank should use the benchmark proposed by the benchmark's administrator and adjust it by the arithmetic average of the differences between the previous benchmark values and the adopted alternative benchmark values calculated for the period of 12 months⁷ before the date of cessation of the benchmark, for which the values of both benchmarks were published.
- In the event that neither the law, the agreement nor the appointing entity indicate an alternative benchmark, the alternative benchmark should be the central bank's rate applicable to the given benchmark's currency, adjusted by the arithmetic average of the differences between the previous benchmark values and the adopted alternative benchmark values calculated for the period of 12 months before the date of cessation of the benchmark, for which the values of both benchmarks were published.

If there is a material change to a benchmark a bank should use the benchmark adjusted by an Adjustment⁸ proposed by the benchmark's administrator or adjusted by the arithmetic average of the differences between the previous benchmark values and the adopted alternative benchmark values calculated

⁶ It is proposed that this first phase lasts 5 Business Days, however, the ZBP leaves more precise arrangements for the parties.

⁷ This is a proposed period that can be changed.

⁸ In the consumers' version of the clauses the term "Adjustment" is only used in the context of a material change of the benchmark. Under the consumers' clauses an Adjustment is "a value necessary to be applied in order to reduce or eliminate the rapid economic effects of the material change of the benchmark, which was provided by the benchmark's administrator"

for the period of 12 months before the date of cessation of the benchmark, for which the values of both benchmarks were published.

Return to benchmark

ZBP proposes that if the benchmark is published again within 30 days, it can be applied again. However, this period should not exceed 30 days, because after this period it is most likely impossible to consider the benchmark as being the exact same benchmark as before.

CONCLUSIONS

The ZBP clauses are paving the way for benchmark emergency clauses in Poland. Although they are only a non-binding proposal and a model fallback solution, they constitute a good starting point for Polish banks to prepare their own fallback clauses. Moreover, as they are the first proposal in this field, they may contribute to the shaping the Polish financial market outside of the banking sector in the matter of fallbacks.

The direction of changes introduced by ZBP assumes the application of clauses also to instruments outside the scope of BMR. This approach should be considered accurate as the risk of the cessation of publication or a material change of the benchmark will affect all agreements that use benchmarks. Therefore, mainly to the mitigate economic risks of benchmark changes, the implementation of fallback solutions should be valid not only for entities that are obliged to do so on the basis of BMR, but also for all entities using benchmarks.

The matter of fallback plans is becoming even more relevant in light of a recent KNF notification addressed to the banks that they should be working on their clauses.

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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