"Financial Benchmarks: the way forward"

Recent events have highlighted the crucial importance of transparent, robust and well governed benchmarks for the global economy. Given that benchmarks can help to efficiently allocate capital at global level and have a global use across a broad range of financial contracts, an internationally coordinated approach to restore confidence in these benchmarks is necessary.

A number of benchmarks are critical to the pricing of a large number of financial instruments. In particular, benchmarks determine the value of financial instruments and payments under many financial contracts, e.g. the interest rate paid on a mortgage can be set by reference to an interest rate benchmark. As per the European Commission's definition, "benchmark means any index by reference to which the amount payable under a financial instrument or a financial contract, or the value of a financial instrument is determined or an index that is used to measure the performance of an investment fund''[1]. By this definition, the Commission's proposal not only covers the critical interest rate benchmarks but equity indices and indices based on other asset classes that can be used to benchmark investment fund performance.

According to estimates indicated in the European Commission's Impact Assessment[2] accompanying its proposal for a Regulation on benchmarks, the value of financial instruments and contracts referenced by all benchmarks (and market indices) exceeds 1,000 trillion euro. If benchmarks do not reflect accurately what they are meant to measure, the price or payments will not be fair. Public confidence in their use may also be undermined when they are not robust and reliable.

In response to the manipulation of interbank interest rates, the European Commission in July 2012 decided to amend its October 2011 proposals for a Market Abuse Regulation (MAR) and Criminal Sanctions for market abuse Directive (MAD) to clarify that any manipulation of benchmarks is clearly and unequivocally illegal and subject to administrative or criminal sanctions[3].

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013PC0641&from=EN,
[2] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013SC0336&from=EN, p. 6
[3] http://europa.eu/rapid/press-release_IP-12-846_en.htm?locale=en

EU Commission Proposal

On 18 September 2013, the European Commission published a proposal (the 'Proposal') for a 'Regulation on indices used as benchmarks in financial instruments and financial contracts'. This Proposal complements the sanctioning regime provided by MAR/MAD in order to ensure the robustness and reliability of benchmarks. The Proposal is currently being negotiated by the Council of the EU and the European Parliament. Once agreed and adopted it will apply 12 months after publication in the Official Journal of the EU.

The main objective of this Proposal is to ensure that benchmarks produced and used in the EU are robust, reliable, representative and fit for purpose and that they are not subject to manipulation. In particular, the Proposal aims to:

- enhance governance and controls in benchmark setting;
- ensure that contributors to benchmarks are subject to adequate controls, in particular to avoid any potential conflicts of interest;
- ensure effective oversight of benchmark setting, including through regular reviews or audits;
- improve the quality of input data and methodologies, including the use of sufficient and accurate data; and
- ensure adequate protection for investors and consumers through improved transparency and suitability assessments[4].

The main issues currently under consideration vis-à-vis the Commission's proposal are:

- Scope and proportionality: whether a wide scope of application is appropriate or a more calibrated approach with regulation focussed on critical benchmarks should be adopted reflecting the diversity of the benchmark industry and the varying potential vulnerability to manipulation;
- Definition of critical benchmarks: what kind of quantitative and qualitative criteria should be used to define the criticality of benchmarks;
- 3rd country regime: how to future-proof the continued availability of non-EU benchmarks to EU entities given the lack of equivalent 3rd Country legislation at the present stage;
- Transparency requirements: the level of information required to ensure users of benchmarks and investors understand the composition and methodology related to a benchmark;
- Supervision: whether ESMA or national competent authorities should directly supervise critical benchmarks;
- Transitional provisions: how to ensure workable transitional measures for EU and third country benchmarks;
- Commodity benchmarks: what specific requirements should apply to commodity benchmarks;
- Governance and assurance including the role of internal oversight and monitoring frameworks and external audit.

Developments at international level

In July 2013, the International Organization of Securities Commissions (IOSCO) published Principles for Financial Benchmarks which cover the submission-setting process, content and transparency of methodologies and governance processes. These Principles provide flexibility as to the scope and means of their implementation. They were endorsed by the G20, are largely embedded in the Commission's Proposal and represent the de facto standard for the global benchmark industry with many administrators already having certified their compliance. In July 2014, IOSCO published its review of EURIBOR, LIBOR and TIBOR against implementation of these Principles. The report found that significant progress was made by these administrators on oversight, governance, transparency and accountability but more work was required on data requirements. IOSCO will continue to look at implementation of its Principles and will publish a report in July 2015. IOSCO is also reviewing the implementation of its Principles in foreign exchange (FX) benchmarks and is expected to publish a report by mid-2015 with its recommendations.

[4] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013PC0641&from=EN

In October 2012, IOSCO published Principles for Oil Price Reporting Agencies (PRAs), which aim to enhance the reliability of oil price assessments that are referenced in derivative contracts. Although the PRA principles were developed in the context of oil derivatives markets, PRAs are encouraged and have decided to implement the Principles more generally to all assessments that are referenced by any commodity derivatives contract, without regard to the nature of the underlying. In September 2014, IOSCO issued a report on the implementation of its PRA Principles which suggested that good progress was achieved since their publication. IOSCO intends to regularly evaluate the PRA Principles going forward.

In July 2014, the Financial Stability Board (FSB) published its report on 'Reforming Major Interest Rate Benchmarks' setting out proposals for the reform and strengthening of major interest rate benchmarks and for additional work on the development and introduction of alternative, nearly risk-free reference rates. A final monitoring report is expected to be delivered in July 2016. Moreover, in September 2014, the FSB published a final report with a set of recommendations for increasing the levels of integrity of FX rate benchmarks. The final report puts forward fifteen recommendations, including the calculation methodology of the WMR benchmark rates; recommendations stemming from the IOSCO review of the WMR fixes; and the behavior of market participants around the time of the major FX benchmarks.

The UK took a leading role in promoting benchmarks reform and in September 2012 published the Wheatley Review setting out a ten-point plan for the reform of LIBOR. These recommendations have now been implemented in the UK and could apply to a wide range of benchmarks. Under this legislation the submission and administration of LIBOR, as well as key individuals, are regulated by the UK Financial Conduct Authority (FCA). As regards input data, LIBOR submissions should, so far as possible, be supported by transaction data.

Additionally, in September 2014, the UK Government published a consultation on 'Recommendations on additional financial benchmarks to be brought into UK regulatory scope'. In December 2014, the Financial Conduct Authority (FCA) confirmed that it will regulate seven additional major UK-based financial benchmarks in the fixed income, commodity and currency markets from 1 April 2015. This extends the FCA's initial regulation of LIBOR (the London Interbank Offered Rate) introduced in 2013 and implements the recommendations of the Fair and Effective Markets Review launched in summer 2014.

A range of other jurisdictions including the US, Japan, Hong Kong Singapore, Canada etc, have implemented or are in the process of putting forward their own proposals to regulate pre-dominantly systemic benchmarks in alignment with the IOSCO principles. However these tend to focus on interest rate benchmarks and are not nearly as comprehensive and wide-ranging as the EU proposal. None of the above mentioned jurisdictions plans to implement legislation that is similar to the one proposed by the European Commission in the foreseeable future.

Conclusion

Undeniably, the financial industry has a responsibility in promoting the integrity of the benchmarks in use. Currently, there is strong commitment from both regulators and industry to achieve benchmark regulation that restores confidence in benchmarks for the benefits of global markets. However, issues such as proportionality, the definition of a critical benchmark, the appropriate treatment of commodity benchmarks, the transitional provisions, the appropriate approach to global coordination as well as the practicability of a suitability assessment of the benchmark when granting credits to consumers continue to be ongoing topics of debate.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Secretariat or the Chair of the Financial Industry Committee.

Chair of the Financial Industry Committee
Peter De Proft, EFAMA Director General
Rue Montoyer 47, B-1000 Brussels
Tel: +32 2 513 3969 / Fax: +32 2 513 26 43
E-mail: peter.deproft@efama.org

Secretariat
Catherine Denis, EPFSF Director
Avenue des Arts 56, B-1000 Brussels
Tel: +32 2 514 68 00 / Fax: +32 2 514 69 00
E-mail: cdenis@epfsf.org

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