BENCHMARK REGULATION: IMPLEMENTATION CHALLENGES

1. The state of benchmark regulation in Europe

1.1. The case for benchmark reform

A Central Bank official explained that benchmark interest rates are important because they are used across a large range of financial market instruments. Benchmark rates impact the assessment of monetary policies and financial stability, given the financial system's overall interconnectedness. Market manipulation and false reporting are not widespread, but they have undermined confidence in the reliability and robustness of existing interbank benchmark rates. An industry representative added that the entire market had been outraged by the misbehaviour of traders in 2012.

This is why Europe has undertaken a fundamental review and reform of benchmark designs and their governance. A regulator suggested that the worst-case scenario would be for the industry to lose access to critical benchmarks. If market participants could not agree on the issue of benchmarks, the FSB had warned that the market would have to manage the situation.

Another regulator explained that EURIBOR is estimated to underpin more than €180 trillion worth of contracts, including approximately €1 trillion of retail mortgages. This demonstrates the diversity in type and duration of instruments covered by benchmark rates. In respect of EONIA, the value of outstanding EONIA-based contracts is established at approximately €450 billion. The vast majority of the euro overnight index swap market, with a notional value of €5.2 trillion, is also linked to EONIA.

While EONIA and EURIBOR have been designated as critical benchmarks, the Central Bank official noted that benchmarks currently do not comply with the new requirements. This prompted the launch of the working group on euro risk-free rates, which is an industry-led group designed to contemplate benchmark rates. ESTER will be produced by the European Central Bank on 2 October 2019 and will gradually replace EONIA as the euro risk-free rate. EONIA will be reformed as ESTER plus a spread, and will continue to be published by EMMI until January 2020.

There is also a taskforce working on benchmarks at IOSCO which is seeking to ensure that all market participants understand the implications of the discontinuation of LIBOR.

1.2. Good progress has been made in Europe

A regulator noted that the involvement of public supervisory bodies has been forced by private-market failure. The market manipulation was difficult to spot, and many benchmarks were not subject to any regulation. Public supervisory bodies 'started from scratch' and decided to take a global view when launching the work stream, which can be seen in the work done by Martin Wheatley and IOSCO. The regulator expressed his admiration for the pace at which the major principles had been drafted and established. Within the FSB's Official Sector Steering Group (OSSG), supervisory entities at national, regional and international levels are working closely on benchmarks. The Belgian FSMA has been appointed as the lead supervisor for EURIBOR and EONIA and benefits from advice from a college of EU supervisors, including ESMA.

A regulator emphasised that good progress was being made on critical benchmarks. On EURIBOR, the hybrid methodology represents good progress. In respect of third-country benchmarks, the regulator considers it important to focus not only on equivalence and recognition but also on the possibility of endorsement. Between these three different routes, Europe should be able to achieve something that will enable the industry to move forward. The regulator emphasised that ESMA would continue to be engaged and involved in the subject of benchmark regulation, especially given the recent decision for it to assume direct supervision of critical and third-country benchmarks.

An expert described the circumstances surrounding the creation of EURIBOR and EONIA, noting that the European Money Markets Institute (EMMI) now administrate these rates. EMMI's governance has been strongly reinforced in recent years. EMMI has two clear objectives: to facilitate the transition from a quote-based methodology to a hybrid methodology; and to be authorised as the administrator of EURIBOR and EONIA by the Belgian FSMA. EMMI has published widely on EURIBOR reform and the market supports its proposals. Last year, EMMI's hybrid methodology was successfully tested and the organisation received positive feedback from a large range of stakeholders. In accordance with the Benchmarks Regulation, EMMI will seek authorisation to administrate EURIBOR by the FSMA, which it hopes to gain by the end of the year. EMMI's hybrid methodology will be phased in gradually to ensure a smooth transition, which will have a smaller impact in terms of differentials.

Another industry representative felt there has been tremendous progress on the administration of globally systemic benchmarks over the last eight years. This work has taken place in coordination with the official sector, most notably in respect of the EU Benchmark Regulation (BMR) and the IOSCO principles. The industry is in a much better position in 2019 relative to the situation approximately 10 years ago.

2. Considering the risks posed by the introduction of benchmarks and discontinuing existing benchmarks

An industry representative stressed that the challenge for the industry is to keep its flows operating while fundamentally changing the plumbing. Considering the challenge of discontinuing and replacing existing benchmarks, a Central Bank official felt that there could be a divergence between different alternative risk-free rates and also sluggishness in the pace of reform, leading to differences in timing for the availability of new benchmarks. Additionally, in the transition phase multiple benchmarks coexisting simultaneously could produce a high degree of complexity.

An industry representative considered consistency an important issue. Each of the major currencies has developed a slightly different solution. While the Swiss and Americans are considering a secured market rate, Europe, the UK and Japan are considering an unsecured one. There is also a completeness issue. Within LIBOR there is agreement on overnight benchmark rates, but there is no visibility on what the term structure will be for the main currencies in the future. Further divergence could result from the Swiss desire for a backward-looking methodology for compounding in arrears, because other jurisdictions are seeking to keep a forward term structure. This also demonstrates a coordination issue. This Swiss example has prompted a debate on term structure in relation to compounding in arrears. ISDA is considering compounding in arrears for the fall-back language, and the working group on euro risk-free rates is examining a forward rate.

Another industry representative agreed that different parts of the industry have different views on issues such as term and spread adjustments. In addition, many deals made using current rates would remain 'on the books' when risk-free rates become more firmly established. The contracts that underpin those positions currently contain fall-back language which is not designed to contemplate the permanent discontinuation of a rate. Clients and banks will have to examine these contracts carefully. There are different ways to address this issue, but bond markets, derivatives markets and loan markets are taking different approaches to this.

The industry representative suggested that there are legal, regulatory, operational and even capital and liquidity risks associated with the transition to risk-free rates. One plausible scenario is a dual-rate environment across a number of currency sets. This will most likely generate significant liquidity dispersion and create follow-through consequences in terms of the paucity of observable prices for FRTB purposes, funds transfer pricing within organisations, interest-rate risk in banking books and valuation adjustments (XVA). The challenges in benchmarks encompass operational risk, trading risk, credit risk, operational risk, legal risk, reputational risk and, ultimately, conduct risk.

2.1. Benchmarks are an integral component of an enormous range of financial activities

An industry representative considered that benchmarks exist to facilitate economic activity in the real economy, which means the industry should reflect on how changes would impact the real economy. It is important to consider how to reform benchmarks in a way that suits the needs of manufacturers, retailers, households and families. It is also sensible to have several different benchmarks, because different financial products have different economic purposes. One benchmark which is appropriate for derivatives transactions may not necessarily meet the needs of a household taking out a mortgage.

2.2. Benchmark rates affect the real economy and financial stability

An industry representative stressed that benchmarks affect financial stability. The FCA has fixed the end of its LIBOR support for yearend 2021. Without a coordinated approach between members of the real economy, the financial sector and the official sector, there is a risk for financial instability around the transition.

A member of the audience highlighted the fact that benchmarks have a direct impact on the solvency of insurance companies, which produces a systemic risk. A regulator explained that benchmarks are embedded across the regulatory regime. Insurance is important, but benchmark rates also have implications for capital and banks. The industry must ensure that these benchmarks can be relied on in all fields of the industry, whether that is insurance or any other.

3. Implementing BMR: transitional challenges

3.1. Setting critical benchmarks in the EU: the future of EURIBOR, EONIA and ESTER

An industry representative praised the approach of European stakeholders to benchmark interest rates in the eurozone. These stakeholders have leveraged a commonsense set of solutions and their approaches are simple to understand. They have committed to a basic and formulaic approach for EONIA, which market participants have bought into, and they have adopted a well-considered hybrid approach to strengthen EURIBOR. Secondly, the European stakeholders tackling this question have been mindful of the real economy. They have acknowledged the need for benchmarks to incorporate credit risk within the context of lending arrangements while establishing an overnight risk-free rate that is appropriate for derivatives contracts. There is a deep empathy towards families and how benchmark reform will impact them. Seeking to avoid unintended consequences for families and the real economy in the transition process is a 'very wise' approach, which will lead to long-term financial stability.

3.2. The two-year transition period – is it sufficient?

A regulator described how the Benchmarks Regulation became formally applicable on 1 January 2019. While some of it has already been implemented, certain things are taking longer than originally expected. This explains why the transition period has been extended to yearend 2021 for critical and third-country benchmarks. An industry representative expressed how delighted his institution had been at the two-year extension. The transition is not a 'first-past-the-post' competition, however. The entire market must transition by the deadline. Large institutions will be internally prepared for the change, but they can only be properly prepared if their entire client base is ready. From this perspective, 2021 is an aggressive deadline.

An industry representative stressed the considerable effort made by the public and private sectors to reform IBORs. This work is necessary but not sufficient. The road to reform the IBORs is very long. One of the biggest vulnerabilities of IBORs is their unsustainable reliance on voluntary contributors. While many of the institutions represented at the conference use LIBOR or EURIBOR, perhaps only one or two contribute to them. Over the next two years, the industry must find ways to make these benchmarks less reliant on voluntary contributions or powers of compulsion.

3.3. There are transition risks associated with the continuity of contracts and fall-back provisions

A regulator noted that the Benchmarks Regulation requires contracts to include fall-back provisions, which poses a difficult problem. The issue requires coordination between the private and public sectors. In the context of EURIBOR and EONIA, ESMA is currently contributing to the working on a way to address fall-back provisions which properly embed the forthcoming changes while ensuring there is a sensible transition period. In May, the working group on euro risk-free rates will publish its work on fall-back provisions in respect of EONIA, and work will begin on EURIBOR fall-backs once there is greater clarity there.

An industry representative from a benchmark administrator emphasised his organisation's commitment to working with data providers to guarantee that benchmarks continue to have integrity while ensuring contributors feel safe about participating in the process.

Another industry representative noted that, while banks are fixated on loans, deposits and bond issuance, large corporate entities have a very small exposure to these financial products but an extremely large exposure to commercial contracts, which also reference LIBOR and EURIBOR. This economic activity must also be transitioned. The industry should support ICE's ongoing efforts to work with globally active banks to seek to publish certain LIBOR settings after year-end 2021 in order to provide more time to digest the impact of this transition for the entire industry, not merely the largest players.

A regulator explained the transition process from the perspective of the FSMA, noting the importance of providing market participants with accurate information. As the current principal supervisor of EURIBOR and EONIA, the FSMA stands ready to provide explanations where appropriate. First, the process of transition is on track. Second, all market participants must be on board for the transition of EURIBOR. The industry needs a stable and representative panel. In terms of EURIBOR and EONIA, the FSMA is currently the lead supervisor and head of the college of supervisors. Both benchmarks are expected to be reformed to be BMR compliant covered by the BMR licence granted by the FSMA in its capacity as lead supervisor.

The FSMA has a specific work stream for each of the benchmarks due to the differences between them. In terms of EONIA, in September 2018 the working group on euro risk-free rates recommended ESTER as the new risk-free rate for the euro-area to replace EONIA. ESTER will also reflect the wholesale euro unsecured overnight borrowing costs of euro-area banks. The ECB will begin calculating and publishing ESTER in October 2019 based on Money Market Statistical Reporting Regulation (MMSR) information from the 52 largest banks in the euro-area. The FSMA reports to the ECB through the Money Market Statistical Reporting Regulation (MMSR), which may have implications for EONIA. At present, EONIA is used in overnight interest-rate swaps and the valuation of financial instruments. Therefore, one of the main challenges is to ensure the new benchmark can fulfil the same role, which entails giving market participants sufficient time to develop a liquid ESTER derivatives market. To solve this challenge, the working group on euro risk-free rates recommended a modification of EONIA methodology, on which the administrator of EONIA has already consulted. EONIA will become ESTER plus a fixed spread, which will be calculated by the ECB. The main advantage of this work stream is that there will be a constant spread and it will smooth out the perceived fear of valuation transfer and balance-sheet impact, lowering the barriers to transition. The amended EONIA rate will likely be BMR-compliant. From October 2019 to December 2021, which is the new deadline agreed at the political level, EONIA will be recalibrated as ESTER plus a spread. This would be made available by EMMI and would be governed by EMMI's BMR licence. Market participants should use this period to replace EONIA with ESTER gradually.

The work stream for EURIBOR is slightly different. EURIBOR is referenced in a large number of long-term transactions, such as mortgages. In order to make EURIBOR BMR-compliant, EMMI has consulted extensively on a hybrid methodology, anchored to the largest extent possible in transactions and tested by various public stakeholders. This hybrid methodology will be gradually implemented during a phasing-in period, which will smooth the transition from a quote-based to a hybrid methodology. At present, the FSMA expects EMMI's licence application very shortly. Based on the preparatory work done by EMMI, the FSMA currently does not anticipate any problems with this application. The new methodology is expected to be BMR-compliant. The FSMA expects to be able to grant EMMI a licence in the summer after consultation with the EURIBOR college of supervisors.

An expert reiterated that EMMI's major challenges were to facilitate the transition to the new hybrid methodology and to present its request for authorisation to the FSMA. This application will be filed before 13 April. There is still a considerable amount of work to do on benchmarks. For instance, the BMR insists that contracts should contain fall-back rates. In terms of continuity of contracts, EMMI is seeking to ensure a smooth transition. EMMI also wishes to enlarge its panel of panel banks. At one time, supervisors did not have the power to block a bank from leaving the panel, but this tool has now been available for five years. After EMMI has been authorised, it will seek to secure the involvement of some important eurozone banks that are not currently part of its panel.

A member of the audience asked the panellists to give details regarding legacy contracts in terms of new benchmarks and how historical contracts could be translated into new contracts. A regulator explained how the work on benchmark reform, was a partnership between the private sector and public supervisory bodies. Many aspects relating to the continuity of contracts must be addressed at the right level by the right body. This is why there are specific work streams on this subject within the working group on euro risk-free rates. It will also be important to take into account the proposals coming from ISDA and other market participants, although there is no legal basis for doing so at an EU or domestic level. A political agreement on the legislation was made many years ago and it must be implemented on time. ESMA will soon play a bigger role in this process. In terms of trust, credibility and visibility, the most important thing is for the market to see that there are no delays in the process. Taking into account the various deadlines, as described by the other speakers, it appears that this process is on track.

3.4. It is vital to ensure that third-country benchmarks are properly managed

An industry representative felt that the industry should not confuse the topic of benchmarks with LIBOR, EURIBOR or EONIA. There are over 100 different IBORs in the world. These rates are very different, and they present a problem of scope. Additionally, it is vital not to confuse volume with risk. Benchmark rates affect hundreds of trillions of euros, but a large majority of that amount is held by 20 firms. These hundreds of trillions of euros do not necessarily mean hundreds of trillions of risks. Another mistake would be to confuse an authorised benchmark with a sustainable benchmark. Some benchmarks are used more frequently, such as LIBOR 12 months in Japanese yen. When an institution asserts itself as an administrator, data providers often do not want to contribute to the rate. In terms of the two-year extension, the industry representative felt that this deadline is difficult but possible for critical benchmarks such as EURIBOR or LIBOR, but it would be impossible to authorise the whole ecosystem of benchmarks.

Another industry representative suggested that problems with third-country benchmarks could have a substantial impact on rates markets, non-deliverable foreign exchange and third-country commodity markets. In a number of markets, particularly those with controlled currencies, NDFs are the typical instrument of choice for corporate treasury hedging activity. For the purposes of BMR, these indices are not centrally administered by Central Banks. The likelihood of regulators or index providers in those markets engaging with the process of recognition in the EU is slim. This suggests that banks and other financial institutions otherwise in scope of BMR should not participate in economic activity in these jurisdictions. However, these markets include Taiwan, India, China and others. Some European corporates' exposure to these markets and currencies is managed entirely legitimately through their desire to dampen FX-related volatility in their day-to-day operations, but this activity is difficult to reconcile with the obligations of the BMR. One solution to this could be a proportionality or relevance test around the nature of the exposure covered by these benchmarks.

A regulator cautioned against underestimating the importance of third-country benchmarks to the workings of the European market. The deadline extension regarding third-country benchmarks will ensure that the European market is sufficiently prepared. ESMA expects the extension to facilitate the availability of third-country benchmarks in the European markets. ESMA is confident that the European Commission will be able to adopt multiple equivalence decisions over the next few years under the Benchmarks Regulation.