

Benchmark regulation



Verena Ross

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Questions around the Euro Risk-Free Reference Rates

In order to facilitate the implementation of the EU Benchmark Regulation, the Euro Working Group on Risk-Free Reference Rates (EURO RFR WG) was created in Q1 2018 by ESMA, the European Commission, the ECB and the Belgium FSMA. This industry-led Working Group was established to identify and recommend a risk-free rate that could serve as a basis for an alternative to current benchmarks. The EURO RFR WG achieved its first goal in September 2018, when ESTER was recommended as the alternative risk-free rate for the eurozone. The Working Group is also committed to identifying fall-back rate for Euribor and EONIA based on ESTER.

The main difficulty currently related to ESTER is that it is not yet available, as the ECB plans to start publishing it, at the latest, in October 2019. In the UK and the US, on the other hand, the alternative risk-free rates (SONIA and SOFR, respectively) are already available, and the build-up of derivative market contracts referencing these interest rates is already taking place. The dynamic of the ESTER derivative markets is difficult to anticipate.

On the more particular issue of so-called fall-back provisions, these are required by the Regulation to increase the legal soundness of contracts referencing benchmarks. Thanks to effective fall-back provisions, the litigation risks and the risk of frustration attached to a contract are materially reduced. For these reasons, the Working Group is committed to recommending legal action plans related to both EONIA and EURIBOR. Such plans should provide market participants with practical guidance for the inclusion of fall-back language based on ESTER in new and, possibly, in existing contracts. ESMA is following this development very closely because of the potential impact on consumers across the EU.

Although not yet published, ESTER is already considered by market participants as a very reliable rate because of the authority of its administrator, the ECB. The members of the Working Group will also consider producing a recommendation on the fall-back provisions for contracts referencing ESTER. Looking ahead, it is expected that these fall-back provisions would increase even further the legal soundness of ESTER-based contracts. ●



Carlos Molinas

Global Head of Business Compliance,
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A new and progressive approach to benchmark regulation

The LIBOR scandals in 2012 exposed important vulnerabilities in a key element of the economy: benchmarks. These failures have impacted the confidence in our financial industry in a way that may take generations to recover. It is no surprise that international initiatives led by FSB and IOSCO developed recommendations and overarching principles for benchmarks. Additionally, UK and EU legislators adopted hard regulations to bring

into their perimeter the provision, contribution and use of benchmarks.

After many years, it is now time to evaluate the impact of benchmark regulation and to assess whether their original objectives have been met.

We have learnt that the benchmark universe is more dynamic and diverse than we initially thought. Farmers use benchmarks to receive compensation based on a hurricane's diameter and wind speed. Fishermen calculate the exact price of a salmon (gutted and head on) so they can settle future contracts. Indices measure mortality rates or the change of house prices to allow landlords and tenants to enter into rental contracts. We saw a firm sponsoring more than 800,000 benchmarks and an administrator claiming to provide more than 150,000 indices. The variety of benchmarks is such that trying to gather data is as challenging as finding the number of fish in the sea.

We knew that a one-size-fit all approach could not be applied to all benchmarks. The strict requirements for administrators and contributors to critical interest rate benchmarks (IBORs, ONIAs) cannot be applied to other benchmarks. To find a proportionate approach, IOSCO relied on self-assessments but hard regulation such as the EU Benchmark regulation (BMR) requires the use of quantitative criteria. Finding data is vital for the BMR to determine whether a benchmark is "critical", "significant" or "non-significant". Yet, we have found that the granular data needed by the BMR to determine the importance of a benchmark simply cannot be obtained.

Lastly, we have seen that administrators rely on data sources that do not gain much from providing

input data. The BMR requirements have given incentives to data sources to request higher prices or stop providing data. Consequently, some third country administrators face the unpalatable choice of either not complying with the EU BMR or face collapse. Unsurprisingly, the list of benchmark administrators that have taken steps to comply is still very short. The benchmark industry is now polarised between some well-established administrators in EU and a vast number of firms with few incentives to be registered. A prohibition for EU firms to use non-approved benchmarks would impact their capacity to lend, borrow or manage their risks especially in foreign currencies.

"It is time to evaluate benchmark regulation and to assess whether their objectives have been met."

- CARLOS MOLINAS

Therefore, a new framework should be considered, based on a step by step approach. The idea is to include all benchmarks under the regulatory perimeter while authorising and supervising only a growing list of "designated" benchmarks. This progressive approach has many benefits e.g. allowing supervisors to apply their resources on a cost effective basis, to learn from the lessons that benchmark diversity can teach us, to keep non-designated administrators on their toes and to mitigate potential dislocations of a quick and too ambitious approach. ●

Jean-Paul Servais

Chairman, Financial Services and Markets Authority, Belgium (FSMA)

Benchmark regulation: implementation challenges

Major interest rate benchmarks have been on the global reform agenda since 2013. Great work has been achieved at international level with the endorsement by the G20 of the IOSCO

Principles for Financial Benchmarks. In addition, the FSB Official Sector Steering Group put considerable effort in strengthening IBORS and identifying alternative risk-free rates. Closer to home, global standards have been anchored in European law with the Benchmarks Regulation, fully applicable since January 2018. The two major benchmarks in the euro zone, Euribor and EONIA, both provided by the European Money Markets Institute (EMMI), have been declared critical by the European Commission in August 2016 and June 2017 respectively.

In February 2018, the ECB, together with ESMA, the >>>



>>> European Commission and the FSMA, established a working group on euro risk-free rates ('WG'), tasked, among other things, with identifying and recommending risk-free rates that could serve as an alternative to current benchmarks used in a variety of financial instruments and contracts in the euro area.

In September 2018, the WG recommended ESTER as the new risk-free rate for the euro area. ESTER will reflect the wholesale euro unsecured overnight borrowing costs of euro area banks. The ECB is expected to start calculating and publishing ESTER by October 2019.

Currently, EONIA is the main overnight rate in the Euro area. It is used in many financial contracts, mainly among professional parties. After having chosen ESTER as the new RFR in the euro area,

the WG recommended a transition path from EONIA to ESTER, whereby EONIA would be recalibrated towards ESTER and discontinued by the end of 2021.

"The transition from EONIA to ESTER is on track and Euribor, under a hybrid methodology, is here to stay."

- JEAN-PAUL SERVAIS

With regard to Euribor, the story is different. In December 2017, an estimated €9.7 trillion of loans linked to Euribor were outstanding, in March 2018, an estimated €1.68 trillion of debt securities linked to Euribor were outstanding and in October

2017 an estimated €108.7 trillion of interest rate derivatives linked to Euribor were outstanding¹, including a significant amount of long-term retail transactions. EMMI has developed and consulted on a hybrid methodology anchored to the largest extent possible in transactions. There are good hopes that under its new methodology, Euribor could be compliant with the Benchmarks Regulation. EMMI has confirmed that it will file for authorization as an administrator of Euribor by Q2 2019.

To sum up, the transition from EONIA to ESTER is on track and Euribor, under a hybrid methodology, is here to stay. ●

1. https://www.ecb.europa.eu/paym/intro/events/shared/pdf/20181109_euro_risk-free_rates/Presentations_Discussion_on_term_rates_initiatives.pdf



Angus Graham

Global Head of IBOR Transition, UBS

The transition from EURIBOR poses significant challenges

The Euro Interbank Offered Rate (EURIBOR), which underpins contracts with nominal value of approximately €180 trillion, is ubiquitous to financial markets and is embedded in products, processes and IT globally. EURIBOR has however been deemed non-compliant with the EU Benchmark Regulation (BMR). As such, use of it in its current form will be prohibited in the future. The BMR and international guidelines require that

benchmarks be anchored by arm's length transactions to the extent possible and that the methodology should reflect evolving circumstances in the markets that EURIBOR seeks to measure.

EURIBOR will consequently be extensively reformed by the European Money Markets Institute (EMMI), the EURIBOR administrator, from the current quote-based methodology to a transaction-based hybrid approach. The aim is to provide the market with a more transparent, robust, and representative index.

Orderly and controlled transition is clearly the best case scenario. Anything else could result in market fragmentation and pose a serious threat to financial stability. However, the path to transition and the final outcome of the reform is uncertain.

Given challenging timelines, there is no guarantee that the reforms to EURIBOR will ultimately be successful. The hybrid methodology must first be authorised by Financial Services and Markets Authority (FSMA), the supervisory authority of EMMI. Only then can EMMI start work on transitioning banks to the new methodology.

Ideally, a reformed EURIBOR would be deemed BMR compliant by FSMA and authorised for both new and legacy contracts. Should the new methodology not meet BMR requirements, however, FSMA could still permit the provision and use of EURIBOR for legacy contracts.

EURIBOR reform thus has the potential to be very disorderly and

to cause serious market disruption. Challenges include insufficient liquidity being built up in the transition period to enable positions to be migrated and effectively hedged. Liquidity will be split between instruments using existing and reformed EURIBOR, increasing costs and reducing market efficiency. The reformed EURIBOR may not be economically equivalent to legacy EURIBOR, leading to an inability to meet the commercial needs of market participants and calling into question the accuracy of pricing, valuation and risk management.

"Orderly and controlled transition is clearly the best case scenario."

- ANGUS GRAHAM

We welcome the decision taken by EU regulators to extend the transition period for certain benchmarks, to allow more time for the significant operational infrastructure change that lies ahead. We must pay due regard to the interests of our customers and treat them fairly. The speed of transition risks not adequately taking into account the judicial consequences of contract law, conduct and fiduciary obligations.

With effective coordination of benchmark reform at a European and global level, and with the industry working in partnership with regulators, orderly and controlled transition can be achieved. ●



Chris Allen

General Counsel for Clients and Products, Standard Chartered Bank

Main challenges posed by the implementation of the EU Benchmarks Regulation and the transition to risk-free rates

Interest rate benchmarks are widely used in the global financial system. The London Interbank Offered Rate ("LIBOR"), for example, is a reference rate for contracts that amount to more than USD 300 trillion, ranging from complex derivatives to residential mortgages. The development of risk-free rates, or RFRs, and the likely discontinuance of LIBOR (and potentially other IBORs), at least in its current form, therefore, represents a huge transition impacting virtually every type of user of financial markets. In addition to featuring in a wide range of financial products used by banks, pension funds, insurance companies, corporates and others, LIBOR is also embedded in regulatory cost of capital, funds transfer pricing, performance modelling, valuations, and accounting (fair value calculations for discounting, impairments and financial leases) frameworks across many institutions.

However, the headwinds to successful transition to RFRs are not limited to the scale and all-encompassing scope of their intended use, significant as those challenges are. Given the potential for transition to RFRs across the next

two to three years, and specifically the signalled intention no longer to encourage panel banks to submit quotes to LIBOR after 2021, most market users are already printing deals across their trading and banking books that will still be live as transition occurs. The market is increasingly developing and adopting fallback or replacement of screen rate language in high yield and syndicated lending deals as well as in derivative documentation to try and cover such transition risk but diverging approaches to the documentation of fallback options across cash and derivative products are already emerging. The resultant basis risk and ambiguity of exposure could have various implications from compromising relief available under hedge accounting to the risk of mis-calculating capital requirements. In addition, while documentary fallback provisions are increasingly being developed and featuring in some deals, the allocation of the costs of transition between buyers and sellers, the management of "value transfer" risk as markets migrate from forward unsecured rates to overnight secured rates, the differing approaches to the voting thresholds required to agree to changes in syndicated deals, and the importance of clear and consistent client communication strategies, all add to the challenge.

"It is imperative that the EU considers how the application of its rules to non-EU activity may prevent EU firms from conducting economically significant business on the global stage."

- CHRIS ALLEN

From the point of view of users, there are additional hurdles arising from the implementation of the requirements related to non-European benchmarks. For example, the restrictions on referencing non-EU indices could have a detrimental effect not only for banks, but equally for European corporates and investors engaged in cross-border activities, most notably in the FX markets. The third country benchmark regime is predicated upon third country administrators wanting their benchmarks to be used in the EU. However, there are concerns that the administrators of some benchmarks do not intend to apply for recognition.

The recently announced extension of the transitional arrangements applying to these benchmarks is very much welcome as it will allow EU users to continue using a number of important indices administered outside the EU for an extended period. However, the transitional arrangements do not solve the underlying challenges with the third country framework in the EU Benchmark Regulation. It is vital that EU policy makers continue to focus on practical solutions. Given the effectiveness of the working group set up by the European Commission and the European Central Bank to consider the transition to RFRs in the Euro area, it may be worth considering a similar working group, with participation of non-EU regulators as well as market participants, focused on the issue of third country benchmarks. It is imperative that the EU considers how the application of its rules to non-EU activity may prevent EU firms from conducting economically significant business on the global stage. ●

Next Eurofi event
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