Financial Benchmarks: Evolution and Regulation

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Financial Markets Law Committee

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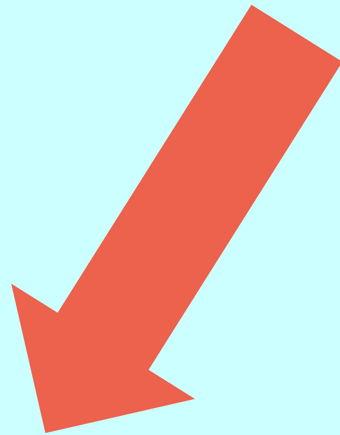
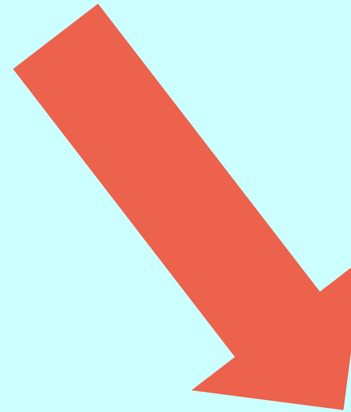
Benchmark Reform:
A Timeline

1. June-September 2012 CFTC and FCA Penalty Notices, Wheatley Review Final Report published.
2. March 2013 New FCA Rules introduced for "specified benchmarks" (i.e. LIBOR)
3. **April 2013 IOSCO Principles for Financial Benchmarks**
4. September 2013 European Commission proposes a Regulation on Indices Used as Benchmarks ("**BMR**")
5. **July 2014 FSB Report on Reforming Major Interest Rate Benchmarks**
6. October 2014 ICE Benchmark Administration ("IBA") consults on evolution of LIBOR
7. November 2014, NYFRB launches Alternative Reference Rate Committee, considers alternatives to $LIBOR
8. March 2015, Bank of England launches Sterling Risk Free Rate Working Group ("**SRFRW**")
9. April 2015 Seven new UK benchmarks "specified" as a result of Fair and Effective Markets Review, inc. SONIA
10. July 2015 IBA consults on revised plans for evolution of LIBOR methodology
11. October 2015 EMMI consults on the evolution of EURIBOR methodology to comply with regulatory standards
12. November 2015 Bank of England consults on expanding input data collection for SONIA benchmark
13. December 2015 European common agreement on a text for the BMR
14. February 2016 ESMA consults on "policy orientations" under BMR
15. February 2016 FCA adopts rules on "FRAND" pricing for specified benchmarks vis-à-vis infrastructure users
16. March 2016, IBA publishes road map for LIBOR evolution
17. April 2016 Adoption of the BMR by the European Parliament
18. May/September 2016 ESMA consults on implementing measures and technical standards for BMR
19. **June 2016 BMR published in E.U. Official Journal**
20. October 2016 Bank of England consults on reform of SONIA – suggests median calculation for methodology
21. February 2017 Bank of England consults on reform of SONIA – suggests trimmed mean calculation for methodology
22. March 2017 ESMA publishes final implementing and technical standards for BMR
23. May 2017 EMMI publishes its decision not to transition to the proposed new EURIBOR methodology

Benchmark Reform





Evolution

- Reform of major interest rate benchmarks continues in 2017
- Other key indices are also seeing significant upheaval.
- Legacy contract issues are "remote but not negligible".

Regulation

- E.U. Benchmarks Regulation, in force June 2016, comes into effect January 2018
- ESMA RTS/ITS published 30 March 2017
- Problems for Euro-denominated benchmarks

FINANCIAL BENCHMARKS: EVOLUTION AND REGULATION

2017 will bring significant changes to key benchmarks

1. EVOLUTION

Key Interest Rate Benchmarks:
Where We Are Now

EURIBOR

- In 2015, EMMI developed a methodology that would ground the EURIBOR entirely in transactions ("Euribor+") and subsequently carried out a "pre-live verification" exercise to test the methodology. This exercise revealed that projected values for the new methodology could not be brought into line with projected values for EURIBOR. On May 4th 2017, after consultation with the Belgian regulator, EMMI published its decision not to pursue the transition.

LIBOR

- IBA published a new code of conduct for panel banks in June 2016. Input data must (by mid-2017) consist of submissions derived from: 1) the Volume Weighted Average Price (VWAP) of panel banks' eligible transactions; 2) contributions derived from transactions (including adjusted and historical transactions, interpolated data etc); and 3) expert judgment "appropriately framed". The publication time of ICE LIBOR has moved from 11.45 to 11.55 London time, with effect from Monday 27 March 2017.

SONIA

- SONIA will in future capture a broader range of unsecured overnight deposits, by including bilaterally negotiated transactions alongside brokered transactions. The Bank of England (which has taken over administration of the rate) proposes to switch to measuring the average rate using a volume-weighted trimmed mean (having originally proposed a median calculation).

ARRC and **SRFRWG**

- The **ARRC** is examining the feasibility of replacing term reference rates, such as $LIBOR, with an overnight reference rate or with the average of such rates. It is closely examining three collateralised overnight repo rates. Following the choice of rate, the ARRC plans to finalise its transition plans and to publish a final report listing its recommendations later in 2017.
- The **SRFRWG** announced on 28 April 2017 that SONIA was its preferred near risk-free interest rate benchmark (RFR) for use in sterling term derivatives and other relevant financial contracts. This rate will now be promoted as an alternative to £LIBOR.

Other Key Financial Benchmarks: an Update

DMO GILT PRICES

- An Independent Reference Prices Review (the **"Review"),** undertaken by Professor David Miles CBE at the behest of HM Treasury to evaluate the future provision of gilt and Treasury bill reference prices, was published on 11 October 2016.
- Currently, the U.K. Debt Management Office (the **"DMO")** publishes end-of-day reference prices for gilts and Treasury bills, covering all outstanding gilts in issue, gilt strips and Treasury bills. The DMO calculates these reference prices using pricing information provided by each of the 19 Gilt-edged Market Makers (the **"GEMMs").** On 21 January 2015, the DMO announced that it intended to withdraw in due course from the provision of these prices.
- Under the proposal, FTSE Russell will operate as the new administrator of the reference prices. The methodology and input data will change.
- In February 2017, the DMO announced that FTSE Russell and Tradeweb would begin to publish reference prices from 20 March 2017, leaving the DMO in the position to cease its provision of reference prices by July 2017.

LBMA GOLD PRICE

- The London Bullion Market Association (LBMA) introduced a code of conduct for participants which will be mandatory from June 2017.
- Trading volumes fell sharply after April 10, when four of the 14 participating banks and brokers stopped withdrew after the auction's administrator, ICE, introduced a requirement to clear trades.

LBMA SILVER PRICE

- Lack of liquidity in silver fix auction has lead to high volatility in the market and the benchmark has strayed from spot price multiple times since January 2016.
- LBMA announced that CME Group and Thomson-Reuters would no longer be the platform facilitators for the Benchmark in March 2017. No new silver benchmark operator has yet been announced.

Benchmark Transition and Evolution:
The Issue of Legacy Contracts

In pursuing the objective of moving to transactions-based rates, transition risks and costs should be minimised as much as possible. These risks and costs can include legal risks arising from litigation and contract frustration and increased hedging costs resulting from reduced liquidity in instruments referencing the alternative rate or from the greater volatility that may naturally occur in more transactions-based reference rates. However, whilst risks and costs arising from legacy contracts should not be ignored, they should not be used to prevent changes regarded as necessary from a systemic perspective.

(FSB, *Reforming Major Interest Rate Benchmarks*, 22 July 2014)

- The question of which implementation pathways for benchmark transition might minimise legal risks of the sort referred to above was addressed, in abstract, as part of a report by a Market Participants Group (the "MPG Report") supporting work by the FSB. Broadly, the MPG Report considered four alternative transition pathways:

  (i) a "seamless transition", according to which an existing benchmark transitions from one methodology to another;[4]

  (ii) a "successor rate" pathway, whereby one benchmark is withdrawn and replaced by another with a different but similar identity;

  (iii) a "market-led" transition, involving the gradual, voluntary adoption of a different benchmark published in parallel to the legacy benchmark; and

  (iv) a "cutover" transition, whereby adoption of a new benchmark is encouraged by notice to users that, after a finite parallel run, the legacy benchmark will be withdrawn at a future date

FMLC on the Evolution of Benchmarks

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*"It is often said that benchmark withdrawal would represent a **frustration** risk for financial contracts and occasionally the same thing is said of benchmark transition or evolution on the premise that the evolved benchmark no longer shares die identity of the original benchmark.*

*A similar issue, which is perhaps more prevalent in civil law systems, is the risk of **force majeure**, whereby a party is excused performance under a contract because performance has become impossible or impracticable owing to the intervention of an unpredictable and overwhelming supervening event. In common law systems, although there is no freestanding doctrine of force majeure, contracts sometimes include **force majeure clauses** contemplating events that may render performance impossible or impracticable and make provision for the parties to be excused further performance. When a force majeure clause is triggered it will normally bring an end to the contract.*

*Frustration will only occur where the parties to the contracts can be said to have wholly failed to allocate the risks of benchmark withdrawal. The parties may be taken to have allocated these risks in a number of different ways. A financial contract may make express provision for benchmark withdrawal—as with a **fallback clause**—or it may be found, at common law, to incorporate an **implied term** which covers the eventuality...*

A report published by a Market Participants Group (the "MPG")… sets out legal risk factors for certain key jurisdictions in the Eurozone and provides that, in those jurisdictions, the doctrine of implied terms is not available. The risk that a contract comes to a disorderly end in the event of benchmark withdrawal or transition may, in light of this, be slightly higher in civil law systems, although fallback provisions will help to mitigate any risk."

History Gives Cause for Comfort…

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Five examples of interest rate transition:

1. In 1981, the Minimum Lending Rate (MLR)—the minimum interest rate at which the Bank of England announced that it would make short-term money available to the market—ceased to be published. A market-wide transition to the prevailing clearing rate (i.e. the base rate published by members of The Committee of London Clearing Bankers) occurred seamlessly and apparently without the need for revisions to contracts on standard terms.
2. In 1998, British Bankers' Association ("BBA"), which was the administrator at the time, took a decision to calculate LIBOR, not as a "prime bank" rate but rather as a rate reflecting banks' "own cost of funds". It therefore significantly amended the question which identifies the benchmark's underlying interest. This change occurred apparently without legal incident.
3. On 4 January 1999, the national currencies of participating Member States were replaced by the euro as their single currency. The BBA ceased to fix LIBOR for the ECU and replaced it on the same screen page with a LIBOR fixing for the Euro. Rates for national currencies for which LIBOR was previously calculated and which were then merged into the Euro (e.g. LIBOR in Deutsche Mark) were published during a transition period—which expired on 31 December 2001—but the fixings were synchronised with the Euro LIBOR fixings and separate panels for rates in national currency units were withdrawn. Banks were advised to redenominate deals—EURIBOR became the designated successor to most national currency floating rate price sources, within the Euro Area. This transition was supported by legislation at the national level in Euro Area Member States. These transitions occurred smoothly.
4. On 31 January 2014, the BBA ceased to act as the administrator for LIBOR, which was transferred to its current administrator: IBA. This handover occurred without incident for financial instruments, notwithstanding contractual references to "BBA LIBOR" or "the British Bankers Interest Settlement Rate" were still common at the time.
5. In 2002 and then again in 2007 significant changes were made to the Brent Crude Oil benchmark methodology by introducing a wider range of crude oils of different grades. The quality change that occurred as a result of these transitions had a direct effect on pricing and thus on the economic interest of parties to futures and forward contracts referring to the benchmark. Despite this, each transition was completed seemingly without any realisation of legal risk.

FINANCIAL BENCHMARKS: EVOLUTION AND REGULATION

The E.U. BMR comes into effect on 1st January 2018

2. REGULATION

The EU Benchmarks Regulation

1. Scope

Regulatory Perimeter (*Cf. Currently only 8 UK benchmarks specified.*)

Article 2:

1. This Regulation applies to the provision of benchmarks…
2. This Regulation shall not apply to:
   (a) a central bank;
   (b) a public authority, where it contributes data to, provides, or has control over the provision of, benchmarks for public policy purposes, including measures of employment, economic activity, and inflation;
   (c) a central counterparty (CCP), where it provides reference prices or settlement prices used for CCP risk-management purposes and settlement;
   (d) the provision of a single reference price for any financial instrument listed in Section C of Annex I to Directive 2014/65/EU…

Article 3:

1. (1) "index" means any figure:
   a) that is published or made available to the public;
   b) that is regularly determined:
      (i) entirely or partially by the application of a formula or any other method of calculation, or by an assessment; and
      (ii) on the basis of the value of one or more underlying assets or prices, including estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys;

3. "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…

The EU Benchmarks Regulation (cont.)

2. Proportionality

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Articles 3(25), (26) and (27)

(25) “critical benchmark” means a benchmark other than a regulated-data benchmark that fulfills one of the conditions laid down in Article 20(1) and which is on the list established by the Commission pursuant to that Article;

(26) “significant benchmark” means a benchmark that fulfils the conditions laid down in Article 24(1);

(27) “non-significant benchmark” means a benchmark that does not fulfil the conditions laid down in Articles 20(1) and 24(1)[.]

Threshold tests are partly dependent on market size. It is not clear whether these tests relate only to markets in the E.U. and how the measures will be affected following the withdrawal from the E.U. of certain markets on Brexit.

The EU Benchmarks Regulation (cont.)

3. Input data

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Article 11 (*NB disapplied in the case of "regulated data" under Article 17*)

1. The provision of a benchmark shall be governed by the following requirements in respect of its input data:

   (a) the input data shall be sufficient to represent accurately and reliably the market or economic reality that the benchmark is intended to measure.

   The input data shall be transaction data, if available and appropriate. If transaction data is not sufficient or is not appropriate to represent accurately and reliably the market of economic reality that the benchmark is intended to measure, input data which is not transaction data may be used, including estimated prices, quotes and committed quotes, or other values;

   (b) the input data referred to in point (a) shall be verifiable[.]

- ESMA has developed draft RTS to specify how input data can be appropriate and verifiable. These introduce a requirement as to "evaluation checks", including "regular" checks that the input data is consistent with the methodology and derives from a reliable source. The RTS also provide for the administrator to conduct spot checks on the internal oversight and verification procedures of a contributor.
- ESMA has also introduced new RTS on codes of conduct for contributors. These include new standards on "policies on the use of discretion when contributing input data". The policies in the code of conduct must specify the circumstances in which the contributor may exercise discretion, the persons permitted to exercise the discretion; any internal controls that must be imposed and the persons charged with evaluating the exercise of discretion ex post facto.

The EU Benchmarks Regulation (cont.)

4. Oversight

Article 5(1)

Administrators shall establish and maintain a permanent and effective oversight function...

Article 4(3)

Where a conflict of interest arises within an administrator due to the latter's ownership structure, controlling interests or other activities conducted by any entity owning or controlling the administrator or by an entity that is owned or controlled by the administrator or any of the administrator's affiliates, that cannot be adequately mitigated, the relevant competent authority may require the administrator to establish an independent oversight function which shall include a balanced representation of stakeholders, including users and contributors.

Annex I – Interest Rate Benchmarks, paragraphs 3(a) and (c)

The administrator… shall have in place an independent oversight committee…

[T]he oversight committee… shall operate with integrity

- ESMA has introduced RTS on the oversight function. ESMA specifies that the objective is to allow the oversight function effectively to challenge the management body and that it should be in a position to act independently of the administrator in certain circumstances. For critical benchmarks, the minimum number of independent members is two. Members of the board or other decision making bodies of the administrator are not allowed to be permanent members of the oversight function.

The EU Benchmarks Regulation (cont.)

5. Cessation

Article 4(4)

If [conflicts of interests arising within the administrator due to its ownership structure, controlling interests or other activities…] cannot be adequately managed, the relevant competent authority may require the administrator to…cease producing the benchmark.

Article 11(4)

Where the administrator considers that the input data does not represent the market… the administrator shall, within a reasonable time period, either change the input data… or else cease to provide that benchmark.

Article 28(2) (*Cessation of a benchmark*)

Supervised entities… shall produce 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. (See also Article 28(1).)

Article 35

A competent authority may withdraw or suspend the authorisation or registration of an administrator…

The EU Benchmarks Regulation (cont.)

5. Transition and continuity

FMLC

Article 51 Transitional provisions

1. An index provider providing a benchmark on 30 June 2016 shall apply for authorisation or registration in accordance with Article 34 by 1 January 2020.

3. An index provider may continue to provide an existing benchmark which may be used by supervised entities until 1 January 2020 or… unless and until [authorisation or registration] is refused.

4. Where an existing benchmark does not meet the requirements of this Regulation, but ceasing or changing that benchmark to fulfil the requirements of this Regulation would result in a force majeure event, frustrate or otherwise breach the terms of any financial contract or financial instrument or the rules of any investment fund, which references that benchmark, the use of the benchmark shall be permitted…. No financial instruments, financial contracts, or measurements of the performance of an investment fund shall add a reference to such an existing benchmark after 1 January 2020.

5. Unless the Commission has adopted an equivalence decision as referred to in Article 30(2) or (3) or unless an administrator has been recognised pursuant to Article 32, or a benchmark has been endorsed pursuant to Article 33, the use in the Union by supervised entities of a benchmark provided by an administrator located in a third country where the benchmark is already used in the Union as a reference for financial instruments, financial contracts, or for measuring the performance of an investment fund, shall be permitted only for such financial instruments, financial contracts and measurements of the performance of an investment fund that already reference the benchmark in the Union on, or which add a reference to such benchmark prior to, 1 January 2020.

- ESMA has observed in its March 2017 *Final Report*, accompanying the new RTS, that Third Country index providers will not benefit from the permission expressly afforded to existing providers to delay their application for registration or authorisation under subparagraph (1). It says there is legal uncertainty as to whether Third Country providers can introduce new indices into the E.U. without regulatory approval before 1 January 2020.

Problems ahead for Euro-denominated benchmarks?

- On May 4th 2017, after consultation with the Belgian regulator, EMMI published adecision not to pursue a planned transition to a transaction-based methodology. This means it has failed to achieve the target reforms set by the FSB in July 2014 to bring IBOR benchmarks into line with the IOSCO *Principles*.
- It was reported at the time of the announcement that with banks reluctant to contribute and few contributors left, a transactions-based methodology would be impossible. Will next steps be to get forced contributions from those banks that recently departed the panel under Article 23 of the BMR?
- If not, will EURIBOR be considered to have fallen short of compliance with the BMR? Not necessarily. By failing to comply with the aspirations of the FSB Report, EMMI is not necessarily failing to comply with the BMR, which specifically contemplates a continuing role for submitters' discretion (also known as "expert judgement").
- An important and related point is that, even if EURIBOR were now not compliant with the BMR it would not necessarily need to be withdrawn for legacy contracts. That is the effect of Article 51(4) which permits the continued publication of a benchmark for use in legacy contracts where to withdraw the benchmark would risk frustration etc.
- In fact, if EURIBOR were not now compliant with the BMR it could probably still be adopted into new contracts by supervised entities until either authorisation is refused to EMMI by the Belgian FSMA or until 1 January 2020. That is the effect of Article 51(3).
- Will contracts move to €LIBOR instead? Probably not. After March 2019 and Brexit, €LIBOR will be a third-country benchmark. E.U. regulators may well be less keen to see supervised entities come to depend heavily on the benchmark in those circumstances. It will not necessarily be need to be withdrawn, however, in a "cliff edge" Brexit scenario. There are three routes into the Union for a Third Country benchmark: i) endorsement by an administrator within the E.U.; ii) recognition by the competent authority of its Member State of Reference (see Title V of the BMR); or iii) registration on the basis of a positive equivalency decision.
- In any event, Article 51(5) BMR provides that Third Country benchmarks which are already used by supervised entities within the E.U. may continue to be used until maturity for legacy contracts and until 1 January 2020 for new contracts.

Financial Benchmarks: Evolution and Regulation

Conclusion