Benchmark Reform: Evolution and Regulation

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Slide 1 — Title

Thank you to RIMES for inviting me back to Paris for a second time. It's always a great pleasure to work with RIMES—it's always a great audience. And quite apart from the calibre of the audience, I love the little marketing freebies… especially the little tins of sweets!

I always take them home with me and give them to my young son. Last year, when he asked where I got them from, I told him that, well, I do work for compliance experts and sometimes I get paid in jelly beans instead of money. He looked thoughtful and I wondered what he was thinking. When he finally spoke up, he told me that when he grows up he wants to work as a compliance expert!

Slide 2 — Benchmark Reform: A Timeline

If my son does choose that career path, I hope that whatever significant new regulation he has to get to grips with, it won't be a tale of benchmarks regulation. I trust that what we are building in Europe today in the way of benchmark reform is, in some sense, the final chapter in the very sorry history of benchmark manipulation.

Just how far benchmark reform has taken us, and how swiftly, can be seen from this timeline. The last four-and-a-half years have witnessed the publication of international standards by the International Organisation of Securities Commissions ("IOSCO"), a significant report on *Reforming Key Interest Rate Benchmarks* by the Financial Stability Board ("FSB") and the introduction of an internationally unprecedented and uniquely comprehensive regulatory framework in the form of Regulation (EU) 2016/1011 on indices used as benchmarks (the "Benchmarks Regulation").

Slide 3 — Benchmark Reform: Evolution and Regulation

Benchmark administrators have played their part. Key interest rate and other benchmarks have, under the watchful eye of the Financial Stability Board, published proposals for reform of their calculation methodologies. These evolutionary reforms will have a significant impact in 2017.

Meanwhile, the comprehensive provisions of the new E.U. Benchmarks Regulation, which will take effect early next year, are already having a radical effect on administrators, contributors and users of the benchmark.

Slide 4 — Benchmark evolution

We'll come on to the legislation in due course. First, however, let's look at the reforms which will take place even before the Benchmarks Regulation takes effect. Let's look at evolution…

Slide 5 — Reform of Key Interest Rate Benchmarks: Where We Are Now

As I mentioned a moment ago, the major interest rate benchmarks have all consulted on and planned for new methodologies. The European Money Markets Institute ("EMMI"), which administers EURIBOR, initially proposed what may have been the most ambitious of these. **It proposed, in effect, to eliminate banks' responsibility for arriving at a cost of funds value by requiring them simply to submit raw transaction data, after which the administrator itself would then calculate an individual cost of funds value for each bank in place of individual submissions and then perform a median calculation on the whole class.** The aim was to eliminate expert judgment in submissions and thus bring the benchmark into line with the IOSCO Principles and with the aims of the FSB Report. Unfortunately, however, the "pre-live verification" exercise conducted to test the methodology revealed that projected values for the reformed benchmark could not be brought into line with projected values for EURIBOR as it is currently fixed. On **May 4th** 2017, after consultation with the Belgian regulator, EMMI published its decision not to pursue the transition.

Proposals for the reform of TIBOR and LIBOR have, on the other hand, retained expert judgment as a feature of banks' submissions and the consultations on these proposals have typically emphasised the need for continuity and stability above the ideological purity of the reforms. The view of regulators appears to be both that expert judgment is both (i) a sensible safety net for indices which rely on data from a shrinking market in unsecured lending and (ii) a good reason to transition our largest markets away from those benchmarks.

A second key interest rate benchmark that has seen significant changes is the Sterling Overnight Index Average or SONIA. The administration of the benchmark has been transferred to the Bank of England, which proposes to widen the class of input data and shift the calculation methodology.

Meanwhile, Working Groups established by central banks to look at replacements for LIBOR have been busy. In particular, the Sterling Risk Free Rate Working Group ("SRFRWG") established by the Bank of England announced on 28 April 2017 that widespread efforts would be made to adopt SONIA as a substitute for sterling LIBOR in market contracts.

Slide 6 — Other key financial benchmarks

Interest rate benchmarks, however, are not the only rates undergoing changes this year.

Here I mention DMO Gilt Prices index, which has embarked upon a bold transition plan. Meanwhile, the LBMA Gold Price and Silver Price are experiencing volatility issues owing, in part, to the implementation of structural changes to their methodologies.

Slide 7 — Benchmark Withdrawal, Transition and Evolution: The Issue of Legacy Contracts

The potential for so much rapid change to give rise to legal risks was noted by the FSB in its 2014 Report. In particular, the FSB observed that benchmark reform can raise the risk of litigation and contract frustration but insisted that these risks should not prevent reforms from going ahead.

The question of which implementation pathways for benchmark transition might minimise legal risks of this sort was addressed, in abstract, as part of an industry report supporting work by the FSB. Broadly, the report considered four alternative transition pathways which may each be said to have some merit as a tool for minimising disruption. These are set out on the slide.[1]

Slide 8 — FMLC on the Evolution of Interest Rate Benchmarks

The question of legal risk has been considered and analysed on multiple occasions by the Financial Markets Law Committee, of which I am the Chief Executive. The Committee has written about the risks of contract frustration and *force majeure* and has undertaken a high-level comparative analysis of the risks in different jurisdictions.

The Committee is largely sanguine about the likelihood of such risks materialising in the context of the proposed IBOR and SONIA reforms while noting that they cannot be wholly ignored and may be greater in some jurisdictions than others.

I think it is correct to say that the risks can be classified as "**remote but not negligible**".

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

(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.

Slide 9 — History Gives Cause for Comfort

As some of you may have heard me say before, the real cause for comfort may not be the legal analysis but the historical one. Market participants are seemingly resistant to litigating over benchmark evolution, probably in recognition of the fact that once the malevolent genie of contract frustration is out of the bottle, the consequences for the markets are likely to be not only disruptive and extensive but also wholly unpredictable.

In an account last year prepared for the purposes of responding to a consultation by EMMI, I listed a dozen cases of benchmark transition which had occurred without the manifestation of legal risk. This slide notes the five of these which have arguably had the most significant impact on markets in London.

Slide 10 — Regulation

And so finally we arrive at that "internationally unprecedented and uniquely comprehensive regulatory framework"—the E.U. Benchmarks Regulation—that I mentioned earlier.

Slide 11 — The E.U. Benchmarks Regulation: 1. Scope

The Regulation—which was published in the Official Journal last June—will bring about a dramatic expansion of the regulatory perimeter in the E.U. Just how wide the scope of the Regulation is can be seen from the width of the definitions on the slide. Very broadly speaking, the new Regulation will cover all benchmarks which are used for valuation purposes or incorporated into financial instruments, provided that they are also made available to the public and involve some element of regular calculation.

There are, however, important exclusions from scope set out in Article 2. These include the disapplication of the regulation from central bank rates and protection for index providers who are unaware that the index is the subject of any financial contract in Article 2(2)(h). There is also a slightly strangely worded exemption for single reference prices which I am inclined to view as an effort to create a safe-harbour for brokers' screen prices.

In February last year, the European Securities and Markets Authority ("ESMA") received a request from the European Commission for technical advice on possible delegated acts and it published its advice in November. This technical advice examined the phrase "**making available to the public**" in the definition of an "index".

ESMA's advice is that a figure shall be deemed to be made available to the public "*if the figure is made accessible to a potentially indeterminate number of (legal or natural) persons outside of the provider's legal entity*." The advice goes on to clarify the issue of being "accessible" by saying that this means the benchmark may be accessed either directly or indirectly (as a result, *inter alia*, of its use by one or more supervised entities as a reference for a financial instrument it issues or to determine the amount payable under a financial instrument or a financial contract, or to measure the performance of an investment fund, or to provide a borrowing rate calculated as a spread or mark-up over such figure), and through a variety of media and modalities, (including, but not limited to, telephone, File Transfer Protocol, internet, open access, news, media, through financial instruments, financial contracts or investment funds referencing the figure or by way of request to the users).

Slide 12 — The E.U. Benchmarks Regulation: 2. Proportionality

The Benchmarks Regulation draws a distinction between critical benchmarks, significant and non-significant benchmarks. It establishes threshold tests for these categories that are partly dependent on market size. For example, critical benchmarks are those which are either referenced by a market worth in excess of 500 billion EUR or is otherwise assessed by regulators to be systemically important in Member States. And a significant benchmark is one referenced by a market worth in excess of 50 billion EUR or which is otherwise systemically significant in Member States. Administrators are required to make the relevant threshold calculations by ascertaining the **nominal** amount of non-derivative instruments, the **notional** amount of derivatives and the **net asset value** of investment funds.

In its November 2016 technical advice to the Commission, ESMA dealt with the topic of measuring the reference value of a benchmark for the purpose of the proportionality classification.

On non-derivative instruments, the advice refers to the concept of "reference data" which has been introduced by Regulation (EU) No 600/2014 ("MiFIR") and Directive 2014/65/EU ("MiFID II") for financial instruments admitted to trading in the E.U.

As for derivatives, ESMA notes that MiFIR and EMIR require the reporting of derivatives trades, including notional amounts, to trade repositories and it proposes to leverage this convenient fact for the purposes of the Benchmarks Regulation.

The role of benchmarks in valuing investment funds is, ESMA acknowledges, still much more opaque. Given that the AIFMD and UCITS directives do not yet impose a transparency obligation in this regard, ESMA has recommended a "fall-back" regime according to which benchmark administrators may use "alternative private providers of information".

The Benchmarks Regulation is a little confusing as to whether the threshold tests relate only to markets in the E.U. On the one hand this is not expressly stipulated in the Regulation's list of explicit criteria, on the other hand:

1. it is unclear what reason the E.U. could have to regulate benchmarks which only affect non-E.U. markets;

2. certain fallback proportionality tests in the Regulation (i.e. those relating to adverse impact in Member States) are clearly restricted to E.U. markets; and

3. ESMA appears to have taken the view that market valuation data is only reliably available if the data in question is regulatory data that is collected by virtue of E.U. regulation.

In light of this, it remains to be seen how the various threshold and proportionality tests, including the fallback tests on systemic importance, will be applied following the withdrawal from the E.U. of certain markets on Brexit.

(For the sake of completeness, I will just mention that benchmarks compiled from regulated data, interest Rate Benchmarks and commodities benchmarks, excluding precious metals, all fall into a category of their own and are subject to a bespoke regulatory regime.)

Slide 13 — The E.U. Benchmarks Regulation: 3. Input Data

One of the central features of the Regulation is its focus on the quality of input data. A crucial question is likely to be the extent to which submissions can continue to incorporate a role for expert judgement, as that concept has commonly been understood and applied to interest rate benchmark submissions. I have said elsewhere that the Regulation itself is ambiguous on this point and I still consider that it is.[2]

ESMA, however, has accepted the use of "expert judgement" in its technical standards published at the end of March. In this it may have been influenced by the widely reported difficulties experienced by administrators like EMMI in obtaining sufficient transaction data.

Among other things, the latest ESMA technical standards deal with codes of conduct for contributors. They include new standards on "policies on the use of discretion when contributing input data". The policies in the code of conduct must specify

1. the circumstances in which the contributor may exercise discretion,
2. the persons permitted to exercise the discretion;
3. any internal controls that must be imposed and
4. the persons charged with evaluating the exercise of discretion *ex post facto.*

[2] Article 11(b) requires "input data" to be verifiable, which begs the question, perhaps, whether "expert judgement" is auditable. Annex 1, on the other hand, specifically retains "expert judgement" as an appropriate category—in the last resort—of input data but the definition of "expert judgement" given in Article 3 for the purposes of the Regulation as a whole is more closely aligned with the concept of data adjustment than it is with the usual idea of an expert opinion. A further source of confusion is that the Regulation also refers to the "use of discretion" without distinguishing this from "expert judgement".

ESMA has also included a technical standard on the benchmark statement, for which the administrator is responsible, which requires the administrator to specify the same features.

More generally, ESMA's standards on input data 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 standards also require the administrator to conduct spot checks on the internal oversight and verification procedures of a contributor.

Slide 14 — The E.U. Benchmarks Regulation: 4. Oversight

The Benchmarks Regulation requires the Administrator to establish a permanent oversight function under Article 5(1). Possible models for the function range from an independent committee to a single person overseer. The appropriate model will be determined according to the proportionality principle. Interest rate benchmarks must have an independent committee according to special rules set out in an Annex to the Regulation.

Last year, ESMA consulted on "proposed modalities" for oversight and observed that the main function of the oversight committee is to ensure there is an effective challenge to the Board or management of the Administrator. The FMLC responded to the consultation taking issue with ESMA's view that the independence of an oversight committee would be enhanced by including Independent Non Executive Directors (or "INEDs") from the Board of the Administrator on the Committee itself.

In the course of considering its position, ESMA came to the view that independence on the board of the administrator is not the same thing as independence on the oversight committee. The new technical standards specify that, where an oversight committee is established for a critical benchmark, two independent members must be appointed who may not be affiliated with the administrator. Moreover, members of the board or other decision making bodies of the administrator are not allowed to be voting members of the oversight function for any benchmark.

Slide 15 — The E.U. Benchmarks Regulation: 5. Cessation

There are several grounds for the cessation of a benchmark set out in the Regulation, some of which are set out on the slide. The Regulation robustly provides that benchmarks will be wound up if they cannot comply with its requirements.

It is not impossible that, for this reason, the Regulation will be responsible for wholesale changes to the landscape of reference rates as benchmarks which are found or perceived to be non-compliant are withdrawn.

Meanwhile, ESMA has established certain disclosure requirements for administrators which require administrators of critical and significant benchmarks to indicate the circumstances in which the benchmark may become non-viable (e.g., for want of input data) and the expected impact of cessation of the benchmark.

Slide 16 — The E.U. Benchmarks Regulation: 6. Transition and continuity

There is no need to panic, however, over benchmarks being withdrawn immediately. The Benchmarks Regulation includes transitional provisions which ensure that, even if a benchmark were now not compliant with the Regulation it would not necessarily need to be withdrawn.

First, Article 51(4) permits the continued publication of a benchmark for use in legacy contracts where to withdraw the benchmark would risk frustration etc.

Second, even if a benchmark were not now compliant with the Regulation it could still be adopted into **new** contracts by supervised entities until either authorisation is refused by a competent authority or until 1 January 2020. That is the effect of Article 51(3).

I have not had the opportunity in this presentation to discuss the provision of Third Country benchmarks into the E.U., which is a shame because it is the very question which Brexit now throws into sharp relief. You will recall, no doubt that there are **three** means by which a Third Country benchmark provider can access the E.U. market under the Regulation and they are mentioned here in Article 51(5): **equivalency, recognition or endorsement.** For those of you who are particularly interested in this aspect of the Regulation, I would draw your attention to the recent publication on 1 June by ESMA of its Final Report on Draft regulatory technical standards on cooperation arrangements with third countries under the Benchmarks Regulation as well as to the curious point at the bottom of the slide regarding the provision of new Third Country benchmarks before 2020.

Slide 17 — Problems ahead for Euro-denominated benchmarks?

On May 4th 2017, as I mentioned earlier, EMMI published a decision not to pursue its planned transition to a transaction-based methodology for EURIBOR. This means it has acknowledged its inability, for the time being, to achieve the target reforms set by the FSB in July 2014 for bringing IBOR benchmarks into line with the IOSCO *Principles*.

It was reported at the time of this announcement that with banks reluctant to contribute and few contributors left, a transactions-based methodology would be impossible. The Benchmarks Regulation vests a restricted power of compulsion in national authorities in these circumstances and some commentators have asked whether banks that recently departed the panel might be subject to these powers under Article 23.

These powers are, however, are a last resort. If they are not exercised here, the question arises whether EURIBOR will be considered to have fallen short of compliance with the Regulation. That seems unlikely. By failing to comply with the aspirations of the FSB Report, EMMI is not necessarily failing to comply with the Regulation, under which ESMA specifically contemplates a continuing role, as we have seen, for "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 immediately. That, as discussed on the previous slide, is the combined effect of Article 51(4) which permits the continued publication of a benchmark for use in legacy contracts and Article 51(3) which allows administrators of non-compliant benchmarks a grace period following the entry into effect of the Regulation.

Nevertheless, EURIBOR clearly faces difficulties ahead. If the markets themselves come to regard EURIBOR as problematic, will contracts move to EUR LIBOR instead? Probably not. Firstly, after March 2019 and Brexit, EUR 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. Secondly, the difficulties in obtaining transaction data arise as a result of structural changes to the unsecured lending market and EUR LIBOR is not immune from these difficulties, which is why industry groups are looking at risk-free alternatives.

As for the future of EUR LIBOR post-Brexit, again some commentators have warned of a "cliff edge" scenario in which it loses access to E.U. markets overnight upon Brexit. That is not going to happen—the Regulation provides diverse routes into the Union and finding one of these should not be beyond reach of the LIBOR administrator. Even if for some reason all three were impossible, Article 51(5) of the Regulation provides, as we have seen, 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.

So, although I do not deny that there may be choppy seas ahead for EUR-denominated benchmarks, I do not see any reason for outright alarm.

Slide 18 — Conclusion

I am going to finish on what I hope is an objective assessment of where we are today.

It is true that markets rely to a very high degree on standard terms and litigation alleging, say, the frustration of a contract on those terms does not need to have a strong chance of success to prove disruptive. It is equally true, however, that history is littered with examples of successful transitions which collectively illustrate, I believe, that market participants are very reluctant to wake the gently sleeping giant of legal risk.

Secondly, the Regulation itself sets strict regulatory standards, yes, and looks squarely at benchmark withdrawal for non-compliant benchmarks but it also goes a long way to preserve continuity by incorporating generous transitional provisions.

The legal risks in today's environment I would say are "remote but not negligible". Vigilance is called for but there is no cause for alarm. To borrow a popular English meme, I suggest we all *keep calm and carry on*.