Feature

KEY POINTS

- The EU Benchmarks Regulation may ultimately lead to the withdrawal of some established indices on the grounds of non-compliance.
- The Regulation's transitional provisions will prevent any dramatic rise in the risks of benchmark withdrawal when the Regulation comes into application next year.
- UK-based benchmarks will not qualify at the point of Brexit for use in new contracts unless and until they have the benefit of equivalence, recognition or endorsement, implying a possible hiatus during which UK administrators may be unable to bring themselves within the terms of the Regulation.

Author Joanna Perkins

Benchmark transition under the new EU Regulation

The EU Benchmarks Regulation (EU 2016/1011, the Regulation) – which was published in the Official Journal last June – will bring about a dramatic expansion of the regulatory perimeter for indices in the EU. A popular perception is that it will eventually lead to the withdrawal of some well-known benchmarks on the grounds of non-compliance. Meanwhile, market participants are justifiably keen to understand the Regulation's transitional provisions, particularly in light of planned changes in relation to key interest rate (or IBOR) benchmarks and the wider question of the UK's anticipated withdrawal from the EU in 2019. This article provides an overview of the Regulation and asks whether the risks of benchmark withdrawal have increased in Europe.

OVERVIEW OF THE REGULATION

Scope

Just how wide the ambit (and ambition) of the Regulation is can be seen from the width of key definitions in Art 3 of the Regulation, including those for "benchmark", "index" and "input data". 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 the scope of the Regulation set out in Art 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. There is also a slightly strangely worded exemption for single reference prices, which may reflect an effort made during negotiations to create a safe harbour for brokers' screen prices.

In February last year, the European Securities 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 published advice examined the phrase 'making available to the public' in the definition of an "index".

ESMA's advice in summary 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 the provider's legal entity. The advice goes on to elaborate on "accessible" by saying that this means the benchmark may be accessed either directly or indirectly and through a variety of media and modalities (including, but not limited to, telephone, File Transfer Protocol, internet, open access, news, media, financial instruments, financial contracts or investment funds referencing the figure or by way of request to the users).

Proportionality

Importantly, the 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 €500bn or otherwise systemically important in member states. Administrators will be 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.

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.

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 in the case of submissions-based indices. The Regulation itself is ambiguous on this point. (Art 11(b) requires 'input data' to be verifiable, which begs the question, perhaps, as to whether "expert judgement" is auditable. Annex 1 on interest rate benchmarks, 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 Art 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, however, has accepted the use of "expert judgement" in technical standards published at the end of March. In this it may have been influenced by the widely reported difficulties experienced by administrators of the IBOR (Interbank Offered Rate) benchmarks in obtaining sufficient transaction data.

Among other things, the latest ESMA technical standards, published in June of this year, 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*.

ESMA has also included a technical standard on the benchmark statement, for which the administrator is responsible, requiring 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.

OVERSIGHT

The EU Benchmarks Regulation requires the administrator to establish a permanent oversight function under Art 5(1). Possible modalities 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 Annex I 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 (Financial Markets Law Committee) responded to the consultation taking issue with ESMA's view that non-executive directors on the board of the administrator, who qualify as independent in that context, could properly fulfil a requirement for a minimum number of independent members on the oversight 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.

BENCHMARK EVOLUTION AND WITHDRAWAL

Cessation

There are several grounds for the cessation of a benchmark set out in the Regulation, including:

(i) under Art 4(4) on grounds of the administrator's persistent conflict of interests;
(ii) under Art 11(4) on grounds that the available input data no longer represents the market; and
(iii) under Art 35 on the grounds that the administrator is no longer registered or authorised.

Article 28(2) (Cessation of a benchmark) provides that '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.'

In this way, the Regulation resolutely confronts the possibility of benchmark withdrawal on the grounds of regulatory non-compliance.

It is not impossible that, for this reason, the Regulation will ultimately 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 (eg for want of input data) and the expected impact of cessation of the benchmark.

Transition and continuity

There is no need for anxiety, however, on the part of benchmark users over indices being withdrawn immediately on grounds of non-compliance. The Regulation includes transitional provisions in Art 51 the first of which – in Art 51(1) – is a two-year grandfathering or grace period, following the entry into application of the Regulation in January 2018, during which EU benchmark providers may apply for authorisation or registration. Even if a benchmark is not compliant with the Regulation during this period it can still be adopted into new contracts by supervised entities until either authorisation is refused or until 1 January 2020. That is the effect of Art 51(3).

Moreover, additional Art 51 safeguards ensure that, even if a benchmark were not compliant with the Regulation after January 2020, it would not necessarily need to be withdrawn. Article 51(4) permits the continued use of an "existing benchmark" in legacy contracts where to withdraw the benchmark would risk frustration or trigger the doctrine of *force majeure*. In technical advice to the European Commission, ESMA took the view last year that "existing benchmark" means benchmarks referenced in financial contracts which are in effect on 1 January 2018, when the Regulation comes into application, rather than in June 2016, when the Regulation was published and came into force.

Non-EU (or Third Country) benchmarks are accorded separate transitional rules under Art 51(5). According to the Regulation, there are three means by which a Third Country benchmark provider can access the EU market under the Regulation and they are mentioned here in Art 51(5): a positive equivalence decision, recognition by a national competent authority or endorsement by an authorised EU benchmark administrator. Ultimately, supervised entities will be prohibited from using Third Country benchmarks which do not satisfy one of these qualifying threshold criteria. The use of non-qualifying benchmarks which are established in the Union as of 1 January 2018, when the Regulation comes into application, is, however, permitted until 1 January 2020, following which use of a non-qualifying benchmark will only be permitted for legacy contracts.

ESMA observed in its March 2017 Final Report, accompanying the regulatory technical standards (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 Art 50(1). It observed that there is, therefore, legal uncertainty as to whether Third Country providers can introduce new indices into the EU without satisfying the Regulation's threshold criteria for access before 1 January 2020.

Problems ahead for key interest rate benchmarks?

This has been a tumultuous year for key interest rate benchmarks. On 4 May 2017 the European Money Markets Institute (EMMI) published a decision not to pursue its planned transition to a transaction-based methodology for EURIBOR. In the wake of this announcement, some commentators asked whether banks that had already departed the panel might be subject next year to the exercise of new powers of compulsion under the Benchmarks Regulation.

Then, on 27 July, the Financial Conduct Authority (FCA) announced that it would no longer support LIBOR after 2021 by compelling panel banks to contribute input data. This was reported in the media as a decision to "phase out" LIBOR and it was preceded by the publication in June of a White Paper by the Bank of England identifying SONIA (Sterling Over Night Index Average) as a suitable rate for adoption in the sterling markets as an alternative to LIBOR.

Collectively, these developments reflect an apparent acknowledgement on the part of competent authorities that the target reforms set by the FSB (Financial Stability Board) in its July 2014 report *Reforming Key Interest Rate Benchmarks* cannot be achieved. The fundamental problem which has been recognised by regulators is that, with banks reluctant to contribute and a diminishing market in unsecured interbank lending transactions, a purely transactions-based submissions methodology – which was the ultimate objective of the FSB report and the 2013 Principles for Financial Benchmarks set down by the International Organisation of Securities Commissions – is impossible to maintain in a stable format.

The IBOR benchmarks may, however, face an even bigger difficulty in the reluctance of banks to contribute. In the UK, the Financial Services and Markets Act 2000 (FSMA, s 137F (inserted by Financial Services Act 2012, s 24) vests a power in the FCA to require supervised entities to contribute to LIBOR. The power is unlimited as to the time for which it can be exercised, but the FCA has announced, as we have seen, that it will not exercise the power, or any other power to compel panel banks, after 2021. Article 23(6) of the Benchmarks Regulation vests a restricted power in the competent authority of a benchmark administrator to compel submissions from supervised entities for 12 months, a period which can then be extended by a further 12 months but which must not exceed 24 months in total. In the case of critical benchmarks the power is further restricted to submissions from supervised entities located in the member state of the competent authority in question under Art 23(12). It should be noted, then, that the competent authority for the EMMI – ie the Belgian Financial Services and Markets Authority – would face a coordination problem in compelling European banks to contribute to EURIBOR. As far as LIBOR is concerned, the Regulation will come into application before the anticipated date on which the United Kingdom will leave the European Union. In these circumstances, the Regulation should, in theory be appropriately implemented by modifying (ie limiting) the FCA's power of compulsion set out in FSMA. The observation of the FCA, however, that it will continue compelling submissions until 2021 suggests that the wider power may be retained – in anticipation, perhaps, of the UK's withdrawal from the EU in 2019 which will arguably provide both an opportunity to depart from the terms of the Regulation and a reason to have particular regard to financial stability. In the case of LIBOR, however, as we have seen, the FCA does not propose to exercise powers of compulsion indefinitely.

Powers of compulsion are, then, soon to be limited and, in any event, they invite problems of both consent and coordination. They are typically regarded by regulators as a last resort and the question naturally arises whether, if the powers of compulsion are exhausted by regulators, or their use is rejected, we can expect the disorderly collapse of a major interest rate benchmark. The answer to this is "no". The Regulation requires administrators to have fall-back plans covering a variety of circumstances. Articles 12(3) and 27(2) of the Regulation require an administrator to have in place published arrangements for determining whether and how the benchmark can be calculated in circumstances of stress and illiquid markets; and Art 28 requires the administrator to produce a statement which identifies plans to be taken when a benchmark ceases to be provided. Even though the Regulation does not yet apply, ICE Benchmark Administration Ltd, the administrator of LIBOR, has published a reduced submissions policy on its website to cater to the situation in which it receives fewer than the expected number of submissions and EMMI has published contingency arrangements in the form of a "Transition Policy" – to be implemented by a "Transition Task Force" – in the event that it becomes necessary to suspend the publication of EURIBOR either temporarily or permanently.

Meanwhile, s 8.3 of the FCA's Market Conduct Sourcebook (MAR) requires benchmark administrators to have regard to the continuity of a specified (ie regulated) benchmark as well as the need for contractual certainty for contracts which reference the benchmark. If a key interest rate benchmark is allowed to fail, it will do so in accordance with measures and procedures drawn up in advance by the administrator and/or its competent authority and these procedures will have due regard to the continuity of market contracts.

One option which might be considered by administrators and regulators in the circumstances of impending benchmark collapse would be the publication on the existing publication venue of fixings from an alternative benchmark. In many cases, standard form market contracts define reference rates exclusively or chiefly by citing the publication venue, so this measure would go some considerable way towards preserving contractual continuity and minimising legal risk.

Biog box
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From 2018 EURIBOR and LIBOR will be assessed for compliance against the requirements of the Regulation. Whether or not this exercise raises the spectre of benchmark withdrawal depends principally on two questions: first, whether a benchmark which fails to implement a purely transactions-based methodology is non-compliant and, second, whether non-compliant benchmarks must be withdrawn.

In regard to the first of these questions, IBOR benchmarks are not necessarily, in failing to comply with the aspirations of the FSB report of July 2014, thereby failing to comply with the Regulation. That is because, under the FSB roadmap, benchmarks must move to a purely transactions-based methodology but under the Regulation ESMA specifically contemplates a continuing role, as we have seen, for "expert judgement".

As regards the second question, even if EURIBOR and LIBOR were somehow to fall short of compliance with the Regulation they would not necessarily need to be withdrawn immediately. That, as discussed above, is the combined effect of Arts 51(1) and 51(3) which allow benchmark administrators a two-year grace period for authorisation and registration and of Art 51(4) which permits the continued publication of a benchmark for use in legacy contracts.

The final part of the continuity "puzzle" for IBOR benchmarks in Europe is, however, less certain: it is the impact of the UK's withdrawal from the EU. In March 2019, when "Brexit" is scheduled to take place, the UK will, unless transitional or permanent treaty arrangements are put in place, become a "Third Country" for the purposes of the Benchmarks Regulation as the FMLC noted in a recent paper on "The Provision and Application of Third Country Regimes in EU legislation" published on 13 July (the TCR Paper). As a result, EU-supervised entities will be prevented from using a UK-administered benchmark such as LIBOR unless it obtains registration, having first satisfied the threshold critieria for non-EU benchmarks. These specify that Third Country benchmark providers can access EU markets by one of the three routes listed above: equivalence, recognition by a national competent authority within the EU or endorsement by an EU-regulated benchmark administrator. It is to be expected that the LIBOR administrator has already developed plans to adopt one of these routes into the EU by the time UK withdrawal occurs and to that extent there need be no "cliff edge" loss of access by either the administrator to EU markets or by EU financial institutions to an important reference rate. There are, however, one or two wrinkles in the Regulation's Third Country provisions which are nevertheless worth noting.

First, as the FMLC observes in the TCR Paper (at para 5.26), there may be uncertainty about regulatory continuity for UK benchmark administrators that initially rely on recognition as a means of access to EU markets, if and when there is a transition by the UK to a positive equivalence determination. Second, there is the point identified by ESMA in its Final Report of 1 June 2017 (at para 279), namely that, unlike EU index providers, Third Country index providers do not have the benefit of a two-year grace period in which to register with ESMA. Prima facie this means that UK-based benchmarks will not qualify at the point of Brexit for use in new contracts unless and until they have the benefit of equivalence, recognition or endorsement. This implies a possible hiatus during which UK administrators may be unable to bring themselves within the terms of the Regulation. Provided this hiatus is resolved, however, in the period before 1 January 2020 set out in Art 51(5), supervised entities will still be able to reference an established benchmark, like LIBOR, in new contracts under transitional provisions.

It is only if UK benchmarks are unable to satisfy the threshold criteria beyond 1 January 2020 that the use of such a benchmark may be prohibited in the EU. (And even in this eventuality, legacy contracts would still be able to reference the index in question.) The situation is slightly more complicated in the case of new benchmarks whose use has not been established in the EU before the Regulation's application date of 1 January 2018. As ESMA notes, new Third Country benchmarks established after 1 January 2018 do not benefit from the transitional provisions of Art 51(5) or the grace period in Art 51(1).

CONCLUSION

This article has expressed the view that the EU Benchmarks Regulation may ultimately lead to the withdrawal of some established indices on the grounds of non-compliance. It has also made the point, however, that the Regulation's transitional provisions will prevent any dramatic rise in the risks of benchmark withdrawal when the Regulation comes into application next year. The article has considered these transitional provisions in the light of recent developments in relation to key interest rate benchmarks and of the UK's anticipated withdrawal from the EU in 2019. It has concluded that, on balance, the transitional provisions will provide adequate protection against disruptive outcomes for users of key interest rate benchmarks in Europe. ■

* This article refers to the FMLC Paper entitled "Issues of Legal Uncertainty Arising in the Context of the Withdrawal of the UK from the EU – the Provision and Application of Third Country Regimes in EU Legislation".

** The Financial Markets Law Committee was established in 2002 to address issues of legal uncertainty affecting wholesale financial markets. As part of its remit, the Committee has undertaken comprehensive work on issues relating to financial benchmark reform, transition and withdrawal. For further information visit www.fmlc.org

Further Reading

- The evolution of benchmarks: a European framework for reform (2016) 5 JIBFL 273.
- LIBOR floors and Zero floors: Where are they now? (2015) 11 JIBFL 722.
- LexisNexis Loan Ranger blog: Could changes in LIBOR-setting lead to frustration in current contracts?