

14 November 2012

## **MACRO-PRUDENTIAL ASPECTS OF THE REFORM OF BENCHMARK INDICES**

**in response to a consultation by the European Commission  
on a possible framework for the regulation of the production  
and use of indices serving as benchmarks in financial and  
other contracts**

## 1. Introduction

Some of the issues surrounding LIBOR/EURIBOR reform were discussed at the ESRB General Board meeting of 20 September. The press release<sup>1</sup> following this meeting stated that *“Financial market reference rates have recently come under public scrutiny; it is necessary that their governance and the setting mechanisms be reformed. The General Board’s discussions focused, in particular, on how to rebuild confidence in the integrity of such instruments, on whether, in the future, reference benchmarks should better reflect changes in bank funding structures, and on how to ensure a smooth transition should regulatory reforms be initiated. The members of the ESRB, acknowledging the global dimension of the issue, look forward to the work of the relevant international institutions and fora, such as IOSCO and the BIS. In this context, the ESRB will put its views forward to the relevant authorities, also within the scope of the public consultation on the regulation of indices that was launched by the European Commission on 5 September 2012.”*

The ESRB herewith responds to the European Commission’s consultation on the regulation of indices with a particular focus on the macro-prudential aspects of the reform of benchmark indices.

Recent revelations of potential misconduct currently under investigation have highlighted that current systems are partly flawed. Shortcomings in calculation methods, the scope for manipulation, and the weakness of the governance of the process have become clear and have undermined confidence. To better understand the flaws and the options for reform that are being considered, the ESRB notes first that the sheer number of financial contracts impacted by the potential reform is tremendous. Indices of interbank interest rates, such as LIBOR and EURIBOR, are used as benchmarks for a range of financial contracts<sup>2</sup>. Concerns have grown that benchmark interbank rates such as LIBOR and EURIBOR might not track interbank borrowing costs accurately.

Given the revealed manipulations, loss of credibility and identified weaknesses, there is a broad consensus that the systems of LIBOR and EURIBOR need to be reviewed and

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<sup>1</sup> <http://www.esrb.europa.eu/news/pr/2012/html/pr120920.en.html>

<sup>2</sup> The notional outstanding value of contracts referenced on LIBOR is estimated to be in the range of US\$233-303tn in the ‘Wheatley Review’ Discussion Paper published by the UK Treasury. Other estimates go as high as US\$800tn. Data on the value of contracts referenced on EURIBOR are less readily available. According to end-2011 BIS data, the notional amount of OTC interest rate derivatives referenced to euro interest rates was US\$184tn: most of these contracts were probably referenced on EURIBOR. The notional amount of exchange-traded derivatives traded on the LIFFE exchange in London in 2011 was EUR477tn, including over EUR241tn relating to three-month EURIBOR futures.

structurally changed. The imperative of reform should also apply more generally to other indices used as references or benchmarks in financial contracts or financial instruments: those which are compiled from submissions such as some CDS and repo indices; those which are computed from actual transactions such as commodity price indices and asset price indices; and proprietary benchmarks, particularly those which are tailored to define payoffs from structured retail products, and which might entail conflicts of interest. Any legislation proposed by the Commission should clearly specify to which benchmarks the legislation refers.

Aside from ongoing investigations into (alleged) attempted manipulations, the ESRB recognises that several institutions have initiated work aimed at restoring credibility and upholding the integrity of market practices. The initiatives underway mainly focus on (i) potential remedies to address the specific shortcomings of reference benchmarks such as amending definitions, methodological changes, and strengthening the governance (e.g. the UK Wheatley Review into Libor), and (ii) evaluate potential alternatives. The ESRB also recognises that global regulators – in particular IOSCO but also FSB – are addressing the global dimensions of reform. In Europe, ESMA and EBA are working to develop principles or guidelines for reference rates and other benchmarks-setting processes. Given the international dimension of the issues at stake, the ESRB looks forward to the work of the relevant institutions and underscores the importance of their continued cooperation.

## **2. Macro-prudential aspects of the reform of LIBOR and EURIBOR**

In view of the work being undertaken by the relevant international institutions, and in particular in response to the European Commission's consultation on a possible framework for the regulation of the production and use of indices serving as benchmarks in financial and other contracts, the ESRB wishes to highlight the following issues from a macro-prudential angle.

### **2.1. The integrity of benchmarks needs to be re-established urgently**

*The ESRB herewith responds to questions 13, 14 and 28 of the Consultation document.*

The integrity of reference benchmarks is of utmost importance for the pricing of financial instruments such as interest rate swaps and forward rate agreements; commercial and non-commercial contracts such as supply agreements; and loans and mortgages. Benchmark indices also play an important role in risk management. The notional amounts referenced to them are staggering and the integrity of these benchmark indices is of systemic importance. For these reasons, the ESRB is of the opinion that a credible regulatory framework for the functioning and oversight of reference benchmarks needs to be established. Governance enhancing measures could have the benefit of increasing immediately markets' confidence in the integrity of benchmarks. These could be introduced together with providing a clear roadmap regarding the regulation and supervision of the systemically important interest rate benchmarks. For example, competent authorities should be provided with supervisory tools in order to make supervisory oversight more effective and should be enabled to impose sanctions for the manipulation of benchmark indices consistently across the EU. Such sanctions are provided for in the proposal by the European Commission for a market abuse regulation. The introduction of stringent control and independent oversight mechanisms on the level of benchmark providers as well as benchmark contributors should be encouraged. With this in mind, the ESRB supports the efforts undertaken by EBA and ESMA in developing principles or guidelines for reference rates and other benchmark-setting processes. That said, the methodology of the reference rate needs to be sound and robust in the first place in order for any governance and/or supervision to be effective.

## **2.2. Benchmarks are club goods**

*The ESRB herewith responds to questions 34 and 35 of the Consultation document.*

The ESRB considers that benchmark indices are certainly nonrival: referring to a benchmark in one financial contract does not preclude its reference in another contract. However, benchmarks are excludable given that providers may charge fees. Such fees are often charged in the case of strategy indices, which are based on a proprietary algorithmic trading strategy. But in practice the use of most benchmarks does not entail a fee. In this case, it is likely that the provider of the non-excluded benchmark does not fully internalise the social benefits of a credible benchmark without error or manipulation. This could provide justification for legal or regulatory intervention, to align the incentives of

contributors, providers and users of benchmarks with the interests of society. This should be complemented with supervision by public authorities. .

### **2.3. Re-establishing confidence requires in the medium term a transition to more transparent interbank markets**

*The ESRB herewith responds to questions 9, 10 and 12 of the Consultation document.*

Next to the lack of regulation and the flawed governance, one potential weakness that has become clear from recent events is the dependence on quote-based survey estimates of funding costs rather than actual transactions for the corroboration or computation of reference rates. The relevant interbank transactions are not registered as of now. Although central bank surveys provide some aggregate data on interbank markets, remedying this shortcoming could be done via a transaction-level registry. The ESRB notes both pros and cons to an establishment of a transaction-level registry.

On the one hand it would provide a starting point for regulators to check the depth of the market and the levels at which transactions are made; it could also potentially provide a form of lagged transparency to markets. The price information underlying each bank's reference rate quote is currently not registered. For the purpose of transparency, banks could be required to register all relevant parameters used to derive their submitted reference rate quotes. This information should be accessible to regulators at all times to enable oversight of the reference rate setting process and the individual submitted quotes. Indeed, this would follow similar steps that are likely to be taken by the FSB encouraging the use of trade repositories in repo and securities lending markets, although the aim is to reduce opacity that may hide systemic risk, rather than to ensure a rate is calculated accurately.

On the other hand, a benchmark based on estimates might have benefits. It can be possible to produce such a reference rate even when there are no transactions in that market, a real issue in the crisis. Quote-based estimates could also smooth out day-to-day volatility, which might be of value to some users (e.g. corporates with only periodic loan resets), although a lower volatility might imply a lower degree of representativeness of the underlying market in times of stress. Furthermore recording transactions in a trade repository could induce false comfort, as the problem would remain of how to assess

whether reference rates are accurate, such as if there were no transactions. Lastly an assessment of the feasibility and the required investments has to be carried out before the transaction-level registry proposal could be considered credible. It is probable that such reforms require investment in information technology.

Benchmark reliability could also be increased, where applicable, by ensuring an as adequate as possible market representativeness of the underlying panel of contributors (for instance in terms of geographical diversification) or by some sort of “contingency mechanism” to be agreed ex ante, for instance in case too few trades take place for the reference rate to be representative and meaningful.

#### **2.4. The possible transition to a new regime in the medium term needs to be managed with caution**

*The ESRB herewith responds to questions 39, 40, 41 and 43 of the Consultation document.*

A possible transition to a new regime and the potential coexistence of several regimes during transition raise the issue of market segmentation risk. The implications, in particular at a time where financial markets still appear fragile, need to be carefully considered.

- (i) While LIBOR and EURIBOR have different structures, they are perceived in many respects as twin rates. The ESRB considers it important that ‘repair policies’ for the respective benchmarks are coherent, while recognising their differences in terms of definition and methodology. The UK government commissioned the Wheatley review of Libor and accepted all of the recommendations<sup>3</sup>, which means they are all likely to be introduced in the near term. This potentially could include issues around old and new benchmark methodologies co-existing or, alternatively, a forced legal conversion of old benchmarks into new ones. There are sizeable practical issues around both introducing and managing any change, with it potentially simultaneously creating winners and losers on any given trading position.
- (ii) Relevant authorities should check that any binding conversion does not threaten continuity of contract and potentially result in compensation or litigation. The UK Wheatley review found that legal considerations were important in considering

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<sup>3</sup> [http://www.hm-treasury.gov.uk/wheatley\\_review.htm](http://www.hm-treasury.gov.uk/wheatley_review.htm)

any prospective change. A possible transition to alternative benchmarks should generally lie in the responsibility of market participants reflecting the freedom of contract.

- (iii) Relevant authorities should consider how to overcome the risk that network inertia would de facto impede any of the reforms envisaged by authorities. One issue will be how to alleviate the co-ordination problems associated with moving from the current equilibrium.

## **2.5. Market participants should be encouraged to consider carefully their usage of benchmarks.**

*The ESRB herewith responds to question 31 of the Consultation document.*

LIBOR and EURIBOR were originally conceived to reflect unsecured short term funding costs of banks. As liquidity and credit risk for banks were perceived to be very low, these benchmarks were, for use in the loans market, considered sufficiently good proxies of risk-free interest rates at different tenors. This is no longer the case: liquidity and credit risk are currently not low. Moreover the role of secured forms of financing has risen noticeably over the past years. Therefore it should be considered whether financial markets would not be better served by greater use of a diversity of more tailor-made benchmarks, for instance:

- Reference indices which take account of structural changes in bank funding structures over recent years.
- Wider use, where appropriate, of reference indices that are closer measures of risk-free interest rates, like overnight rates which are used in overnight interest rate swaps (OIS)<sup>4</sup>.

While the ESRB abstains from suggesting specific tailor-made benchmarks for certain transactions, a greater use of a diversity of benchmark indices may better reflect the changes and risks in markets, make financial markets more efficient and avoid overreliance on one single (possibly inaccurate) index. Regulators should thus caution users of benchmarks against inertia, whereby a single benchmark is typically referenced solely by virtue of path dependency. Regulators should encourage users of benchmarks to consider carefully which benchmark is most appropriate for their purpose.

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<sup>4</sup> EONIA itself is based on rates for unsecured overnight interbank transactions and so does not include a term risk, but still to some small extent credit risk. Overnight rates appear more appropriate for many users of interest rate swaps, where the economic purpose is typically to transfer interest rate risk rather than bank counterparty risk.

## **2.6. Desirable characteristics of reliable and robust benchmarks from a macroprudential perspective.**

*The ESRB herewith responds to question 7 of the Consultation document.*

From a macroprudential angle, a benchmark should not be manipulated, and mechanisms should be in place to prevent any abuse. Deliberate distortion of benchmarks is a market abuse and should be punished accordingly. Moreover, the interpretation of the economic meaning of a benchmark should never be at odds with its concept and calculation procedure. For example, an interpretation of the LIBOR and EURIBOR as “risk-free” rates is clearly mistaken: counterparty and liquidity risk has always been part of such rates.

Calculation of a benchmark should be rule-based, not discretionary. From a financial stability perspective, rules for conceivable eventualities should be worked out in advance, in order to ensure that the provision of a reliable benchmark is possible even during periods of market stress. Provision of a benchmark should have stringent contingency plans, secure protection against human and technical failure and preferably suitable strategies ensuring continuity in case of failure.

Overreliance on one single benchmark should be avoided. Benchmarks provide information and foster market interconnectedness. Concentration on one benchmark could foster contagion, as excessive volatility is carried from one market to the next, thus spreading market panic and possibly leading to market breakdown.

Greater transparency is necessary to bolster credibility. Benchmarks should be transparent with respect to applied methodology, contributing members, and the sample selection criteria, among other points. The ESRB generally supports a form of lagged transparency to markets at large. This, however, first requires a thorough impact analysis in order to avoid the stigmatisation of weaker banks and turmoil in funding markets. Furthermore, certain frameworks that do not include lagged transparency of submitted quotes, while achieving the appropriate incentives structure, should not be ruled out.

*The ESRB does not object to the publication of this ESRB response to the Consultation by the European Commission.*