



BENCHMARKS: REFORM, EVOLUTION AND TRANSITION

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TIMELINE OF KEY REGULATORY DEVELOPMENTS

2012 Wheatley Review of LIBOR

2013 IOSCO's Principles for Financial Benchmarks

2014

1. Report by Financial Stability Board's ("FSB's") Official Sector Steering Group ("OSSG") on IBOR benchmarks
2. FSB's Final Report on Foreign Exchange Benchmarks

2015

1. Regulation of 7 new benchmarks by UK Fair and Effective Markets Review
2. Financial Conduct Authority's consultation paper on fair, reasonable and non-discriminatory ("FRAND") access to regulated benchmarks
3. ??? EU's proposed Regulation on benchmarks

The work of the FMLC

- Paper; “Observations on Proposals for Benchmark Reform” (December 2012)
- Paper; “Discussion of Legal Uncertainty arising from the Proposal for a Regulation on indices used as Financial Benchmarks” (March 2014)
- Letter to the Financial Stability Board on its Consultative Document regarding Foreign Exchange Benchmarks (August 2014)
- Letters to HM Treasury and the Department of Energy and Climate Change on Recommendations made in the Context of the Fair and Effective Markets Review (October 2014)
- Letter to the European Commission on the Proposal for a Regulation on indices used as Financial Benchmarks (March 2015)
- Letter to the Financial Stability Board on the Regulation of Commodity Benchmarks (April 2015)

LIBOR: WHEATLEY REVIEW, THEN AND NOW

Then: in 2012, the concern was that even relatively minor references to existing benchmarks, unless carefully managed, posed a legal risk for \$300 trillion worth of outstanding contracts which refer to LIBOR

Now: the Wheatley reforms have been largely implemented. Currencies and tenors have been withdrawn and the administration of LIBOR has passed from the British Bankers' Association to ICE Benchmark Administration (IBA)

IOSCO Principles for Financial Benchmarks

Superseded the Wheatley Review

Key Recommendations regarding

1. Governance arrangements
2. Quality of benchmarks
3. Quality of methodology
4. Accountability

FSB Official Sector Steering Group

Regulators in the shape of the FSB's OSSG examined the bigger question:

How do we transition to wholly new benchmarks that are compliant with the IOSCO Principles?

LIBOR Evolution

- Statutory regulation of the administration of and submission to LIBOR in the UK
 - (already regulated under certain provisions, dedicated legislation effective since April 2015)
- ICE Benchmark Administration Position Paper on the Evolution of ICE LIBOR proposes
 - Anchoring ICE LIBOR further in transactions other than deposits (e.g. OIS, Repos, FX Forwards, FRAs and FRNs)
 - Permitting submitters to draw on transactions executed
 - in different locations (not just London);
 - with different counterparties (i.e. not just banks); and
 - across 24 hours (not just at 11.00 am)

LIBOR Transition

Market Consultative Groups established by the Federal Reserve Bank and the Bank of England

- Goal: identify appropriate Risk Free Rates for market transition from LIBOR and other “risky” sterling/dollar reference rates.
- Method: industry consultative groups established by Federal Reserve and Bank of England

Proposed EU Regulation on benchmarks

Scope:

All published benchmarks used to reference a financial instrument traded or admitted to trading on a regulated venue.

Notable provisions:

Third country benchmarks (articles 19 - 21)

Require “equivalence decision” or recognition by a national competent authority

Critical benchmarks (articles 12 – 14)

Reference financial instruments with a notional value in excess of €500 billion

Authorisation and supervision of administrators (articles 5–11; 22–24)

A complete reform of market and business practices

Proposed EU Regulation: benchmark withdrawal

- Benchmark withdrawal would seem to be a more worrying prospect than either benchmark evolution or benchmark transition. In this regard, there are one or two provisions in the proposed EU Regulation to watch out for.
- First, the Proposal prohibits the use (which may include use for valuation purposes) of any existing benchmark in financial instruments where the benchmark in question has seen a decline in its user market by 95% or more. This implies that thereafter it can no longer act as a reference rate even for legacy contracts
- Second, the Proposal prohibits the use by supervised entities (i.e. financial institutions) of any benchmark for which the administrator is not authorised or registered in the EU. This suggests that, on the coming into force of the proposed regulation, a great number of legacy financial contracts may need to be unwound or re-papered. Some unauthorised or unregistered benchmark administrators are likely to withdraw their benchmarks at this point for lack of commercial incentive as their user numbers and licence fees decline. Of particular concern in this regard are the large number of standard market contracts which reference—or are valued against—non-EU or “Third Country” indices, such as the S&P 500 Index.

The Fair and Effective Markets Review

- Joint review by HM Treasury, the Bank of England and the Financial Conduct Authority into the way wholesale financial markets operate.
 - Consultation on Market Manipulation (Chapter 5)
- Interim recommendation: 7 New Benchmarks to fall within the Regulatory scope of the Financial Conduct Authority
 - All 7 benchmarks became a regulated activity overseen by the FCA on 1 April 2015.
- Final Report
 - 21 recommendations designed to:
 - **“Raise standards**, professionalism and accountability of individuals
 - **Improve the quality, clarity** and market-wide **understanding** of **FICC trading practices**.
 - **Strengthen regulation of FICC markets** in the United Kingdom.
 - **Launch international action** to raise standards in global FICC markets.
 - **Promote fairer FICC market structures** while also enhancing **effectiveness**.
 - **Promote forward-looking conduct risk identification and mitigation.**”

Related Regulatory Developments

FSB Final Report on Foreign Exchange Benchmarks

- Recommendations regarding
 - the calculation methodology of the WMR benchmark rates;
 - the publication of reference rates by central banks;
 - market infrastructure in relation to the execution of fix trades; and
 - the behaviour of market participants around the time of the major FX benchmarks

Related Regulatory Developments

FCA Consultation: Fair, reasonable and non-discriminatory (“FRAND”) access to regulated benchmarks

- A response to FCA Consultation Paper PS16/6 (“Bringing additional benchmarks into the regulatory and supervisory regime”), which
 - “raised concerns regarding the unconstrained ability of administrators to set the prices of benchmarks.”
- Core concern:
 - ensuring the **integrity, reliability** and **credibility** of regulated benchmarks.
- Core proposal:
 - introduce FRAND requirements into chapter 8 of the FCA Market Conduct Sourcebook (“MAR 8”) “in order to limit the ability of benchmark administrators to exploit their market power in a way that might hinder effective competition.”

FLAWLESS BENCHMARKS?

Objective

Evolution or transition to wholly compliant benchmarks

Problem

Transitioning legacy contracts to wholly new benchmarks—and even evolving existing benchmarks—raises the spectre of legal risk on a new scale

MITIGATING LEGAL RISK

The FSB noted that benchmark transition would incur legal risk.

How likely is this risk to materialise?

MITIGATING LEGAL RISK

(contd.)

In answering this we can draw comfort from market participants' reluctance to litigate. The following provide reassurance:

1. In 1981 the Minimum lending Rate ceased to be published.
2. In 1998, the British Bankers Association took the decision to calculate LIBOR, not as a "prime bank" reference rate but rather as a rate reflecting panel banks' "own cost of funds.
3. On 31 January 2014, the British Bankers Association ceased to act as the administrator for LIBOR and the benchmark was transferred to its current administrator: ICE Benchmark Administration Ltd.

CONCLUSION: THE CHALLENGE THAT WE FACE

There is every reason to be optimistic that benchmark reform will occur seamlessly in the next few years as it has on the occasions discussed above. While this may be disappointing news for lawyers, it is very good news indeed for the markets.