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EUROPEAN PARLIAMENTARY FINANCIAL SERVICES FORUM

EPFSF Briefing

"Indices and benchmarks – State of play"

Introduction:

Benchmarks and indices serve a variety of purposes in financial markets – they may determine reference rates used to determine the coupon paid on a security, a basket of securities or as a purely indicative reference rate to calibrate the expected performance of a fund. More generally financial benchmarks and indices may even reflect the state of an economy.

However similar in purpose, it is important to differentiate between *rate benchmarks* and *market indices*, as the two are not synonymous. Rate benchmarks provide interest rate levels that can be used as reference rates for securities. Conversely, market indices reflect the total return on a basket of securities (typically designed to represent an underlying market) and can have a wide variety of uses at both the security and the portfolio level, including as a performance reference. Market indices can be further split between *public indices* which are widely licensed for use by market participants generally and *private indices* which are highly customised indices created for use with a limited range of market participants.

Owing to the economic function and centrality to financial markets of benchmarks and indices, it is important to ensure the highest degree of integrity in their compilation. Subsequent failure to ensure the integrity of these tools undermines investor confidence in the market and may lead to unintended distortions in the real economy and to the expectations of consumers of financial services, such as savers and investors.

Since March 2011, investigations have been taking place in relation to possible manipulation of rate benchmarks for interbank borrowing rate. In July 2012, the manipulation of the LIBOR benchmark became evident and worldwide policy makers started to be concerned over the integrity and accuracy of other benchmarks widely used in global financial markets. Investigations are ongoing and regulators in the Europe, US and Japan are assessing what future policies options should be considered.

Categories and usage of indices and benchmarks:

Across all markets and asset classes, there are a wide range of benchmarks and indices which are constructed in significantly different ways. The key features of both rate benchmarks and market indices are summarised in the table below:

	Rate benchmark	Market index
Features	Values represent interest rate levels	Values represent return on a basket of securities
Purpose	Can be used as reference rates for securities	Can have a variety of uses at both the security and portfolio level
Composition	Benchmark values determined by a variety of methodologies including survey submissions from panels of banks and/or transactional data (where available)	Benchmark providers own the intellectual property and offer their use commercially under license agreements. The criteria to select which securities to include are set by the benchmark provider. There is strong competition between providers who offer similar products to the investment marketplace

Examples	• LIBOR &EURIBOR, • Euro Overnight Index Average (EONIA), • DTCC GCF Repo Index • Retail Price Index	• S&P 500® Index, Russell 1000® Index, • Barclays Aggregate Bond Index • FTSE 100, Euro STOXX 50, CAC40 • EuroMTS government Bond Index, • Barclays Aggregate Bond Index

Developments of discussions at EU level:

In July 2012, the European Commission amended its proposals for the Market Abuse Directive and Regulation to clarify the inclusion of any manipulation of benchmarks within the scope of administrative or criminal sanctions. Market abuse legislation is currently in trialogue negotiations.

Furthermore, the European Commission launched a consultation seeking views on a possible new regulatory framework to be applicable to the production and use of a broad range of benchmarks and indices serving as benchmarks in financial and other types of contracts. The Commission stated in its consultation[1] that *"work is required at a Union level due to the global nature of benchmarks. Member States acting without an EU framework in this area could lead to a patchwork of rules, could create an unlevel playing field within the single market, result in an inconsistent and un-coordinated approach and reduce the Union's ability to influence outcomes and achieve an internationally consistent regime at a global level"*.

As regards the ongoing work of the European supervisors, in January 2013 ESMA and EBA launched a joint consultation paper on principles for benchmark setting processes in the EU. The proposed principles included a general framework for calculation methodology, governance and supervision. The final principles are expected to be applicable by early Q2 2013 and are aimed at bridging the interim period until a potential formal regulatory framework for benchmarks and indices at European level is in place.

In parallel to the work done by DG Internal Market and the ESAs, the DG Competition will proceed with the antitrust investigations initiated in 2011. In September 2012, speaking at a conference in New York, Competition Commissioner Almunia stated that: "*the investigations focus on the markets for derivatives that are priced by reference to benchmark rates for various currencies. We are investigating whether cartel arrangements took place between a number of international banks".*[2]

Impact of potential regulation - Transition and Continuity:

Concerning the scope of the possible EU legislative proposal, stakeholders hold different opinions on whether the same regulation should be extended to both rate benchmarks and market indices or whether there should be a tailored approach. Certain stakeholders argue that for benchmarks or indices which are not related to the interbank lending, high level principles are sufficient and that whilst benchmarks and indices may share certain characteristics, there are also many features which differentiate them. In addition, some stakeholders believe that the main consequence of additional rules in respect of private indices, would be to increase costs borne by the end investor or otherwise reduce investor choice.

Moreover certain stakeholders believe that any future legislative framework should ensure a level playing field for all market participants. They argue that any and/or for benchmarks and indices should be based on the processes by which the level of such benchmark or index is set rather than their use by a particular group of market participants.

[1] http://ec.europa.eu/internal_market/consultations/docs/2012/benchmarks/consultation-document_en.pdf

[2] Almunia speech: http://europa.eu/rapid/press-release_SPEECH-12-629_en.htm

Another key issue which was covered in the Commission's consultation relates to the continuity of existing benchmarks and indices. According to a great number of the responses, any potential legislative proposal should carefully consider the economic and legal impact of any fundamental change of existing indices on contracts referred to a specific index or benchmarks and the costs for end users and investors.

Furthermore, key policy makers [3] have acknowledged that a number of firms involved in benchmark data submissions have recently withdrawn from benchmark setting panels. In this respect, certain market participants have raised concerns that too rigid a regime (e.g. making the contribution to the benchmarks compulsory) could lead to the departure of a number of firms involved in benchmark data submissions which could ultimately harm the existence of certain benchmarks.

Developments at international level:

In September 2012, IOSCO created a Board-level Task Force on Financial Markets Benchmarks in order to identify relevant benchmark-related policy issues and develop global policy guidance and principles for benchmark-related activities. IOSCO has also been closely working with BIS Central Bank Governors Group and the Financial Stability Board to examine these issues.

Simultaneously to the EBA/ESMA joint consultation, in January 2013 IOSCO also launched a consultation on how financial benchmarks should be set and managed. In this consultation, IOSCO took a broad approach to classifications, defining *a benchmark as any price, rate, index or figure that is made available to users, calculated periodically and used for reference purposes*. The consultation also identifies benchmark-related policy issues across the securities and derivatives markets and other financial sectors. It addresses, among other issues, the correct level of regulatory oversight, methodologies for calculations, governance structures on conflict of interests and the appropriate level of transparency. In April 2013, IOSCO published another consultation on a set of high-level principles for benchmarks used in global financial markets. It is expected that IOSCO will issue its final principles by summer 2013[4]. IOSCO has also completed work on the role of Price Reporting Agencies ("PRAs") within spot oil markets[5]

In the United States, financial benchmark reform is being considered by the Commodity Futures Trading Commission (CFTC),

Concluding remarks:

The European Commission is currently reviewing how financial benchmarks and indices are compiled and supervised, with a legislative proposal expected before the summer 2013. The Commission consultation provided indications about the key areas where the Commission may propose changes. Some of the key questions that will likely be addressed in the new proposal will be which authorities will have the power to supervise benchmarks and what types of benchmarks should be regulated and to what extent.

Finally, policy makers appear to be in agreement that any legislative measure should take into account the growth of globalised financial markets and must be underpinned by appropriate regulation and coordination at global level. In this respect, all industry stakeholders also agree that consistency should be ensured between the European and international measures on the regulation of indices and benchmarks.

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[3] Barnier statement: http://europa.eu/rapid/press-release_MEMO-13-82_en.htm and ECB statement: http://www.ecb.europa.eu/press/pr/date/2013/html/pr130208.en.html

[4] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD409.pdf

[5] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD391.pdf

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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