



EUROPEAN COMMISSION

## MEMO

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# Proposal for a Regulation on indices used as benchmarks in financial instruments and financial contracts – Frequently Asked Questions

## General questions

### 1. What are indices and benchmarks and how are they used in financial markets?

An index is a statistical measure, typically of a price or quantity, calculated from a representative set of underlying data. When this index is used as a reference price for a financial instrument or financial contract it becomes a benchmark. Notable examples are the London Interbank Offered Rate (LIBOR) and the Euro Interbank Offered Rate (EURIBOR) which serve as benchmarks for interest rates. The manipulation of LIBOR and EURIBOR has sparked concerns about the integrity of benchmarks around the world.

Benchmarks determine the value of many financial instruments and payments under many financial contracts as well as being used to measure the performance of investment funds; e.g. the interest rate paid on a mortgage can be set by reference to an interest rate benchmark, and the investment and pension funds in which many citizens invest use benchmarks. Estimates suggest that the value of financial instruments and contracts referenced by benchmarks exceeds 1 000 trillion euro. If benchmarks do not reflect accurately what they are meant to measure, the price or payments will not be fair. Benchmarks can fail to measure what they are meant to when they are manipulated or are not representative. Confidence in their use may also be undermined when they are not robust and reliable.

### 2. What are the LIBOR/EURIBOR scandals? What happened?

A number of recent events have highlighted shortcomings in the benchmarks process. These came to light in the summer of 2012 following the settlements which regulators reached with several banks for the manipulation of the LIBOR, EURIBOR and TIBOR (Japanese) benchmarks. These settlements revealed how contributing banks exploited the discretion in these benchmarks' methodologies and attempted to manipulate the benchmarks' levels. The manipulations were motivated by the conflicts of interest created by traders' derivative positions or the need to signal the favourable credit standing of the banks. Failures in governance and control arrangements facilitated these manipulations and the lack of clarity about regulatory oversight hindered the relevant authorities' ability to identify and respond to the problem.

While these are the most high profile events, there are investigations underway of potential manipulation of gas benchmarks by the Financial Conduct Authority (FCA) and Ofgem (the energy regulator) in the UK, as well as a Commission investigation over suspected collusion to distort oil price benchmarks. Concerns have also been reported in the press regarding the manipulation of foreign exchange benchmarks.

Several Commission investigations into alleged cartel arrangements involving benchmarks, including EURIBOR and LIBOR and trading in related derivatives, are also ongoing (see [MEMO/11/711](#), [SPEECH/13/151](#)).

These cases of actual or alleged manipulation have highlighted both the importance of benchmarks and their vulnerabilities. The integrity of benchmarks is critical to the pricing of many financial instruments, such as interest rate swaps and forward rate agreements, and commercial and non-commercial contracts, such as supply agreements, loans and mortgages. They also play an important role in risk management.

Where a benchmark is not robust and is subject to the risk of manipulation, as was the case with LIBOR and EURIBOR, its use may harm investors, markets and the wider economy. In particular, consumers will be harmed when their mortgage repayments or the returns from pension funds in which they invest their savings are altered as the result of the manipulation or unreliability of the benchmarks to which they are referenced.

According to the ECB, in March 2012 an average of almost 60% of the total loans to the non-financial sector in the euro area were based on floating interest rates (this would amount to approximately 3 trillion euro) and the percentage of loans to households based on floating interest rates reached 40% in the same period. While the available statistics do not provide details about which benchmark rates are used, in terms of reference or maturity EURIBOR is known to be the most widely used reference rate.

Italian consumer groups Adusbef and Federconsumatori have filed complaints in which they estimate that the manipulation of EURIBOR affected 2.5 million Italian households through EURIBOR-based mortgages, costing them 3 billion euro.

### **3. Why adopt a proposal for Regulation on benchmarks?**

Doubts about the integrity and accuracy of indices may undermine market confidence, cause significant losses to investors and distort the real economy. The changes proposed by the Commission to its market abuse and criminal sanctions proposals will ensure that any abuse is properly sanctioned (see [MEMO/13/774](#)). But we also need to prevent future problems and improve the way benchmarks are produced and used. In light of its [public consultation](#) and the analysis of its impact assessment, the Commission concluded that regulation was necessary to improve the functioning and governance of benchmarks in the EU.

Regulation at EU level is required because whilst some benchmarks are national, the benchmark industry as a whole is international in both production and use. For benchmarks that are widely used or produced across several Member States, national action may lead to fragmentation of the single market and could facilitate regulatory arbitrage, as benchmark production can be easily moved to other Member States. By contrast, an EU initiative helps to enhance the single market by creating a common framework for reliable and correctly used benchmarks across different Member States.

#### **4. What are the main objectives of the proposal for a Regulation on benchmarks? Who will benefit from it?**

The main objective of this proposal is to ensure that benchmarks produced and used in the EU are robust, reliable, representative and fit for purpose and that they are not subject to manipulation. In particular, the proposal aims to:

- enhance governance and controls in benchmark setting;
- limit and manage conflicts of interest at benchmark providers and contributors;
- improve the quality of input data and methodologies, including the use of sufficient and accurate data; and
- ensure adequate protection for investors and consumers through improved transparency and suitability assessments.

Citizens with mortgages or loans tied to benchmarks, as well as commercial and financial users, would benefit from the fact that those benchmarks are robust and free from manipulation. Consumers would not be sold financial contracts based on inappropriate benchmarks. Confidence in markets that depend on benchmarks would also be restored following recent scandals about the alleged manipulation of benchmarks.

#### **5. What changes does the proposal make to ensure the provision and use of robust and reliable benchmarks?**

The main changes are:

- benchmark providers will be regulated and supervised, as will contributors who are already regulated (e.g. as financial institutions);
- conflicts of interest will have to be managed;
- the providers of benchmarks and contributors to benchmarks will need to ensure appropriate governance and controls over the benchmark-setting process;
- methodologies will need to be transparent and robust and ensure the use of sufficient, accurate and representative underlying data;
- improved transparency of the benchmark-setting process; and
- suitability of assessments of benchmarks for retail contracts.

#### **6. How will the proposal improve the supervision of benchmarks?**

The provision of benchmarks will become a regulated activity and will therefore be supervised. This should ensure their reliability. The supervision of benchmark administrators will be carried out by the national competent authorities, under the coordination of the European Securities and Markets Authority (ESMA). Where a benchmark is deemed to be critical (see question 16 below), a college of national supervisors including ESMA will be established and take key decisions concerning the supervision of the benchmark administrator (e.g. authorisation, sanctions). ESMA will act by binding mediation if this is necessary to resolve disagreements on important issues. This will help ensure the effective exchange of information and a coordinated approach to their supervision.

Competent authorities will be empowered to impose administrative measures and sanctions in cases of breach of this Regulation. They will be given the necessary powers to prevent benchmark manipulation, including the powers to access documents, request information, carry out on-site inspections or investigations and require the cessation of any practice that is contrary to the provisions of this Regulation. The proposal also provides for administrative sanctions to be imposed in cases of breaches of the Regulation. Fines on individuals could reach a maximum of at least three times the amount of the profits gained or up to 500 000 euro, and for firms the maximum fines are up to 1 000 000 euro or 10% of their total annual turnover (whichever is greater). Member States remain free to impose even higher maximum sanctions in their national law.

## **7. Is this proposal consistent with the initiatives on financial benchmarks reform at international level?**

As benchmarks are global in their provision and use, ensuring the consistency of the proposal for a Regulation on benchmarks with the international standards set by the International Organization of Securities Commissions (IOSCO) [Principles for Financial Benchmarks](#) has been a priority of the Commission. The Commission has participated actively in the IOSCO task force drafting these principles which were adopted in July this year.

The proposal allows for third-country benchmarks to be used by supervised entities in the EU provided that the Commission has adopted a decision recognising that the benchmark provider is located in a jurisdiction with a legal framework and supervisory practice which are equivalent to the Regulation, in particular taking into account whether that third country's legal framework and supervisory practice ensure compliance with the IOSCO Principles on financial benchmarks.

## **8. How does the benchmarks proposal fit in with other European regulation such as the Market Abuse Regulation/Directive, Markets in Financial Instruments (MiFID) and the ESMA/EBA principles for benchmark setting?**

The sanctioning regime provided by MAR/MAD alone is not sufficient to ensure the robustness and reliability of benchmarks. This proposal is aimed at complementing the proposals for a Market Abuse Regulation and Directive (MAD/MAR) by providing a regulatory framework for the provision of robust and reliable benchmarks, legal certainty to stakeholders involved in benchmark setting and thereby help ensure ex ante that benchmark manipulation does not occur.

The MIFID proposal will strengthen the provision of benchmarks by increasing the transparency of markets and so increase the availability of more robust data.

The Commission was closely involved in the elaboration of the [European Securities and Markets Authority/European Banking Authority principles for benchmarks](#) published in June this year, which are broadly consistent with the Commission proposal, and will serve as helpful guidance to market participants and competent authorities pending the adoption of the Commission proposal by the co-legislators and its subsequent entry into application.

The ESMA/EBA principles are aimed at providing clarity in the intervening period before this proposal comes into effect and following these principles should provide participants with a glide path towards meeting the requirements of this proposal.

## **9. What are the next steps in the adoption of the proposal for a Regulation on benchmarks?**

This Commission proposal has to be considered and adopted by the European Parliament and the Council in the ordinary legislative procedure before becoming law. This process is expected to be completed by the end of this parliamentary mandate and the rules to come into effect one year later.

### **Technical questions**

## **10. Which benchmarks are covered by the proposal?**

The proposal is comprehensive and covers benchmarks that are made available to the public and are used to reference financial instruments which are listed or traded on a regulated venue, or financial contracts (such as mortgages) in the EU, or are used to measure the performance of an investment fund. Benchmarks provided by central banks are exempted as they already have systems in place that ensure compliance with the objectives of the draft Regulation.

The proposal ensures a proportionate approach by calibrating its requirements to the risks and specificities of different types of benchmarks. For example, the proposal includes specific requirements for interest rate and commodity benchmarks. The objective of these specific sectoral requirements is to address in a proportionate and effective way the specificities and risks presented by interest rate and commodity benchmarks. Commodity benchmarks have particular risks and characteristics and so provisions are included in an annex; these are a codification of the IOSCO Oil Price Reporting Agencies principles. Benchmarks calculated using data from already regulated venues, such as stock exchanges, are also released from certain obligations to avoid dual regulation.

The reason for a comprehensive approach is that benchmarks share similar vulnerabilities. Recent investigations into the manipulation of interest rate, energy and foreign exchange benchmarks emphasise the need for a framework that applies to all benchmarks in order to ensure their integrity and restore market confidence.

## **11. How does the proposal address the risk of benchmark manipulation?**

The risk of benchmark manipulation derives from the combination of conflicts of interest with the use of discretion where these are not subject to adequate controls and governance. And where benchmarks are not transparent, users of benchmarks will not be aware of these risks. More importantly the absence of regulatory oversight means that the authorities are unable to identify and rectify problems that arise.

The proposal addresses potential conflicts of interest in benchmark-setting through requirements on effective governance, including requirements to manage conflicts of interest, in particular of the relevant employees, and for adequate oversight, control and accountability frameworks, codes of conduct, complaints and outsourcing procedures, due diligence and appropriate skills and training of personnel.

It minimises discretion by requiring the use of robust methodologies and sufficient and reliable data. In particular, transaction data should be used where possible, although if this is not possible, other data, such as estimates, may be used provided that it is always verifiable.

It requires transparency of methodology and input data and a statement for users about what the benchmark measures, what its uses are and what its risks are.

The provision of benchmarks will be made subject to authorisation and supervision by the competent authority of the Member State where the benchmark provider is located.

The benchmark administrator will produce a code of conduct which clearly specifies the obligations and responsibilities of the contributors when they provide data for a benchmark. Where the contributors are already supervised financial entities, compliance with this code will be a regulatory requirement.

## **12. How does the proposal ensure effective governance and controls over the benchmark-setting process?**

The proposal will ensure effective governance and controls by requiring, among other measures: good governance measures, oversight functions, the implementation of measures to manage conflicts of interests, effective controls over processes and input data, transparency measures and codes of conducts for contributors.

## **13. Does the proposal mandate the use of transaction data in benchmark setting?**

The proposal requires that sufficient and accurate data be used as input data for a benchmark. This means that transaction data should be used where possible. However non-transaction data may be used when available transaction data is not sufficient, provided that such non-transaction data is verifiable. It requires the use of robust and reliable methodologies by providers and calculators of benchmarks. It also requires underlying data to be sufficient, accurate and representative of the actual market or economic reality that the benchmark is intended to measure. This data must also be obtained from a reliable and representative panel or sample of contributors.

## **14. How does the proposal ensure that benchmark administrators fulfil their duty of providing robust and reliable benchmarks?**

Benchmark providers will need to apply for authorisation and they will be subject to supervision of the compliance with all their obligations under this Regulation. Their main obligations are to have appropriate governance and controls in place, as well as to use robust methodologies and sufficient data and provide appropriate transparency. Providers will also need to publish benchmark statements which define what the benchmark measures and when discretion is exercised, and which describe the appropriate uses of the benchmark and in what circumstances it may cease to be fit for these purposes.

All contributors to a benchmark will need to sign a legally binding code of conduct specifying their obligations, drafted by the benchmark provider. Where the contributors are already subject to financial supervision, compliance with this code will be a regulatory requirement.

### **15. How does the proposal increase transparency in relation to the provision of benchmarks?**

The proposal requires transparency on the calculation methodology for the benchmark, its underlying data as well as on the benchmark-setting process. It also requires benchmark providers to publish benchmark statements which clearly and unambiguously define what the benchmark measures and the instances when discretion is exercised, as well as the circumstances in which it may become unreliable. The statement must also describe the appropriate uses of the benchmark and in what circumstances it may cease to be fit for these purposes. Thus, it will provide transparency on what benchmarks measure, their methodologies and their purpose and on when they may become unfit for purpose.

### **16. What are critical benchmarks and why is it proposed that colleges of national supervisors, including ESMA, be established for them?**

A critical benchmark is a benchmark, the majority of contributors to which are supervised entities, and that is used as a reference for at least 500 billion euro of financial instruments in notional value. If such a benchmark were to cease to be provided, this would have a significant adverse impact on the financial stability, the orderly functioning of markets, consumers, or the real economy of one or more Member States. Therefore, ensuring the robustness and reliability of critical benchmarks is very important.

Critical benchmarks often have an impact in more than one Member State leading to competent authorities in several Member States being concerned by their oversight. Furthermore, contributors to critical benchmarks are often located in different jurisdictions, thus, the coordination of their supervision and information-sharing may prove difficult across the relevant competent authorities in different Member States. The most effective solution for these issues is the creation of colleges of national supervisors including ESMA. This will facilitate information-sharing and the coordination of their supervision.

### **17. How does the proposal protect consumers and investors?**

Ensuring robust, accurate and reliable benchmarks that are free from manipulation protects all investors who have financial instruments or contracts that reference benchmarks. In addition requiring transparency about what the benchmark measures and should be used for as well as on the underlying data ensures that investors can make informed choices about benchmarks.

Certain consumers may however be at a disadvantage in exercising a choice about which benchmark to use. Therefore, where a regulated entity such as a bank intends to enter into a financial contract, such as a mortgage, with a consumer, it should first assess the suitability of the benchmark and warn the consumer if it is unsuitable.