



EUROPEAN CENTRAL BANK

EUROSYSTEM

EUROSYSTEM'S RESPONSE TO IOSCO'S CONSULTATION REPORT ON FINANCIAL BENCHMARKS

On 11 January 2013 the International Organization of Securities Commissions (IOSCO) submitted for public consultation its “Consultation Report on Financial Benchmarks” (hereinafter, the “Consultation”). The Consultation addresses key issues concerning governance, methodology and the oversight of reference rates, as well as issues generated by the transition to alternative reference rates, and will form the basis for the forthcoming IOSCO principles to be applied at the international level. The Eurosystem supports IOSCO's initiative, which complements similar work undertaken within the European Union by the European Commission, the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA).

The Eurosystem welcomes the opportunity to provide its views on forthcoming principles governing the process of contributing to reference rates, of which Libor, Euribor and Eonia are of particular importance from the perspective of the Eurosystem. Although Libor, Euribor and Eonia are market initiatives, the Eurosystem has always taken a keen interest in them, given their policy relevance, as well as in other important reference rates. The Eurosystem shares the view that upholding the integrity and credibility of these market reference rates, as well as their continuous viability, is important for monetary policy and financial stability purposes.

I OVERALL STANCE

The Eurosystem already expressed its views on the main elements of the regulatory reform concerning reference rates, such as Euribor, in its response to the European Commission's public consultation on indices¹, which was concluded on 29 November 2012. The Eurosystem recommended introducing substantial governance reforms and increased regulatory and supervisory scrutiny in the short term, with a view to restoring and upholding the credibility of Euribor and other systemically important reference rates. More precisely, considering Euribor's systemic importance, its function as a public good and its role in monetary policy transmission, the Eurosystem recommended that Euribor and other systemically important reference rates should be regulated, with the aim of enhancing the governance of all the key processes involved in producing the rate. The Eurosystem also considers it important that the regulations and the supervisory practices concerning Euribor and other systemically important reference rates are commensurate with the identified risks, and that they are uniformly applied and enforced across national jurisdictions. This ensures a level playing field, avoids regulatory and supervisory arbitrage and preserves the incentives for data contributors to continue to participate in systemically important reference rate panels.

The Eurosystem considers that it would be beneficial for Euribor to move, as soon as possible, but at least over the medium term, towards a more transaction-based, market-determined solution that can be implemented in an orderly manner and that can represent a viable alternative to the current setup. In this respect, the Eurosystem believes that it is crucial to safeguard the role of the private sector in reforming Euribor. In the context of reforming reference rates, the Eurosystem considers that the role of public authorities is to respond decisively to the identified risks and deficiencies by introducing a set of uniform regulatory requirements, while leaving to private reference rate administrators the choice of reference rates best suited to user needs in private contracts, as well as the task of defining and making the appropriate changes to the calculation methodologies of existing reference rates in order to address the revealed shortcomings. The

¹ See “European Commission's public consultation on the regulation of indices – Eurosystem's response”, published by the ECB on 14 November 2012 and available on the ECB's website (www.ecb.europa.eu).

authorities could support the transition process by providing an adequate transition regime which addresses the operational and legal risks in a transparent, predictable and equitable manner.

2 PROPOSED CRITERIA FOR IOSCO'S FORTHCOMING PRINCIPLES AND THEIR IMPLEMENTATION

The Eurosystem welcomes the fact that, since its recommendations regarding the scope for Euribor reform were published, a number of other important reform initiatives have been launched at the international and European levels, such as this Consultation, as well as the EBA and ESMA's consultation on the principles for benchmark-setting processes in the EU², to which the Eurosystem will also respond. Given that such initiatives may guide future international principles and legislation adopted at the EU or national levels defining the regulatory and supervisory framework for the production of reference rates, the Eurosystem finds it relevant to define certain criteria for such future principles and legislation. In particular, the Eurosystem considers that IOSCO's forthcoming principles, and any associated implementation guidelines, should meet the following criteria.

CRITERION 1: PRINCIPLES AND IMPLEMENTATION GUIDELINES COMMENSURATE WITH IDENTIFIED RISKS.

The Eurosystem believes that IOSCO's forthcoming principles, implementation guidelines, code of conduct and any regulatory and supervisory requirements that may be adopted on this basis at the EU or national levels, which would apply to reference rates such as Libor, Euribor and Eonia, should be both adequate and commensurate with the identified risks. They should address the identified risks and deficiencies while avoiding imposing unnecessary or excessive burdens on the reference rate data contributors, for example by requiring overlapping measures addressing the same risks or, in the case of contributors with international operations, requiring that various national supervisors implement overlapping or contradicting measures. An appropriate balance must be found between a sound production process with adequate controls and safeguards on the one hand, and cost-efficiency for data contributors on the other. This balance is also essential to avoid deterring market participants from voluntarily contributing data to reference rates. In particular, IOSCO's forthcoming principles, and any resulting regulatory and supervisory requirements, should distinguish between different levels of operational risk entailed by specific reference rate calculation methodologies. A distinction should be made, for instance, between methodologies which are entirely transaction-based and those which involve some expert judgement on the part of data contributors; the latter would need more intensive oversight.

CRITERION 2: HARMONISED REGULATION, SUPERVISION AND ENFORCEMENT.

The Eurosystem considers that Libor, Euribor and other systemically important reference rates should be regulated, given their role as a public good and their importance in monetary policy transmission³. To be efficient, such regulation and supervision needs to be based on principles introduced in a consistent manner at the international level. Indeed, considering that many of the contributors to reference rates such as Libor and Euribor are international entities which operate across multiple jurisdictions, there is a compelling need for coordinated and uniformly implemented rules and supervisory practices concerning the governance, submission and calculation of such systemically important reference rates across national jurisdictions. Otherwise, non-harmonised national regulation, differing interpretations of the same principles and laws, or unaligned actions by national supervisors could lead both to higher compliance costs for contributors in some jurisdictions, and to an uneven playing field, thereby decreasing incentives for voluntary contributors to the reference rate production process, and potentially encouraging regulatory and supervisory arbitrage. Considering IOSCO's mission to develop, implement and promote adherence to internationally recognised and consistent

² See the EBA and ESMA's consultation paper "Principles for Benchmarks-Setting Processes in the EU", published on 11 January 2013 and available on the EBA website (www.eba.europa.eu) and the ESMA website (www.esma.europa.eu).

³ Currently, neither the submission to, nor the administration of Euribor is regulated at the EU level. Meanwhile, the Eurosystem notes that, as far as regulation of Libor is concerned, relevant legislation has been introduced in the UK implementing the earlier recommendations contained in the final report of the Wheatley Review of Libor. See "Wheatley Review of LIBOR: Final Report", published in September 2012 and available on the UK Treasury's website (www.hm-treasury.gov.uk). Also see the UK Financial Services Act 2012.

standards of regulation, oversight and enforcement, the Eurosystem encourages IOSCO to promote and support the implementation, at the international level, of uniform principles for the regulatory and supervisory framework regarding systemically important reference rates.

CRITERION 3: APPROPRIATE AND TIMELY METHODOLOGICAL CHANGES.

The Eurosystem recognises the importance of the issue of data sufficiency in the construction of credible reference rates, as raised by the Consultation⁴. A reference rate which is considered insufficiently anchored to transaction data may require methodological changes or a transition to alternative reference rates with a more liquid compilation base. The Eurosystem supports the view of IOSCO's task force that a reference rate should be anchored, when possible, by observable transactions, entered into at arm's length, between buyers and sellers (which does not imply that non-transactional information is inappropriate). Any such methodological change should: (a) include a suitability assessment of alternative solutions, including a cost-benefit analysis; (b) be implemented in an orderly manner which does not endanger the financial stability of the financial system; and (c) safeguard the role of the private sector in the process. The Eurosystem believes that IOSCO is well placed to oversee and coordinate such work on the methodological framework at the international level.

More specifically, as already noted in its earlier response to the European Commission's public consultation, the Eurosystem considers Euribor's move towards a more transaction-based solution, subject to appropriate feasibility testing, to be beneficial. Given the important role that both Euribor and Libor play in various jurisdictions, the Eurosystem considers it important that a unified framework on transaction data sufficiency, which defines the criteria for undertaking methodological changes, is agreed for these rates. Such a framework should: (1) clarify what role the authorities and national supervisors should have in initiating methodological changes aimed at making reference rates more transaction-based, and what should be left to the private sector; (2) establish objective criteria which determine when the methodology used to calculate a reference rate needs to be revised, for example by moving towards a more liquid compilation base, in a manner that will ensure uniform interpretation and implementation by both reference rate administrators and national supervisors; (3) assess whether the alternative methodology or reference rate(s) is a viable alternative to the one being replaced, including from a cost-benefit perspective; (4) identify and address the implications of any proposed methodological changes for financial stability and the smooth functioning of financial markets; and (5) put forward a realistic timeline for the transition process, also considering the current state of financial markets.

CRITERION 4: MITIGATION OF TRANSITIONAL RISKS.

The Eurosystem welcomes the Consultation's in-depth discussion of the issues generated by a transition to an alternative reference rate⁵. The Eurosystem agrees with the Consultation's view that a market transition between reference rates needs to be transparent and implemented in such a way as to minimise the impact on all classes of market participants. The Eurosystem also supports the introduction of "living wills" by reference rate administrators – in other words a default plan in case a key reference rate becomes unviable in the market and must be dropped; such provisions would make the transition to a new reference rate more transparent and could also reduce the need for public sector intervention. For such plans to be workable, however, they must include a framework that holds the administrator to the commitments made in the plan.

Specifically as regards Euribor, the authorities should support the work of the private sector in identifying what form a reformed Euribor should take, or which alternative reference rate(s) would be best suited to serve as a replacement, rather than imposing specific solutions on the market. Once a suitable solution has been identified, the authorities could substantially contribute to the transition to the new methodology or reference rate by providing an appropriate legal framework in a timely manner. Such a transition regime would mitigate the operational and legal risks and protect the

⁴ See Consultation, Chapter 4, Section A: "The sufficiency of data used to construct Benchmarks".

⁵ See Consultation, Chapter 4, Section B: "Transition Issues".

rights of affected contractual parties in a transparent and predictable manner. Specific legislation may be needed at the national level to define such transitional arrangements and safeguard the continuity of contractual parties' rights and obligations under existing contracts. The appropriate involvement of sponsors of relevant standard market documentation may facilitate the design of sufficiently robust arrangements. Such a process should, as far as possible, be coordinated internationally to ensure equal treatment of contractual parties.

CRITERION 5: ROBUST CONTINGENCY PLANS.

The Eurosystem agrees with the Consultation that contingency plans for data collection and use in situations of market stress should be clearly defined by the reference rate administrator⁶. Both administrators and users should have robust contingency plans in place in case of non-availability of key reference rates. IOSCO's principles could therefore provide that appropriate contingency arrangements need to be in place for the cases in which reference rates such as Euribor, Eonia and Libor are no longer available or reliably computed, with potential negative outcomes for the stability of financial markets. Such contingency arrangements may involve a reliance on specific alternative methods for establishing a rate value to be used in place of the reference rate in transactions and instruments depending on it, for example standard derivative instruments involving cash settlements based on that reference rate. The feasibility of applying such alternative methods in typical contingency situations should be demonstrated and verified by the competent supervisory authorities, with the appropriate involvement of sponsors of relevant standard market documentation where needed.

⁶ See Consultation, Chapter 4, Section B: "Transition Issues".