German Banking Industry Committee

Die Deutsche Kreditwirtschaft

German Savings Banks Association | Charlottenstrasse 47 | 10117 Berlin | Germany

EUROPEAN SECURITIES AND MARKETS AUTHORITY
103 Rue de Grenelle
Paris
75007
France

Submitted via the ESMA website

Contact: Dr. Reinhold Rickes
Telephone: +49 30 20225- 5303
Fax: +49 30 20225- 5305
E-mail: reinhold.rickes@dsgv.de
Our ref:

Ref. DK:
Ref. DSGV:

15 February 2013

Response to EBA/ESMA's consultation paper "Principles for Benchmarks-Setting Processes in the EU"

Dear Sir or Madam,

We highly welcome the opportunity to participate to the EBA/ESMA consultation on the above mentioned Principles for benchmark setting. However, taking into account the recent announcement of Commissioner Michel Barnier to present a regulation framework for benchmark setting[1] within a rather short timeframe we support EBA/ESMA suggestions to consider IOSCOs work and to closely liaise with the EU Commission in order to align the principles with possible future legislative proposals. Therefore, for all market participants it would be of utmost importance to establish a framework providing continuity between the principles and future legislation.

There is a risk that the final EU regulations on benchmarks will considerably differ from this framework. If the benchmark administrators and contributing firms will implement these principles and in the end the possible future benchmark regulations would differ significantly, they would have to modify their benchmark setting structures, which would lead to an enormous increase of implementation costs. Regarding specific benchmarks such as the EURIBOR which are of paramount importance for functioning financial markets, we embrace all efforts to strengthen robustness and confidence. But care needs to be taken in order to safeguard a smooth transition phase until the new regime will be fully implemented. Ideally, for all other benchmarks, instead of a short-term solution, it would be preferable to prepare a stable regulation for benchmark setting on the firm grounds of a solid impact assessment, in order taking into account the complex economic repercussions of any regulation of benchmarks.

- Key public benchmarks such as the EURIBOR are of paramount importance for functioning financial markets. Any interruption, discontinuation of any such benchmark will have far reaching and serious and incalculable consequences for all market participants. The same applies of course to a fundamental loss of confidence in the reliability of a benchmark. Such loss of

[1] Déclaration du commissaire européen Michel Barnier sur les taux interbancaires de référence ; Bruxelles, le 8 février 2013

confidence may already be caused if the data basis on which the benchmark is based erodes or becomes less and less representative.

- Users should generally be able to assume in the future that benchmarks which are subject to regulatory scrutiny and possibly even certified provide a reliable reflection of the market.

- German market participants have a keen interest in **enhancing confidence** in major benchmarks. We therefore regard the creation of a regulatory framework as both necessary and desirable. Financial institutions submitting to financial benchmarks are prepared to fulfil new requirements. But these should not generate disproportionate costs or impose requirements not appropriate to the nature of a benchmark or index. As such, a proportionality principle should be included to ensure the principles are applied appropriately, for example, with heightened controls for widely used, public benchmarks than if an index is produced by a single firm for a small number of professional clients.

- For key public benchmarks, it will be equally important to convince not only contributing institutions but further market participants to continue to take an active part in setting them. Ideally, the number of contributing institutions should be restored or even further increased.

- It is also important that institutions across Europe should participate on equal terms. We should avoid creating an **uneven playing field,** which places an unjustified additional burden on institutions by any of the national legislators or supervisory authorities. At present, regulators are not dealing with this problem in a consistent or concerted way. This is not conducive to a establishing a pan-European market.

- In cases where the calculation of a benchmark depends on voluntary contributions, the legal framework should **not act as a deterrent**. On the contrary, the broader the basis is for calculating a benchmark, the less susceptible this benchmark will be to manipulation. Regulation needs to avoid deterring market participants from contributing to the calculation of major benchmarks. It is vital that regulation introduced in the interests of the market does not end up causing market disruption. The proposed obligations on benchmark contributors arequite challenging.

- The proposed reform should therefore include the proportionality principle suggested above and take a **two-pronged approach**. It is not enough to offer a robust framework for future benchmarks. Important existing benchmarks must also be provided with the means of making a smooth transition to the “new world”. We would therefore suggest making a distinction in the principles between “new benchmarks” and “old benchmarks” and allow for a transition period for those benchmarks that are less significant to a wide range of market participants to adapt their processes and governance in line with the principles.

- There should be defined binding standards, principles or regulations only for systemically important benchmarks. For the rest of all benchmarks solely non-binding standards should apply. There should be a gradation of benchmark setting obligations. A wide range of benchmarks exists. A “one size” regulation could be not adequate for all of them. It can´t be ruled out that due too strict benchmark principles and regulations a variety of benchmarks will disappear. This could decrease market transparency.

Question 1: Definition of the activities of benchmark setting
Do you agree with the definitions provided in this section? Is this list of activities complete and accurate?

The definition of "benchmark" is central to the scope of the subsequent principles. The ESMA/EBA definition is very broad, capturing not only key public benchmarks like Euribor but also a wide range of market indices, sometimes only produced for a handful of clients and/or not produced as a reference for financial instruments. It should be very well considered to exclude such indices form the definition of benchmarks. More so, as the entities computing them have no control over usage by third parties. The definition does not make a distinction between these or take into account that some of the proposed principles may not be applicable to these less extensively used benchmarks. None of the principles make a distinction between the desired "new order" of benchmarks, which are to be created to offer greater resistance to manipulation, and existing benchmarks, which have evolved under the "old order" and cannot be replaced overnight. Unfortunately, not all the proposed principles can be applied to existing benchmarks without a certain transition period. We would therefore suggest using the terms "**new benchmark**" and "**old benchmark**" and introducing an element of proportionality, and allowing a transition period to bring less significant benchmarks into compliance with the principles to enable the principles to differentiate between the two categories.

Moreover, the definition of benchmark used in the Consultation Paper is based on the definition used in the proposals for a Regulation and a Directive on market abuse, both amended by the European Commission on 25 July 2012. We understand that there does not exist another landmark in the EU regulation framework for the debut but we doubt that this wide definition might be useful for a first step of standard setting and suggest therefore to narrow down the scope of the application of the principles to market wide used benchmarks which are public goods for the financial markets because of their dissemination into a large variety of contracts. The well-known issues markets are currently facing are stemming from such public goods benchmarks so they are first in line to deal with. Individually created benchmarks for client contracts merit their own approach of standard setting with regard to organization, compliance efforts, internal rules etc.

Question 2: Principles for benchmarks
Would you consider a set of principles a useful framework for guiding benchmark setting activities until a possible formal regulatory and supervisory framework has been established in the EU?

In principle, we believe that a transitional regime makes good sense and will help to restore confidence. But this view presupposes that care is taken to ensure the principles can also be **readily applied to existing benchmarks**. To facilitate this, a distinction should be made between "new benchmarks" and "old benchmarks", as suggested in our reply to Q1 and a transition period should be allowed to bring less significant benchmarks into compliance with the principles. Additionally, we deem it of utmost importance that possible future legislation by the EU Commission is closely aligned with the EBA/ESMA principles and IOSCO's work on benchmarks and vice versa. For market participants continuity among the principles, as an interim solution, and possible future EU legislation is absolutely essential.

Another key question is whether benchmarks will be crisis-resilient. “New benchmarks” should have to be designed to remain robust even in times of crisis. They should, for instance, provide for alternative settings, even if the liquidity of their underlyings temporarily dried up.

Question 3: General principles for benchmarks
Do you agree with the principles cited in this section? Would you add or change any of the principles?

We have serious reservations, as far as most “old benchmarks” are concerned, about the requirement for **liquid underlyings** and for benchmarks to be based on “**actual market transactions**” (A.1). Current experience with Euribor has shown that these requirements cannot always be met. Using actual transactions is not a panacea. Euribor is supposed to mirror the interbank money market. A market which has run dry due to the financial crisis, especially for certain maturities. Relying on very few transactions would provide a very volatile benchmark. Furthermore, even a single transaction could alter the fixing. This renders a transaction based benchmark even more prone to wrongdoing. As a consequence it is essential to rely on expert estimates to avoid suspending calculations and disrupting the market. It should be made clear that this practice is legitimate.

Furthermore, using transactions directly from the interbank market would alter the meaning of the benchmark. Euribor is the rate between best banks at exactly 11:00 Brussels time. Using an average over a timespan (e.g. one day) would not give one rate for a concrete point in time.

For “new benchmarks” too, provision needs to be made for situations in which an otherwise liquid market temporarily dries up. This should not trigger the immediate suspension of the benchmark with unforeseeable consequences for the market.

If a benchmark is supposed to mirror the lending conditions in the wider economy this could be done by not relying on interbank rates only, but also on lending to corporates and thus deriving an appropriate rate from a wider market. So if in times of stress one market dries up contingency of the benchmark is secured.

We would like to comment also on intellectual property rights on indices and the need to pay license fees. In developing the new standards care should be taken that public or market indices are accessible and usable for interested parties and that the new rules do not contribute to monopolization of intellectual property rights in these indices and to the use of these indices becoming subject to license fees.

In our answer to Q1, we believe the proposed principles are not suitable for customized proprietary indices. These indices are rather specific in nature and should not in the scope of the new regime. Alternatively, a different regime would be necessary to address the particularities of such indices as the proposed regime for public or market indices does not seem fit for purpose.

Question 4: Principles for firms involved in benchmark data submissions
Do you agree with the principles cited in this section? Would you add or change any of the principles?

Submitting market participants in Germany have already taken a critical look at their policies and procedures and, where necessary, have made them more robust. We therefore agree with the application of the proposed principles to benchmarks which are extensively used by market participants.

Regarding Euribor, German banks have market conformity checks in place and rigorous processes to validate submitted data. If deviations from the previously submitted rate or deviations in the estimates of different experts within a bank for the same day are detected an escalation process is in place to validate these deviations. These processes start with a difference of only one or very few basis points and may even involve the board level.

Under certain circumstances, however, we foresee problems in requiring a comparison with actual, verifiable transactions for “old benchmarks”. Since data submissions for Euribor are currently based on expert estimates, transaction-based verification is not feasible. At most, a “plausibility check, to the extent possible” should be called for in this context.

A public declaration of compliance would not only, as intended, establish liability under criminal law, but would also give rise to civil liability vis-à-vis the public as a whole. This would generate liability risks on a virtually unforeseeable scale. The introduction of a declaration of compliance would therefore act as a considerable deterrent and thus achieve the exact opposite of the political objective, namely to strengthen benchmarks by encouraging broad participation. This principle should therefore be dropped.

In some cases it will be not worthwhile for the contributing firms to realize this range of obligations and they would probably give up their submission. In addition the contributing firms (and also other benchmark processing parties) should not and cannot undertake tasks of supervisory authorities. How should internal sanctions or zero-tolerance policies be defined? The efforts and costs to implement this proposal could be higher than the benefit of taking part in the benchmark for the contributing firm.

Question 5: Principles for benchmark administrators
Do you agree with the principles cited in this section? Would you add or change any of the principles?

We agree with the inclusion of independent members in governance functions. Consideration should also be given to involving public bodies, such as the ECB, in the administration of important benchmarks.

By contrast, we do not agree with principle C.9, which requires the compliance function of the administrator to monitor implementation of the principles in contributing firms. A benchmark administrator neither has the capabilities nor should it have the authority to ensure implementation of principles within the entity of a contributing firm. This is the task of supervisors.

Principle C.10 requires the administrator to carry out consistency checks “on the basis of transaction-based or other verifiable data”. We have the same concerns here as those expressed in our reply to Q4. Since data submissions for Euribor are currently based on expert estimates, transaction-based verification is not feasible. At most, a “plausibility check, to the extent possible” should be called for in this context.

For benchmarks which are not systemically important it could be difficult to find independent members for governance/compliance functions, which do not belong to another benchmark processing party. The fact that these members should also participate in the determination of the methodologies for the calculation of the benchmark could be considered as an intervention into the entrepreneurial freedom of the benchmark administration. To be able to monitor the appropriateness of submissions it is of utmost importance that calculation and control is carried out by people with profound knowledge of the market and current market developments.

Moreover the benchmark administrator may not have the instruments and the authority to audit the benchmark calculation agent or retain access and control on his activities. It would be an intervention in his company secrets and in the practice impossible to fulfil such obligation. It should be also clarified what should happen in the case when the benchmark administration and benchmark calculation activities are exercised by the same entity/person.

Question 6: Principles for benchmark calculation agents
Do you agree with the principles cited in this section? Would you add or change any of the principles?

Essentially, our above comments apply here too.

Question 7: Principles for benchmark publishers
Do you agree with the principles cited in this section? Would you add or change any of the principles?

Essentially, our above comments regarding question 5 apply here too.

Question 8: Principles for users of benchmarks
Do you agree with the principles cited in this section? Would you add or change any of the principles?

The obligations to be imposed on benchmark users are excessive. Users should generally be able to assume in the future that benchmarks which are subject to regulatory scrutiny and possibly even certified provide a reliable reflection of the market. In no way will they be in a position to ensure that the benchmark administrator and benchmark calculation agent are in compliance with applicable principles. Rather, the focus from a regulatory perspective should lie on certifying relevant benchmarks by a supervisor, e.g. such as the European Central Bank or ESMA. Newly introduced benchmarks will realistically only find a sufficient number of panel banks and users if they will be deemed reliable and sustainable. Certification by an authority will most likely provide for such reliability.

From a user perspective, one of the problems is that nearly every credit institution will be covered by the scope because of the general importance and wide spread use of financial benchmarks in the community.

For this reason, the **Principle F1** will mean the implementation of a regular benchmark assessment in each credit institution in the EU as they are users of financial benchmarks pursuant to the current definition. From a view of balancing bureaucratic needs and supervisory advantages, this reaches definitely too far and does not take into account the public goods characteristic of financial benchmarks

meaning that these benchmarks are trusted in because of the institutional arrangement comparable to the trust into a currency but controllable only up to a certain degree. We agree that there should be some user control for benchmarks in the market to get a feedback mechanism but to demand regular assessment results in a bureaucratic overload. For example, in order to assess a money market reference rate a financial institution needs to be participant of the money market to be informed enough of the current conditions. Small and medium sized credit institutions are not part of the money market market so they are not able to assess rates.

With regard to the **Principle F2,** it is impossible for most of the benchmark users to judge the compliance of the benchmark administrator and the benchmark calculation agents for similar reasons as mentioned above. Therefore, the burden of validating the compliance of benchmark administrators and calculation agent should not fall on benchmark users. For users it should be sufficient to rely on the confirmation, preferably in conjunction with a supervisor's certification. Thus, principle F2 should be deleted.

Principle F.3, which requires users to develop contingency plans, is problematic. The principle is very far-reaching, obliging users to use alternatives not only if the benchmark is suspended, but even "in the event of occasional operational problems, or other market disruptive events, which lead to the benchmark not being reliable." This would require a material assessment which should be undertaken by a central body, not by each individual user. Ideally, it should be the administrator, possibly in consultation with supervisors, who is responsible for deciding that an emergency exists. Legislation governing stock exchanges has provisions along these lines to cover cases where quotes are suspended. These could be used as a basis for contingency planning. Generally speaking, contingency measures should be the responsibility of the benchmark administrator but not the benchmark user.

Question 9: Practical application of the principles
Are there any areas of benchmarks for which the above principles would be inadequate? If so, please provide details on the relevant benchmarks and the reasons of inadequacy.

With respect to the objective to base future benchmarks to the extent this is feasible on actual transactions it has to be taken into account that currently unforeseeable events and developments may cause circumstances in which the relevant transactions may no longer occur for an extended period of time or where the number of transactions qualifying may be too little to serve as a reliable basis for the benchmark. Thus, at least as a contingency, projections and expert evaluations/assessments still need to be admissible.

Question 10: Continuity of benchmarks
Which principles/criteria would you consider necessary to be established for the continuity of benchmarks in case of a change to the framework?

If the principles were applied in their entirety to Euribor at present, considerable difficulties would arise. The idea of requiring benchmarks and their calculations to be verified by actual transactions is especially problematic. Desirable as such a requirement may be in theory, it is totally unrealistic in the current market environment. For a transitional period at least, we will have to live with expert estimates, which can at most be subject to plausibility checks, but not to transaction-based verification.

The various benchmarks are referenced, used or relied on, directly or indirectly, in a great variety and multitude of contracts, financial instruments and transactions. Many of these have long terms and maturities. Each benchmark serves a specific economic function and/or intends to reflect a specific and unique economic value. A benchmark can thus only be exchanged for another benchmark where the underlying economic values are sufficiently comparable so that it performs a similar function. Likewise, material changes to the new underlying method of calculation, definition or composition of a benchmark must not alter the nature of a benchmark to such an extent that it may no longer be suited to serve its original function.

In addition, it would be extremely challenging from a practical and legal perspective to procure a legally binding and enforceable replacement of an existing benchmark or a materially altered benchmark since this would require the identification and subsequent amendment of all agreements and/or replacement of financial instruments containing the (direct or indirect) reference to the benchmarks in question - which in many instances will result in protracted negotiations and in some cases may even require consent of multiple parties involved.

Against this background it will not be possible to fully replace an existing benchmark by another or materially amend the manner in which it is calculated, defined or composed in short term. Rather, any such replacement or amendment will require an extended transition period during which it will be necessary to ensure the continuation of any existing benchmark. Furthermore, this also means that any new regulatory requirements for benchmarks have to provide for such transition periods in respect of existing benchmarks.

Yours sincerely,
on behalf of the German Banking Industry Committee
German Savings Banks Association
by proxy

Dr. Reinhold Rickes
Economics/Financial Markets