



Financial Services User Group's (FSUG)

reply to the Consultation document on the regulation of indices

A Possible Framework for
the Regulation of the
Production and Use of
Indices serving as
Benchmarks in Financial and
other Contracts

29 November 2012



FSUG c/o European Commission
Internal Market and Services DG
SPA2 4/69, BE-1049 Brussels
markt-fsug@ec.europa.eu

FSUG was set up by the European Commission to:

- advise the Commission in the preparation of legislation or policy initiatives which affect the users of financial services
- provide insight, opinion and advice concerning the practical implementation of such policies
- proactively seek to identify key financial services issues which affect users of financial services
- liaise with and provide information to financial services user representatives and representative bodies at the European Union and national level.

FSUG has 20 members, who are individuals appointed to represent the interests of consumers, retail investors or micro-enterprises, and individual experts with expertise in financial services from the perspective of the financial services user.

Introduction

FSUG welcomes the opportunity to make a submission to this consultation. The critical role LIBOR/ EURIBOR and other benchmark rates play in financial markets and economic activity means that the governance structures and regulation relating to the setting and publishing of these rates needs to conform to the highest standards.

The FSUG response is structured as follows.

In part 1: we raise serious concerns about the limited scope of the Commission's initiative which seems to ignore the wider misuse of benchmarks and indices in the financial system – particular in relation to the sale, advertising, marketing and promotion, and distribution of financial products.

In part 2: we set out our response to this specific consultation. Most of the questions are of a technical nature aimed at market participants. FSUG does not have the time or resources to respond to these questions. Therefore, we have restricted our response to the critical issues of governance and accountability, and the process of setting benchmarks.

As we set out below, a range of reforms are needed to tackle market abuse, minimise the risk of manipulation recurring, ensure integrity and restore confidence in the market. To achieve these objectives, reforms should cover the following issues:

- governance and independence of the system for the development, production and use of indices and benchmarks;
- greater transparency and accountability in the system;
- a revised process for setting, verifying and publishing benchmarks;
- internal conduct and standards of behaviour expected of market participants; and
- regulation, oversight, sanctions and redress mechanisms.

FSUG
November 2012

FSUG concerns about the limited scope of the review

We note that the consultation document focuses almost entirely on the role of benchmarks and indices in the pricing of financial instruments in the market. We agree that this pricing role is critical to the integrity and effective functioning of financial markets and fully support the need for reform.

However, we are surprised and somewhat disappointed that the consultation document – with the exception of a very small reference to role of indices as benchmarks for performance management in paragraph 1.4.2 – seems to ignore the potential for indices and benchmarks to be misused by product manufacturers, distributors, and advisers in the:

- sale, advertising, marketing and promotion, and distribution of financial products and services; and
- reporting on the performance of financial products and services to ordinary financial users.

Most types of financial products are susceptible to this form of misuse including investment, insurance, savings, and mortgage products. Moreover, the potential for misuse can occur along the entire financial supply chain – in wholesale, institutional and retail markets.

This misuse of indices and benchmarks can have a number of detrimental effects on financial users as individuals and at the group level. For example, misuse can lead to:

1. deliberate or reckless misselling of inappropriate products or misrepresenting of potential risks and rewards of financial products to users – for example, borrowers being locked into expensive mortgages or loans.
2. financial users making sub-optimal choices and decisions pre-sale, at point of sale, and post-sale – for example, the use of retrospective ‘past performance’ data in the distribution of investment products is a particular problem. Similarly, retail investors may stick with a seriously underperforming investment fund due to the inappropriate use of a particular index or comparator benchmark in communications between the fund manager and investor. Another example of potential detriment is consumers on the point of retirement choosing an annuity with the inappropriate inflation benchmark.
3. competition being undermined if financial users are persuaded into, and stay with, inefficient, uncompetitive financial providers by inappropriate use of benchmarks.
4. at the macro level, a major misalignment of assets and liabilities – for example, the misuse of benchmarks can result in pension funds investing in assets unsuited to meet future liabilities.

Of course, much of the detriment arises from the way financial products are promoted and distributed not just the misuse of benchmarks and indices. However, the growing complexity of financial services and products means that indices and benchmarks play an increasingly prominent role in the design, manufacturing, sale, advertising, promotion, and distribution of financial products and services and subsequent reporting to financial users.

Another obvious gap in the consultation document is the lack of any reference to the need to understand the behaviour of financial users in response to benchmarks or indices. Clearly, if

the Commission wants to ensure that indices and benchmarks are used responsibly and with integrity, then it must also understand how financial users respond to these information signals.

Specifically, the Commission must consider:

- the types of behaviours and responses these information signals trigger;
- financial user understanding of the suitability of benchmarks and indices; and
- given the limitations of financial education and information solutions with regards to influencing consumer behaviour and, therefore, producer and adviser behaviour, the type of regulation required to ensure that the industry uses these benchmarks and indices properly.

Therefore, we urge the Commission to ensure that, if it does not intend to widen this specific consultation to incorporate the wider misuse of benchmarks and indices, it should instigate a separate piece of work on this issue.

The potential and actual misuse of benchmarks and indices (and more generally misleading sales and promotions) could be dealt with by ensuring that agents in the financial supply chain had a clear fiduciary duty of care to financial users including with regards to the use of indices and benchmarks.

Differentiation between index and benchmark

It is worth noting, that the consultation document is mixing these two terms, which can cause significant detriment to the third parties.

Index is a simple presentation of development of one or more underlying assets or prices. The same can be said for the benchmark, but the difference is in a contractual usage and following legal consequences associated with its usage. Benchmarks can be built of one or more indices, but at the same time are a viable part of commercial contracts or legal agreements. This significant difference returns the necessity to recognize these two terms also in any following regulation and legislation.

If the benchmark is used in any legal contracts or agreements that influence the position of a contract party, transparency regarding the methodology, input data, calculation and dissemination of the benchmark is automatically higher.

Therefore we suggest differentiating between these two terms and focusing on the transparency of the benchmarks as they have significantly wider consequences for third parties.

Summary of FSUG recommendations on reforming benchmarks

The estimates of the value of contracts linked to LIBOR alone ranges from \$300 TRN to \$800 TRN. However, recent events show that the governance and regulation of these benchmark rates is flawed and needs to be fundamentally reformed.

It is difficult to say with any degree of precision the extent of the manipulation of key reference benchmark rates due to the lack of comprehensive, independent investigations. However, as the 'Wheatley' Review¹ points out, other key benchmark rates and mechanisms are vulnerable to similar conflicts of interest and weak governance flaws evident in LIBOR.

These include: the critical Price Reporting Agencies (PRAs) which compile commodity prices including oil, and a range of global interbank benchmarks including key European interbank benchmarks such as EURIBOR, BUBOR, CIBOR, PRIBOR, and WIBOR.

The key question is: what reforms are needed to ensure these forms of market abuse are tackled?

A range of reforms are needed to tackle market abuse, minimise the risk of manipulation recurring, and restore confidence in the market. Reforms should cover the following issues:

- governance and independence of the system for the development, production and use of indices and benchmarks;
- greater transparency and accountability in the system;
- a revised process for setting, verifying and publishing benchmarks;
- internal conduct and standards of behaviour expected of market participants; and
- regulation, oversight, sanctions and redress mechanisms.

Governance and independence

The current governance arrangements mean that banks and financial institutions which may stand to gain from manipulating rates have a major influence over the submission of constituent rates and the process of setting rates. There is no meaningful independent oversight.

We propose that new governance arrangements are put in place. Our key recommendation is that for the key European reference rates a new, independent Market Rates Oversight Committee should be established under the auspices of the European Supervisory Authorities (ESAs) or relevant national supervisor.

This committee should be responsible for oversight of the rate setting process including:

- the eligibility of participating financial institutions and instruments;
- the submissions process;
- the methodology used for rate setting; and

¹ The Wheatley Review of LIBOR: initial discussion paper – a review undertaken by Martin Wheatley, managing director of the UK Financial Services Authority (FSA) and CEO designate of the Financial Conduct Authority (FCA)

- the process for the publication of rates.

This committee should have a proper balance of representation with a majority of independent, public interest representatives to ensure independence and integrity and critically to restore confidence and trust. Clearly, it would not be appropriate for any financial institutions with a commercial interest in rate setting to be involved with the committee.

Transparency

As part of the governance reforms, the transparency of the rate setting process needs to be improved. Clearly, there are trade offs between granting anonymity and full transparency in the process. Anonymity creates more opportunities for manipulation but may be justified on grounds of genuine commercial sensitivity. However, the risk of manipulation and abuse can be addressed by creating the new governance structures outlined above along with a robust sanctions regime.

More generally, transparency can improve governance and accountability and help restore confidence and trust in the system. This can be achieved by publicising names of the Committee members and publishing minutes of meetings in keeping with the process followed, for example, by the UK's Bank of England Monetary Policy Committee (MPC). The minutes could be suitably redacted to protect genuine commercial confidentiality.

A revised process

The submission process is flawed and open to abuse. Moreover, rates do not necessarily reflect true market conditions as the submissions are based on the judgment and inference of those making submissions not actual transactions – this can leave the process open to manipulation.

Therefore, a standardised, transparent, independently monitored process is needed for overseeing and verifying individual submissions by participating financial institutions.

The new committee outlined above should develop and publish a new submission process setting out clear rules for participating institutions with regards to:

- the responsibilities of employees involved in submitting constituent data;
- the process for submitting constituent data to the committee;
- the methodology for calculating the benchmarks; and
- verification and corroboration of constituent data.

There are two possible options for improving the existing system. One approach would be to use actual money market transactions data with the new committee establishing and overseeing a trade reporting mechanism. This would deal with many of the concerns around governance and quality of submitter's judgment.

Alternatively, a hybrid system could be introduced. The current system – which is vulnerable to manipulation – could be enhanced through the use of market transactions data to corroborate submissions.

However, it may be that, following consultation and review, policymakers conclude that LIBOR/ EURIBOR are not 'fit-for-purpose' and that alternative benchmarks are needed.

There are a number of potential alternative rates that could be used including: central bank rates; overnight cash lending rates such as SONIA or EONIA; certificates of deposit (CDs) or commercial paper (CP); overnight index swaps; short term government debt securities; or repo rates.

Clearly, each potential alternative would need to be fully evaluated to establish the pros and cons. Moreover, managing the transition to new benchmarks would be difficult given the potential for disruption and the need to renegotiate contracts.

Setting rates based on actual transaction data offer significant advantages compared to offered rates which are more vulnerable to manipulation, and poor judgment. As mentioned it may transpire that the current system can never be made 'fit-for-purpose' and new, bespoke benchmarks are needed.

However, this would take some time and involve considerable transition risks. Therefore, we do see merit in establishing a 'hybrid' interim system – see above.

Internal conduct standards and behaviours

The current system – which relies on participating financial institutions submitting constituent data – is clearly vulnerable to manipulation and poor judgment. If some form of 'hybrid' system is to be adopted then policymakers need to introduce new standards of behaviour for financial institutions and individual employees involved in the submission process (and for other employees such as traders who may stand to benefit from manipulation).

These new standards of behaviour should cover: internal governance structures; the submissions mechanism; record keeping and audit trails; compliance and disciplinary procedures.

Further consideration is needed on whether 'Chinese walls' within financial institutions could ever be made strong enough to prevent manipulation – policymakers may have to accept that Chinese walls may never be good enough in the real financial world and a trade reporting system may be necessary.

Regulation, oversight, sanctions and redress mechanisms

As mentioned above, the oversight of critical benchmark rates should come under the authority of the relevant ESA or national supervisory authority.

Moreover, the actual activity of submitting rates to the oversight committee should become a regulated activity meaning that participating financial institutions and employees would be subject to appropriate supervision and be covered by a relevant criminal sanctions regime.

The existing legal and regulatory framework within member states and at EU level is piecemeal and inconsistent. To create a more robust, coherent and consistent regime two actions are needed:

- i) the setting of benchmark rates should be made a regulated activity to ensure it falls properly with the scope of regulation and sanctions regimes; and
- ii) EU policymakers should establish harmonising legislation to ensure that member states implement the proper regulatory and legislative powers.

However, the first step for EU policymakers should be to publish a comprehensive analysis of the gaps in criminal sanctions powers across the EU.

We do not have the information or resources to answer this question at the moment. Clearly, policymakers at global, EU and national level will have to undertake further detailed analysis of the legal consequences before embarking on a particular solution.

At the same time, LIBOR manipulation may have made mortgage repayments more expensive than they should have been and many millions of consumers from all over the world may have been affected. Some of them will be able to launch individual or class actions against their banks, but a lot of others will not be compensated. To avoid the same story into the future, FSUG is on the opinion that simplified redress mechanisms should be created and implemented.

This marks the end of FSUG response to this consultation