



**Financial Services
User Group's (FSUG)**

response

**to the Consultation
on Market manipulation:
Lessons and reform
post LIBOR/EURIBOR**



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FSUG response to the Consultation on Market manipulation: Lessons and reform post LIBOR/EURIBOR

Identity of the contributor

Name of the person and/or organisation responding to the questionnaire:

Financial Services User Group (FSUG)

http://ec.europa.eu/internal_market/finservices-retail/fsug/index_en.htm

Description of the main activities of the organisation:

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.

Please indicate whether you object to the publication of the identity of the contributor:

yes, I object

no, I do not object

If you object, an anonymous contribution may be published.

Topic 1: Tackling the culture of manipulation

Q1: How widespread is the problem? Are there other financial instruments, markets and/or benchmarks vulnerable to potential manipulation?

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 estimates of the value of contracts linked to LIBOR alone ranges from \$300 TRN to \$800 TRN¹. However, recent events show that the governance and regulation of these benchmark rates is flawed and needs to be fundamentally reformed.

¹ See paragraph 2.7 in *The Wheatley Review of LIBOR*.

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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' Review² 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.

What action should be taken 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:** the current governance arrangements mean that banks 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
- 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. 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. 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.

² *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).

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- **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.

- **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).

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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, and sanctions:** 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.

Q2: What action should be taken to ensure the integrity and quality of all benchmarks, financial instruments and markets?

See above, for FSUG's proposals on how to reform the governance of the current system – these reforms would improve the integrity and quality of benchmarks and functioning of financial markets.

- a) Do both benchmarks and those entities that input into the setting of the benchmark need to be regulated?

Yes. FSUG believes that the governance and process relating to the benchmarks and the institutions and individuals involved must be regulated.

- b) Are traded rates as opposed to offered rates a better basis for input? Or should a 'hybrid' approach be adopted?

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.

- c) Should the posters of rates be granted anonymity? What would be the potential downside to such an approach? Would such a status add or diminish the integrity of prices?

Clearly, there are trade-offs between granting anonymity and full transparency. 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.

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- d) What kind of powers should regulators of the financial sector be given to set and introduce criminal sanctions for attempted or actual manipulation of benchmarks?

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.

Topic 2: Establishing integrity and trust post LIBOR/EURIBOR

Q3: What specific measures should be taken at European/Global level to improve investor confidence? How can cooperation between global regulators be improved?

See above for our response to this question. The recommendation for a new, independent Market Rates Oversight Committee established under the auspices of the European Supervisory Authorities (ESAs) or relevant national supervisors would allow for cooperation at EU and global level.

How can legislators ensure continuity between existing contracts which rely on Libor/Euribor (some \$500 trillion of contracts) and future contracts?

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.

Q4: What specific measures could be taken to enhance transparency and information quality in the financial sector?

It is not clear if this question refers to the specific problems relating to LIBOR/EURIBOR or much wider problems in the financial sector. If it is the former, then the new regulatory model we have set out above would provide the much needed improvements in transparency and disclosure.

However, if it is the latter – that is, wider problems in the financial sector – then this obviously requires much wider reforms of regulation and corporate governance in the financial sector. FSUG is currently in the process of producing a series of three papers on regulatory reform which we would be happy to share with the ECON committee.

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Q5: What future action could be taken to achieve better governance in order to prevent future manipulation and establish integrity, trust and fairness in the financial services industry?

Similarly, it is not clear from the question if ECON Committee is asking about the specific issue of benchmark rate manipulation or the need for much wider reform of financial markets.

Again, if it is the former, our proposals set out above would address these concerns.

If it is the latter, our programme of work on regulatory reform would provide ECON with a set of actions specifically designed to improve the way the financial services sector behaves and enhance the effectiveness of financial regulation.