

EUROSYSTEM'S RESPONSE TO THE EBA AND ESMA'S PUBLIC CONSULTATION ON THE PRINCIPLES FOR BENCHMARK-SETTING PROCESSES IN THE EU

On 11 January 2013 the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) submitted for public consultation a document entitled “Principles for Benchmarks-Setting Processes in the EU” (hereinafter, the “proposed EBA-ESMA principles”). The document lays down principles for good practices to be applied by contributors of the reference rate data, reference rate administrators and other participants in the reference rate production process.

The Eurosystem welcomes the proposed EBA-ESMA principles, which aim to bridge the current gap in EU legislation given that the submission of the reference rate data and the administration of reference rates are currently not regulated. The Eurosystem notes favourably that the proposed EBA-ESMA principles,¹ as well as the recommendations addressed to the Euribor-European Banking Federation (EEBF) and to the national supervisory authorities (NSAs) with regard to the administration of Euribor and the supervision of banks participating in the Euribor panel,² are consistent with Eurosystem's recommendations with regard to Euribor, as presented in its response to the European Commission's public consultation on the regulation of indices.³

The Eurosystem believes that the proposed EBA-ESMA principles, although not legally binding, will provide a valuable voluntary framework until a potential formal regulatory and supervisory framework is devised. These principles are particularly important given that they have been aligned with the work undertaken by the European Commission and may form the basis of potential future legislative proposals.

The Eurosystem welcomes the initiatives undertaken by the European Commission, EBA and ESMA and the opportunity to contribute to principles governing the process of contributing to reference rates, of which Libor, Euribor and Eonia are of particular importance. 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.

The Eurosystem's response is in three parts. First, comments are made regarding general criteria which should be met by the future EU regulation and supervision of reference rates. Second, selected specific regulatory proposals are considered. Third, recommendations are made with regard to banks' continued participation in the Eonia/Euribor panel.

I GENERAL COMMENTS ON THE REGULATORY REFORM AND SUPERVISORY OBJECTIVES

The Eurosystem supports both strengthening the reference rate calculation methodology and improving the governance of the reference rate production process. As further explained below, the regulatory process initiated in this respect

1 See the proposed EBA-ESMA principles, paragraphs 26-30.

2 The EBA and ESMA's recommendations to the EEBF and the EBA Recommendations [to national authorities] on supervisory oversight of activities related to banks' Euribor panel participation, which were published together with the review of Euribor's administration and management and the proposed EBA-ESMA principles on 11 January 2013.

3 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 (<http://www.ecb.europa.eu>).

should meet the following criteria: 1) a regulatory and supervisory framework commensurate with identified deficiencies, 2) a harmonised and consistent implementation across Member States, 3) carefully planned and well-timed changes in the reference rates' methodology, and 4) adequate mitigation of possible transitional risks.

CRITERION 1: REGULATORY REQUIREMENTS AND SUPERVISORY PRACTICES COMMENSURATE WITH THE IDENTIFIED RISKS.

The Eurosystem believes that proposed regulatory requirements and any supervisory action undertaken should be commensurate with the identified risks. The EBA and ESMA are best placed to coordinate and monitor how their proposed principles are applied in practice and to ensure that the supervisory actions address deficiencies, while avoiding placing unnecessary or excessive burdens on the reference rate data contributors, for example by requiring overlapping measures addressing the same risk. An appropriate balance must be found between a sound production process with adequate controls and safeguards on one side, and cost-efficiency for contributing banks on the other side. This balance is essential also to avoid deterring market participants from voluntarily contributing data to reference rates. In particular, the regulatory and supervisory requirements should distinguish between methodologies which are entirely transaction-based and those which involve some expert judgement on the part of contributing banks; the latter would need more intensive oversight.

CRITERION 2: HARMONISED SUPERVISORY PRACTICES ACROSS NATIONAL JURISDICTIONS.

In particular for euro area reference rates or reference rates with international contributions, there is a compelling need for coordinated and uniformly implemented supervisory practices across national jurisdictions, including the uniform interpretation and implementation of the proposed EBA-ESMA principles; the EBA and ESMA are best placed to undertake such coordination at the EU level. Otherwise, non-harmonised national laws, differing interpretations of EU rules or unaligned actions by national supervisors would lead to higher compliance costs for contributors in some jurisdictions, as well as an uneven playing field and decreasing incentives for voluntary contributors to the reference rate production process.

CRITERION 3: APPROPRIATE AND TIMELY METHODOLOGICAL CHANGES.

The Eurosystem welcomes the EBA and ESMA's resolve to strengthen the methodology for the production of reference rates, through the more precise definition of their constituent elements and through more representative and transparent data compilation and rate calculation procedures.⁴ The role of public authorities in this respect is to respond decisively to the identified risks and deficiencies by introducing a set of uniform regulatory requirements, while leaving the choice of appropriate detailed changes in the rate methodologies to private reference rate administrators and hence ensuring that the produced rates reflect sound market practices and needs.

When fostering changes in the production methodology for reference rates such as Euribor, the EBA and ESMA should, in particular: (1) clarify the methodological standards that such reference rates need to meet, including for example the liquidity criterion for the underlying compilation base, in a manner that will ensure their uniform interpretation and implementation by both reference rate administrators and the NSAs; (2) identify and address implications of the implied proposals for methodological changes for financial stability and for the smooth functioning of financial markets; (3) put forward a realistic timeline for the preparatory work, also considering the current state of financial markets; and (4) define the role of the European Supervisory Authorities (ESAs) and NSAs in the process, especially if their active involvement is necessary to safeguard financial stability in the short term.

⁴ See the proposed EBA-ESMA principles, paragraph 29, section A (General framework for benchmarks setting), as well as sections B and C.

CRITERION 4: MITIGATION OF TRANSITIONAL RISKS.

The Eurosystem believes that, should the EBA and ESMA decide to foster extensive changes to the reference rate production methodologies, they should also design a robust transition regime that would mitigate the operational and legal risks and protect the rights of affected contractual parties in a transparent and predictable manner. Specific legislation may be needed at both the EU and national level to define such transitional arrangements and safeguard continuity of contractual parties' rights and obligations under existing contracts. Appropriate involvement of sponsors of relevant standard market documentation may facilitate the design of sufficiently robust arrangements.

2 SPECIFIC REGULATORY REFORM PROPOSALS

The Eurosystem makes the following comments concerning selected specific reform proposals.

a) *The introduction of a more liquid underlying compilation base⁵ for the reference rates and their calculation, on the basis of actual transactional data, should be supported provided it can be implemented in an orderly manner.*

In particular, as already noted in the Eurosystem's earlier response to the European Commission's public consultation, an increased reliance on transaction-based figures in the calculation of the Euribor rate or of the rate chosen as its replacement would be beneficial. Such a change may nevertheless have legal and financial stability consequences that need to be assessed. The options for making Euribor or its replacement rate more transaction-based could, for example, include expanding the set of unsecured transactions considered in calculating the rate. The Eurosystem encourages the EBA and ESMA to assess which is the best way to contain the legal and financial stability risks that may arise in the implementation of longer-term measures aimed at increased liquidity of the compilation base for reference rates and their stronger link to actual transactional figures.

Specifically as regards Euribor, the authorities should acknowledge that a transition to a more liquid underlying compilation base or to an alternative reference rate based entirely on market mechanisms would be likely to take a longer time and face significantly greater resistance than a managed transition involving public authorities. Under this latter option, the public authorities should support the work of the private sector in identifying the form a reformed Euribor should take or the alternative reference rate that would be best suited to serve as a replacement for Euribor, rather than impose 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 (see criterion 4 above).

b) *Administrators and users should have robust contingency plans in place⁶ for the case of non-availability of key reference rates.* The EBA and ESMA should ensure that appropriate contingency arrangements are in place for 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 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 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.

⁵ See the proposed EBA-ESMA principles, paragraph 29, section A (General framework for benchmarks setting), point A.1 – Methodology.

⁶ See the proposed EBA-ESMA principles, paragraph 29, section A (General framework for benchmarks setting), point A.5 – Continuity.

3 ENSURING BANKS' CONTINUED PARTICIPATION IN THE EONIA/EURIBOR PANEL

The Eurosystem has closely followed the recent decisions by some banks to withdraw from the Euribor/Eonia panel. The Eurosystem considers it crucial to ensure the continuous viability of these reference rates, including the representative membership of Euribor/Eonia panel and hence their capacity to adequately reflect developments in the euro area.

Consequently, the Eurosystem welcomes the EBA and ESMA's recommendation to the EEBF to work decisively towards ensuring the representativeness of the Euribor panel and to maintain present panel participation. The Eurosystem also welcomes the EBA's recommendation to all authorities supervising Euribor/Eonia panel banks that they encourage banks to be part of the Euribor panel because of the importance of Euribor in their own respective jurisdictions.

The Eurosystem considers that (i) the NSAs and EEBF are best placed to ensure that panel banks continue to participate in the Euribor/Eonia panel and to give incentives to non-panel banks to join it, and (ii) that they should recognise the importance of a stable and representative panel for the financial stability of the euro area and of the Single Market and therefore should take appropriate measures to ensure this.

The Eurosystem also encourages banks to remain in, or rejoin, the respective panels while the regulatory framework is being amended and thus prevent potential disruptions to the functioning of financial markets.

The Eurosystem welcomes the European Commission's intention to introduce further legislation to regulate systemically important reference rates, of which Euribor and Eonia are of particular importance from both a monetary policy and financial stability perspective. Such legislation could significantly increase market confidence in these reference rates. The Eurosystem also welcomes the Commission's intention to include in its legislative proposal the power to compel mandatory submissions for systemically important reference rates, in order to prevent disruptions to their production process. Such a provision would ensure that reference rates such as Euribor and Eonia have a sufficiently large panel and can be computed at all times.