

EUROPEAN COMMISSION'S PUBLIC CONSULTATION ON THE REGULATION OF INDICES EUROSYSTEM'S RESPONSE

On 5 September 2012 the European Commission released for public consultation a working document entitled “A Possible Framework for the Regulation of the Production and Use of Indices serving as Benchmarks in Financial and other Contracts”, in order to assess whether further regulation in the production and governance of benchmarks is necessary.

The initiative of the Commission follows the evidence of Libor, Euribor and Tibor manipulation and the ensuing investigations by the UK, US and Japanese authorities, which triggered public debate as well as numerous initiatives to assess the options for reforming these benchmarks. The Commission has already taken several steps towards restoring the credibility of benchmarks by proposing on 25 July 2012 amendments to its proposal for a regulation on market abuse and its proposal for a directive on criminal sanctions for market abuse¹ to ensure that the manipulation of such benchmarks is prohibited and appropriately sanctioned. The reform of Libor is currently being led by the United Kingdom's Financial Services Authority which, following a public discussion paper, issued its recommendation in this regard on 28 September 2012. The recommendation will constitute the basis for a number of proposals to be included in the United Kingdom's Financial Services Bill.

The Eurosystem welcomes the initiatives undertaken by the European Commission and the opportunity to contribute to the analysis of the reforms needed to restore confidence in benchmarks, among which Libor and Euribor are of particular importance. Although Libor and Euribor are independent market initiatives, given their policy relevance the Eurosystem has always taken a keen interest in them as well as in other important benchmarks. The Eurosystem shares the view that upholding the integrity and credibility of these market benchmarks is important.

The Commission's public consultation is broad in scope and includes not only interest rate-based benchmarks like Libor and Euribor, but also commodity-based and other benchmarks. The Eurosystem's response focuses on the scope for Euribor reform, as Euribor represents a key interest rate benchmark in the euro area and is of particular importance for the transmission of the euro area's monetary policy. The Eurosystem believes that the Commission's current assessment of the need for benchmark reform represents an opportunity to consider which measures can be taken to increase

¹ Amended proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse) (submitted in accordance with Article 293(2) TFEU) (COM(2012) 421 final) and Amended proposal for a Directive of the European Parliament and of the Council on criminal sanctions for insider dealing and market manipulation (submitted in accordance with Article 293(2) TFEU) (COM(2012) 420 final).

Euribor's reliability, representativeness and resilience, which would in turn increase the market's confidence in the benchmark and also improve the transmission of monetary policy. Nevertheless, the Eurosystem's response to the Commission's consultation should be considered without prejudice to the final opinion that the European Central Bank (ECB) will adopt on the legislative proposals of the Commission once the ECB is formally consulted.

This response is structured as follows: the overall stance of the Eurosystem with respect to the Commission's public consultation is presented in the first part of the document. Part two provides an assessment of Euribor's function as a public good, its systemic importance and its role in the transmission and implementation of monetary policy. Part three presents the Eurosystem's view on the governance reforms that need to be undertaken in the short term, part four discusses reform options in the medium to long term, and part five addresses the impact of potential regulation.

I OVERALL STANCE

The Eurosystem believes that there is significant scope for Euribor reform and that there are a number of measures that can be taken to increase the market's confidence in Euribor's reliability, representativeness and resilience.

The Eurosystem believes that any approach to Euribor reform should distinguish between short-term measures aimed at immediate enhancement of confidence in the integrity of the benchmark, and more medium to long-term changes.

In the short term, the focus should be on improving the governance process, as well as on providing a clear road map for both the regulation and supervision of Euribor. Regarding governance, the ECB takes the view that in order to enhance the governance structure surrounding the Euribor rate-setting process there are a number of important measures that can be taken that are relatively easy to implement and that have the potential to increase the market's confidence in Euribor. It is also important for the changes implemented in the short term to be fully consistent with potential later reforms, to avoid unnecessary disruptions.

Furthermore, the Eurosystem believes that while such governance reforms represent necessary measures, further initiatives aimed at enhancing the reliability, representativeness and resilience of Euribor need to be considered. An increased reliance on transaction-based figures in the calculation of Euribor should be beneficial in this respect, although such changes can only be specified at a later stage after thorough testing. Making submissions more transaction-based would also enhance the effectiveness of the recommended governance measures, as transaction data are easier to verify ex post. However, any changes could have legal and financial stability implications, which need to be assessed.

The Eurosystem considers that, given the systemic importance of Euribor and its role in monetary policy transmission, the European Supervisory Authorities (ESAs) could be involved in the supervision of the Euribor rate-setting process. The Eurosystem believes that authorities such as the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) are better placed than the ECB to assume such a role, as the conflicts of interest would be more limited.

The Eurosystem believes that supervisory involvement could encompass the key governance aspects of the Euribor rate-setting process: the rate submission process at panel bank level, the calculation and dissemination of Euribor, the robustness of the governance of Euribor-EBF and the ex post checking process. The supervision process should be extended to other systemically important benchmarks in the EU.

Considering Euribor's and Libor's systemic importance, as well as their function as a public good and their role in monetary policy transmission, the Eurosystem believes that their regulation and that of other systemically important financial interest rate benchmarks should be considered, with a view to enhancing the governance of all the key processes surrounding the rate-setting process.

The Eurosystem acknowledges the results of the Wheatley Review of Libor² and welcomes its proposals to strengthen the governance structures surrounding Libor, including through regulation and supervision, and to make Libor more transaction-based. The Eurosystem notes that the Libor reform proposals are broadly consistent with the considerations of the Eurosystem with regard to Euribor.

Furthermore, the Eurosystem considers that the process of reforming Euribor, Libor and, potentially, other interest rate benchmarks should be coordinated at the European and global level to ensure consistency and a level playing field.

2 THE IMPORTANCE OF THE EURIBOR BENCHMARK

The Eurosystem takes the view that Euribor is of systemic importance for the financial stability of both the euro area and the international financial system. Its role has evolved over time, together with its standardisation and the increased liquidity and availability of financial instruments referring to it. Today, it serves as a reference rate for contracts amounting to a notional value of hundreds of trillions of euro, linked to both over-the-counter (OTC) and exchange-traded derivatives³, and therefore connects a large number and wide range of market participants.

² "The Wheatley Review of Libor: final report" was published on 28 September 2012.

³ According to the latest data available from the BIS, at the end of 2011 the notional amount outstanding of OTC interest rate derivatives (forward rate agreements (FRAs), swaps and options) was USD 504 trillion. Of this total, the largest share by currency was recorded for the notional amounts referenced to euro interest rates (USD 184 trillion, of which USD 143 trillion related to interest rate swaps, USD 17 trillion to FRAs and USD 23 trillion to interest rate options), which were greater than the amounts referenced to US dollar rates (USD 161 trillion). While the BIS data do not indicate this, there is a broad consensus in the market that the main reference rate underlying euro interest rates is Euribor. As regards exchange-traded interest rate derivatives, data published by Euronext show that the total notional amount of the three-month Euribor futures contracts traded on the LIFFE exchange in London in 2011 was EUR 242 trillion and the total notional amount of the Euribor options on futures was EUR 126 trillion.

Over time, Euribor has taken on a social function and is now a public good. The non-financial sector, including the general public, has a stake in its integrity. Euribor rates are widely used as reference rates for loans by banks to non-financial corporations and households⁴; they have also been incorporated in various retail products.

The Eurosystem considers that Euribor has an important role in the transmission and implementation of monetary policy in the euro area. Monetary policy decisions and expectations are directly reflected in the Eonia and Euribor rates that serve as a reference for highly liquid and standardised derivative products, such as forward rate agreements (FRAs), futures and interest rate swaps. In turn, these form the basis for the pricing of various marketable debt instruments. Prior to the crisis, the Euribor rates tracked very closely the expected path of the ECB's policy rate, measured by the Eonia overnight index swap (Eonia OIS), thus coming close to being risk-free rates. While this relationship has been weakened recently, as the bank credit risk embedded in these rates has increased compared with the very low pre-crisis levels, it remains strong, particularly in the shorter tenors, which provide the main underlying rates for the euro interest rate swaps.

In sum, given the importance of the role that Euribor plays as a public good and in the transmission and implementation of monetary policy in the euro area, it is important that its integrity is preserved and, whenever possible, enhanced.

The approach to Euribor's reform should therefore take into account the features that a systemically important benchmark should have from a monetary policy transmission point of view. Euribor's reform should make it (i) more reliable, with a robust and credible governance structure to oversee its calculation; (ii) more representative of the nature of the underlying market in accordance with its definition; and (iii) more resilient, ensuring that it can be reliably calculated during periods of market stress. From a monetary policy transmission point of view each of these three characteristics are key features of a benchmark rate, allowing the market's monetary policy expectations to be propagated to the pricing of most assets and instruments, including the tradable ones, such as bonds, as well as the non-tradable ones, such as loans.

3 THE SCOPE AND NATURE OF SHORT-TERM REFORM MEASURES

The recent investigations into the manipulation of Libor and Euribor illustrate their vulnerability to inaccurate submissions and manipulation attempts. The potential for flawed incentives to carry out such attempts arguably increased during the crisis, especially for benchmarks like Libor, which have a significant signalling effect with regard to individual bank creditworthiness. In this context, a comprehensive review of all governance issues surrounding the rate-setting process is warranted.

⁴ Almost 60%, on average, of the total loans to the non-financial sector in the euro area at the end of March 2012 were based on floating rates (BSI Statistics). While the available statistics do not provide details about which benchmark rates are used, in terms of reference or maturity Euribor is known to be the most widely used reference rate. Although lower (but also growing over time), the percentage of loans to households based on floating rates reached 40% in the same period.

The Eurosystem believes that with regard to the governance process surrounding Euribor there are a number of short-term measures which, if taken, have the potential to enhance confidence in the rate's reliability and representativeness. These governance enhancement measures could be implemented in a relatively short period of time while allowing market disruptions to be kept to a minimum. They should be carried out with the main desired achievement in mind – i.e. the integrity of the submissions and of the process – and should therefore take into account the four main processes that determine Euribor, in the manner detailed below.

- i) As regards the submission of rates at panel bank level, a course of action to be considered is that of introducing and enforcing Chinese walls, along with other internal procedures aimed at ensuring that the Euribor rates are accurate and submissions are not improperly influenced.
- ii) In the calculation and dissemination of Euribor, a clear definition of the checks performed by the calculation agent, as well as of the escalation procedure and the legal responsibilities of all involved parties in the event of suspect or unusual quotes, could be envisaged. The criteria on which the checks are based should not be made available to the public or to the contributing banks, in order to minimise manipulation attempts.
- iii) As regards the governance of the benchmark provider Euribor-EBF, the possibility of taking the following steps should be analysed further, with a view to restoring confidence in the integrity of the process.
 - a. Making both the Board of Directors of Euribor-EBF and its Euribor Steering Committee more independent of the banking community and more diverse, to reflect the public nature of Euribor and to address inherent conflicts of interest. The inclusion of other stakeholders, such as pension funds, insurance companies, asset managers, academics and consumer protection groups, could be considered.
 - b. Introducing a reliable mechanism for the investigation of suspect submissions, as well as a credible sanctions procedure. The EBA, ESMA or a designated agent could play a role in the investigative and sanctioning processes.
 - c. Introducing changes to the legal nature of the Euribor Code of Conduct for contributing panel banks to make it binding. In this regard, the Euribor-EBF Euribor Steering Committee could, for example, be placed in charge of the limited sanctions provided by the Code of Conduct, such as suspension from the panel. For other sanctions, the intervention of public institutions would probably be necessary.
 - d. Strengthening the Euribor panel of banks. This process could be undertaken on two interconnected levels, as outlined below.
 - A reconsideration of the criteria for membership of the Euribor panel of banks set out in the Euribor Code of Conduct, to ensure a participation which is both sufficient in size and

representative of the segmented euro area money market. The membership criteria should be clarified to ensure that eligibility is based on money market activity parameters and less on credit criteria, in order to preserve an adequate geographic representation on the Euribor panel. The Eurosystem also considers that the Euribor panel of banks needs to be regularly and effectively reviewed to ensure that it is composed only of banks that remain eligible.

- The encouragement of eligible banks not currently on the panel to take part in it. The option of requiring such eligible banks to participate in the panel should also be considered, to ensure that the panel is sufficient in size and sufficiently representative. This, in turn, would make Euribor more representative, and harder to manipulate.

iv) As regards ex post checks, the following could be considered:

- a) the introduction of adequate ex post checks, including but not limited to substantive checks of the submitted rates by an independent entity approved by the ESAs;
- b) the introduction of a mandatory audit of the panel banks' rate submission processes, to assess and verify their integrity.

In this regard, a private entity could be mandated to check the quotes (in particular against the real trades), audit them, and afterwards report to the Euribor Steering Committee.

The Eurosystem considers that the introduction at this stage of changes to Euribor's existing definition and methodology should be carefully assessed in view of the envisaged costs and benefits.

The Eurosystem believes that the outright replacement of Euribor with alternative benchmark rates would barely be feasible at this stage for a number of reasons, including the potential unsuitability of such alternative benchmarks for some of the current Euribor users and the existence of long-standing legacy contracts. Moreover, the process of transition to new benchmarks could entail significant legal and financial stability risks.

4 MEDIUM TO LONG-TERM MEASURES: MOVING TOWARDS MORE TRANSACTION-BASED METHODOLOGIES AND ALTERNATIVE BENCHMARKS

The Eurosystem believes that in addition to the necessary enhancement of the governance process surrounding Euribor, more changes could be envisaged to increase Euribor's robustness. In particular, the Eurosystem believes that a shift towards a more transaction-based approach in the medium to long term could increase the robustness, representativeness and integrity of the benchmark. The merits of and best method for shifting towards a more transaction and market-based Euribor need to be assessed without delay, even if implementing such changes may only be feasible at a later stage.

The extent to which actual transactions could form the basis for the calculation of the benchmark needs to be thoroughly studied, especially given that transaction volumes in longer tenors are often insufficient to derive reliable results in all market conditions. One promising solution may be represented by the option to combine transaction-based data with survey-based estimates. This could be achieved via several different means, which would require further assessment before a firm conclusion could be drawn.

The options with regard to reforming Euribor by replacing it with alternative benchmarks are currently not obvious. For example, those market participants who prefer a reference rate closer to the risk-free rate have increasingly embraced a benchmark based on the Eonia OIS, despite it lacking both the term liquidity and credit premia currently reflected by Euribor. Nevertheless, the magnitude of this switch remains, so far, unclear. It is also not clear whether such a benchmark could replace Euribor in terms of all the purposes for which it is used as a proxy for the banks' short-term unsecured funding costs. Benchmarks based on secured borrowing rates, despite reflecting a growing trend towards collateralised borrowing, currently lack a term structure, have insufficient term volume, incorporate some level of subjectivity or present an undesirably high level of collateral heterogeneity and rate dispersion. In fact, secured borrowing rates reflect heterogeneous factors such as the collateral credit premia, the correlation between borrower default risk and the collateral default risk, the haircut applied, collateral substitution rights and credit management policies from any central clearing.

It is not excluded, and could also be desirable, that other benchmarks, such as the Eonia OIS or secured benchmarks, could prove themselves to be valid alternatives, co-exist with Euribor and be used for some of the purposes for which Euribor is currently used. However, the complete replacement of Euribor with an alternative benchmark may not be feasible even in the medium to long term if banks still need benchmarks reflecting their short-term unsecured costs of funding.

Private sector initiatives are important for the development of the financial system and therefore the envisaged regulatory and supervision measures should allow for the development of market-led initiatives, and for the transition to new benchmarks while ensuring their integrity.

5 THE IMPACT OF POTENTIAL REGULATION: TRANSITION, CONTINUITY, COSTS AND COORDINATION

The Eurosystem believes that any Euribor reform should be managed in such a way as to achieve the desired results while minimising market disruptions. Any proposed changes aimed at making Euribor more transaction and market-based need to consider the related legal and financial stability implications.

Authorities should also assess which role they should play in the process, which role should be reserved for the private sector, and which is the right balance between implementing far-reaching measures and containing the legal and financial stability consequences.

The Eurosystem considers that the choice of alternative benchmarks should be market-led, with users choosing the best alternatives for their needs. The Eurosystem also believes that market participants should undertake an in-depth analysis of their use of quote-based interest rate benchmarks, understand both their advantages and limitations, and decide whether alternative benchmarks are better suited to their needs.

On the other hand, the Eurosystem also acknowledges that legal risks and uncertainties can be significantly reduced if legislation is used to effect the transition from a benchmark intended to be discontinued to a particular new benchmark or to a reformed Euribor benchmark over a well-defined transitional period, as this would protect the legal validity of existing contracts affected by the transition. Under this latter option, the authorities would take responsibility for identifying a single alternative benchmark that is best suited as a Euribor replacement, or for prescribing what form a reformed Euribor should take. The important legal and financial stability issues that may be raised by changing Euribor's methodology and potentially its definition in order to make it more transaction-based need to be carefully assessed. Such changes may lead to changes in the economic value of contracts and potentially even to disputes between contractual parties.

The Eurosystem stresses that the reform process of both interest rate and other financial benchmarks needs to be coordinated at the European and global level to ensure a consistent framework and a level playing field. It welcomes the various initiatives undertaken by numerous stakeholders to analyse the reform options and considers that the Financial Stability Board and the International Organization of Securities Commissions (IOSCO) are well placed to coordinate the process at the international level.

© European Central Bank, 2012

Address:

Kaiserstrasse 29,
60311 Frankfurt am Main,
Germany

Postal address:

Postfach 16 03 19,
60066 Frankfurt am Main,
Germany

Telephone:

+49 69 1344 0

Website:

<http://www.ecb.europa.eu>

Fax:

+49 69 1344 6000

All rights reserved. Reproduction for educational and non-commercial purpose is permitted provided that the source is acknowledged.