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Towards benchmark stability and integrity

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Chair

Ladies and Gentlemen,

First of all, I would like to thank Martin Scheck and ICMA for inviting me to address you today. The conference has already covered a range of topics that are on all of our minds, regulators as well as market participants and investors. In my contribution I want to draw your attention to a single theme that has not recently received the attention it deserves but which has returned to the top of many of our agendas, and that is financial benchmarks. It is appropriate that this conference ends today with a panel of some of the key public sector agents in financial benchmark change.

Let me say a few words on why benchmarks have come into focus for legislators, regulators, and central banks and then briefly recall the role played by ESMA to date. I will then conclude with my views on where the current global initiatives on interest rates benchmarks should take us, and the main challenges that we face. A number of aspects will form a theme throughout my address: we have all ignored that our train went in the wrong direction, we failed to alter its course when we should have, and we only have limited time left to get the train back on the right track.

But, how did we end up here in the first place? I believe it was a coincidence of two factors: Firstly, very few, very specific financial indices, designed for limited purposes, that is: interest rate benchmarks measuring unsecured interbank borrowing, became the global household reference for all types of financial contracts, for loans, bonds, derivatives and investment funds. This has grown to become a significant financial stability risk. It is even more concerning if we face the facts and acknowledge that the market that these indices were designed to measure has changed and that interbank borrowing markets have significantly dried out. Secondly, the globally most relevant interbank interest rates benchmarks, like LIBOR and Euribor, were unregulated and their methodologies and governance allowed manipulation on a scale rarely seen in the financial sector.

So, it was a matter of urgency that the public sector stepped in – to re-establish integrity and to prevent future manipulations, but also to ensure that indices are accurately measuring what they are intended for, in short: to make sure that benchmarks are robust, reliable and accurate. Different global and local initiatives have addressed these objectives in recent years: ESMA, together with EBA, developed principles on the benchmark setting processes in 2013, while IOSCO published its broader principles on financial benchmarks in the same year, and the Financial Stability Board (FSB) recommended a reform of major interest rate benchmarks in 2014. While following the Wheatley review of LIBOR, the UK was the first jurisdiction to subject a benchmark to public supervision.

Most of these initiatives have concentrated on interest rates benchmarks and none of these initiatives was as broad and detailed as the European Benchmarks Regulation (BMR). The BMR entered into force in June 2016 and, globally, it is the only binding set of rules that covers all types of indices. It governs the provision as well as the use of benchmarks by supervised entities in the EU – including those indices that are provided in third countries.

The BMR has introduced a levelled approach to the regulation and supervision of different categories of benchmarks. The European Commission has declared the biggest interbank interest rates benchmarks EONIA, Euribor and LIBOR as being critical benchmarks, and they are supervised by colleges to ensure that supranational perspectives are taken into account. ESMA is a member of these supervisory colleges to promote and monitor their efficient and effective functioning and to ensure consistent supervisory practices across critical benchmarks. In this capacity, ESMA has also already published two methodological frameworks to further align the work of the colleges.

ESMA was also asked to ensure that the provisions of the BMR apply proportionately through the technical advice submitted to the European Commission and drafting its Technical Standards. However, ESMA's task was not finished when these Level two measures were delivered. Discussions with stakeholders have not abated as many benchmark administrators are still preparing their applications for authorisation and the BMR grants a transitional period until the end of next year.

Let me stress this: we will all have to live with the strict schedules that this date imposes on us. The BMR will fully apply from early 2020 as stipulated by the co-legislators.

Today, ESMA is frequently asked, by market participants and national regulators, to give its guidance on how to apply many of the rules in this entirely new field of regulation. It is important that the BMR is applied consistently throughout the European Union – and with the least market disruption without compromising the Regulation's objectives. Therefore, to support a smooth implementation of the BMR, ESMA has already published a range of Q&As, including last week a Q&A on the relevance of the BMR for prospectuses, and will publish guidelines for non-significant benchmarks later this year.

But in a globalised environment, business does not stop at European borders. Consequently, one of the areas that we discuss the most is the application of the BMR to indices that are provided outside the EU. Many global indices have become regular instruments for many European businesses, in banking as well as in the real economy, for hedging or for proprietary trading. It is crucial for the European economy that important third country benchmarks can continue to be used, provided that they adhere to minimum standards of integrity and that European regulators have a person to address for the supervision of these indices.

ESMA has published guidance on some areas of third country benchmarks and has clarified that these indices can continue to be used throughout the transition period, which ends on the first of January 2020. It has become clear that this time period is needed by the third country index providers, who, like their European counterparts, will have to adopt a set of brand new requirements. The IOSCO principles for financial benchmarks are helpful and have established an international minimum standard and the BMR takes these principles as the yardstick when assessing third country administrators and supervisory regimes.

As I said earlier, the BMR takes a proportionate approach. Only those indices which are used most frequently and which do not rely on regulated data, are subject to the most stringent set of rules. It is clear that these critical benchmarks, which are relevant to financial markets across the EU, need to be supervised coherently and consistently. The same holds true for third country benchmarks that will continue to be used in the EU: It would be an undesirable outcome if these benchmarks were treated differently in the respective Member States of reference. The most effective way to ensure coherent and consistent supervision is to create a single point of entry into the European market. Therefore, I want to express my full support for the proposed role for ESMA as a supervisor of critical and third country benchmarks as envisaged in the Commission's reform of the European Supervisory Authorities. ESMA's Board of Supervisors had already backed this proposal in May 2017.

The IOSCO Principles in 2013 and the EU Benchmarks Regulation in 2016 were milestones on the road to robust benchmarks and their enhanced governance. But regulation has its limits – it cannot guarantee that benchmarks continue to be the right and representative measure if the underlying markets evolve. In recent years, the greatest, most urgent and most challenging tasks in financial benchmarks reform has been to adequately reflect such a market evolution.

The FSB has already recommended in its 2014 report that the financial industry find fall-backs to major interest rate benchmarks. The FSB has also recommended that alternative benchmarks should be identified, or developed where necessary. A multiple-rate approach should ensure that a benchmark is fit for purpose in each of the highly varying areas of use. But since then a major component in the equation has changed: the interbanking borrowing market has become increasingly illiquid for many currencies and tenors in a low interest rate environment. Data findings have been similar for the biggest interest rates benchmarks in Europe: panel banks have entered into so few trades that a solid interest rates benchmark solely based on interbank transactions is simply not feasible. The European Money Markets Institute tested such a reform of Euribor with live data – and saw little support, especially for longer tenors. The plan to move to a Euribor+ was subsequently abandoned. The UK regulator has conducted a data analysis of LIBOR and has accepted that for the time being, the benchmark would have to continue to rely on expert judgement submissions – but has stated that the current LIBOR has an uncertain future, at least post 2021.

So we find ourselves in a situation today where major benchmarks' viability is at risk - benchmarks, which have become essential for global financial stability and which have instruments and contracts worth trillions of Euros referencing them. And the task has become to find viable alternatives – that may even serve as a replacement for existing interest rate benchmarks in legacy contracts.

More urgently than ever, the task today is to find the right benchmark for the right purpose. And let me be honest: this is a task where the financial industry needs to take the initiative. ESMA and the international regulatory community will give all the support it can. But with the ever increasing reliance on these very few special purpose benchmarks by an entire industry, it was the private sector that steered the ship into the wild waters it is now in, and it is the private sector which should stay on-board to guide the ship back to safer waters.

Therefore, I acknowledge with delight that financial institutions have assumed their responsibility and that industry groups have been founded to identify alternatives to the most relevant interest rate benchmarks for different currencies – in US Dollars and Pound Sterling, in Japanese Yen and in Swiss Francs – and recently, also for the Eurozone, with the establishment of the Risk-Free-Rate (RFR) Working Group. I am very grateful that Koos

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Timmermans from ING chairs the Working Group and a good start has been made to address the challenging work that needs to be accomplished in a tight timeframe.

All of the currency groups are coordinated by public sector representatives, by the Fed, the Bank of England, the Bank of Japan and the Swiss National Bank. For the Eurozone this coordination is a joint effort by public institutions, the ECB, the European Commission, the Belgian regulator FSMA and ESMA. That already reflects the complexity of the situation we are in: as I explained before, the EU is the only region with detailed binding rules and authorisation requirements and the search for alternative risk-free reference rates in the Union and the introduction of the new ECB overnight rate coincides with the transitional period of the BMR. Euribor and EONIA have to be compliant with the BMR if banks want to continue to use them, that is at least the case for new products. In that context I should mention that EMMI has stepped back from reforming EONIA in light of the introduction of the new ECB rate, and the reform of the Euribor methodology is a work in progress, the latest consultation only ended two weeks ago. I can only encourage EMMI's efforts to strengthen Euribor as much as possible.

Another distinguishing characteristic in the EU is Euribor's large-scale use in consumer credit and mortgages in many Member States. Some jurisdictions have even made the reference to Euribor mandatory for consumer loan contracts, in other countries it is at least established practice for banks to ask for an interest rate based on Euribor when consumers borrow money to buy a home or to finance their education. This exposes private households to the developments in the wholesale money market – including bank credit risk. Moreover, consumer contracts usually also have a much longer term than for example interest rate derivatives. Consequently, many European banks will have thousands of legacy consumer contracts referencing Euribor in the decades to come.

These issues, namely financial stabilty and consumer protection, are ESMA's key concerns. Therefore, it is appropriate that ESMA is not only part of the group of public institutions coordinating the Euro RFR working group, but that ESMA takes a prominent role in the work stream on contract continuity. I am grateful that Jose Manuel Gonzalez Paramo from BBVA is willing to chair this work stream, especially considering his experience with the use of Euribor in consumer contracts. It is important to ensure that any solution to include fallbacks in the contracts – or even to transition them to a newly identified interest rate benchmark – is well balanced and not to the detriment of either party. The dedicated subgroup is currently taking stock of the different legal frameworks in the Member States and it has already become clear that changing contracts with consumers will be a significant challenge.

Of course, consumer contracts are certainly not the only relevant use of Euribor – and of EONIA. Syndicated loans, interest rate swaps, futures, invetsment funds – the whole spectrum of financial products references the major interest rate benchmarks in very different modalities.

Let me therefore conclude by stressing that it is therefore crucial that the major industry associations, including ICMA of course, are on board when candidates for alternative RFRs are discussed, when term structures are developed, and when matters of implementation are debated. I want to thank ICMA for participating in the RFR Working Group and for contributing to its work streams. Moreover, I believe that today's conference is a great occasion to discuss the work that we are undertaking globally: reforming benchmarks worldwide is a pressing challenge that calls for all of us to play our part.

Thank you very much.