



Our ref: ICAEW Rep 29/13

Your ref: Principles for Benchmarks-Setting Processes in the EU

ESMA
103 Rue de Grenelle
75007 Paris
France

Submitted online at: <http://www.esma.europa.eu> >> “Your Input – Consultations”

Dear Sir/Madam,

ICAEW Rep 29/13 – Our response to your paper Principles for Benchmarks-Setting Processes in the EU

ICAEW is pleased to respond to your request for comments on *Principles for Benchmarks-Setting Processes in the EU*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully,

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ICAEW REPRESENTATION

Principles for Benchmarks-Setting Processes in the EU

Memorandum of comment submitted in February 2013 by ICAEW, in response to the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) consultation paper *Principles for Benchmarks-Setting Processes in the EU* published in January 2013.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *Principles for Benchmarks-Setting Processes in the EU* published by ESMA and the EBA on 11 January 2013, a copy of which is available from this link. <http://www.esma.europa.eu/system/files/2013-12.pdf>

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. The Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues facing the financial services industry acting free from vested interest. It draws together professionals from across the financial services sector and from the 25,000 ICAEW members specialising in the sector and provides a range of services including a monthly magazine *FS Focus*.

MAJOR POINTS

Support for the initiative

5. We support the initiative of ESMA and the EBA in seeking to bring greater credibility to financial benchmarks through increasing integrity by further formalising the way in which benchmarks operate.
6. ICAEW's priority in this area is how the work of auditors can help support confidence in financial benchmarks. Over the past months we have particularly focussed on the integrity of benchmarks, primarily through the provision of assurance over benchmark submissions and compilation as required by regulation and demanded by the market in the future. To this end ICAEW has published an *Exposure Draft and Interim Guidance for the Performance of Assurance Work on Benchmarks and Indices*¹ in February 2013.

Other considerations

7. When considering a framework for benchmark submission, particularly in the case of a complex benchmarks like LIBOR and EURIBOR, it must be borne in mind that judgements have to be made, even in fully liquid markets. For example trades made, even in high volume, may not be representative of the definition due to size or counterparty for example. As such those responsible for submission make judgements about the adjustments required to use actual trade data to meet the LIBOR definition, which adds inherent complexity to the process.
8. Our response to this consultation has been framed in terms of economically important benchmarks. We feel it is important to recognise that there are numerous benchmarks in

¹ <http://www.icaew.com/~media/Files/Technical/Financial-services/icaew-03-13fsf-guidance-for-assurance-on-benchmarks-and-indices-final.pdf>

existence, some of which can more effectively self-regulate than others, and that a proportionate approach needs to be applied.

RESPONSES TO SPECIFIC QUESTIONS/POINTS

Question 1: Definition of the activities of benchmark setting

Do you agree with the definitions provided in this section? Is this list of activities complete and accurate?

9. We agree with the definitions provided in this section, and consider the list of definitions to be comprehensive. However, it may be possible to expand upon the definition of users to include those 'secondary users' who are not product designers or sellers, but the ultimate consumer of a benchmark-linked financial product.
10. We believe that to restore trust in financial benchmarks the support of ultimate product users will be required.

Question 2: Principles for benchmarks

Would you consider a set of principles a useful framework for guiding benchmark setting activities until a possible formal regulatory and supervisory framework has been established in the EU?

11. Yes, the principles are a useful framework, but it must be ensured that they are consistent with international initiatives, for example IOSCO's proposals² and those of the FSA³ in the UK. Given the very international nature of benchmarks it may be possible that there is confusion around jurisdiction, which will be counter to the restoration of integrity as well as the potential for practical confusion where multiple regulators are working to address the same issues.

Question 3: General principles for benchmarks

Do you agree with the principles cited in this section? Would you add or change any of the principles?

12. Yes we agree with the principles cited in this section but would point out the following:
13. Methodology: Precision is important, but also needs not to be so precise as to reinforce negative effects should the underlying market of interest of the benchmark suffer problems, for example the lack of actual trades on which to base interest rate benchmark submissions when the market became illiquid.

When considering the reliability of the method there will be a distinct difference between considering whether it is functioning sufficiently in terms of principles versus practice, for example where the principles underlying the benchmark method remain reliable, but change is needed to the details of the calculation. (Eg with EURIBOR, is a 'prime bank' still fit for purpose in the definition, as opposed to is a specific bank still a worthy submitter to the benchmark,).

Any reactive changes to methodology would have to consider the potential implications for existing contracts which might follow.

² <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD399.pdf>

³ <http://www.fsa.gov.uk/static/pubs/cp/cp12-36.pdf>

We agree with the principle that ‘underlyings should be sufficiently liquid’⁴ (we would like to point out that the word underlyings may not be widely used nor understood), but they may not be, and the methodology needs to allow for this as rapid change to a benchmark methodology to accommodate changing market conditions is likely to be extremely difficult in practice.

14. **Governance:** The principle regarding governance structure implies that no trade bodies would be allowed to administer benchmarks. This may provide greater independence of benchmark setting but conflicts of interest may still exist, for example caused by the way in which the administrator is remunerated. It is important that the governance processes provide sufficient safeguards against threats to independence. We note inconsistency with the IOSCO principles which do not appear to rule this out.
15. **Transparency:** We agree that benchmarks should be transparent, accessible and with fair and open access. We do not feel this precludes a benchmark being an economic good which is paid for, as long as there are no unreasonable preconditions to access. As well as being balanced with confidentiality, transparency must also be balanced with stability (for example, delayed publication of benchmark data and statistics, and the removal of the requirement for named publication of LIBOR submissions as proposed by the FSA). It is also possible that the administrator would want to keep some elements of how they calculated the benchmark private (for example weightings of different submissions) as a greater level of information could provide incentive for or ability to manipulate a benchmark in future.

Question 4: Principles for firms involved in benchmark data submissions

Do you agree with the principles cited in this section? Would you add or change any of the principles?

16. We are in agreement with the principles cited within this section. We would further draw your attention to the control objectives for submitters articulated within our aforementioned guidance⁵ which further describes how these types of principles can be fulfilled in the day to day execution of duties by the submitter organisation and individuals.
17. With regard to point B.4 we would encourage that any policy be principles based: a set of rules about collusion may be more difficult to enforce in certain instances whereas it may be clearer whether or not a principle and ethos have been followed.
18. In respect of point B.5 we would encourage clear articulation of ‘normal requirements’, being normal requirements for financial statement and audit purposes as opposed to any one company’s ‘normal requirements’.
19. There would be the potential to expand point B.11 to include representations regarding compliance from directors of the submitting entity, not just management. As part of our assurance guidance we consider the need for and potential content of directors’ representations regarding submission to and administration of benchmarks⁶.

Question 5: Principles for benchmark administrators

Do you agree with the principles cited in this section? Would you add or change any of the principles?

20. We generally agree with the principles cited in this section, but would make the following additional points:

⁴ A.1 pg 8

⁵ Page 37 <http://www.icaew.com/~media/Files/Technical/Financial-services/icaew-03-13fsf-guidance-for-assurance-on-benchmarks-and-indices-final.pdf>

⁶ Pages 21 - 22 <http://www.icaew.com/~media/Files/Technical/Financial-services/icaew-03-13fsf-guidance-for-assurance-on-benchmarks-and-indices-final.pdf>

21. Principle C.2 seems consistent with, but not articulated as fully as the IOSCO and FSA proposals regarding governance committees. We would value alignment of the requirements in this area.
22. With regard to principle C.6, as mentioned in paragraph 14 above, there may be aspects of the methodology which the administrator may wish to keep private, for the reasons explained above.
23. Principle C.9 could be clarified. The ability of the governance/compliance function of an administrator to ensure that principles applying to contributing firms are implemented appears to extend the role of the administrator into that of a quasi-regulator. Without a clear definition of how light touch or invasive an oversight committee is expected to be the cost of and time required to perform the function could increase dramatically, affecting how economical production of the benchmark is.
24. The various regulatory consultations appear to present a range of potential responsibilities for the administrator with regard to checking submitted data. Principle C.10 states that the administrator should perform consistency checks on transaction based or otherwise verifiable data, whereas other consultations seems to extend this responsibility to corroboration of submissions on a daily basis. The proposed level of responsibility will greatly affect the administrator business model and should be carefully considered and consistent between regulatory bodies, not only because this will greatly influence the attractiveness or lack thereof, or becoming a benchmark administrator. As with the point above, thought should also be given to how, if this level of corroboration is to be required, the affect it will have on the administrators costs, and how they will seek to monetise the benchmark to cover these costs and ensure benchmark administration is a business activity with commercial rationale, rather than being done as a favour to the industry.
25. Where attestations are considered as a method of restoring trust in the individuals and bodies who are responsible for the production of benchmarks it should be questioned whether they will have sufficient value in the current environment or whether some sort of assurance would be needed. This is further considered within our guidance.

Question 6: Principles for benchmark calculation agents

Do you agree with the principles cited in this section? Would you add or change any of the principles?

26. We agree with the principles cited in this section but would seek further clarification that where the calculation of the benchmark is outsourced, whether the outsourcing company and individuals have to be regulated persons (as proposed by the FSA for administrators and submitters). If so this would likely push up the cost of the calculation agent's services.
27. We would also make the points regarded to attestation as raised in paragraph 24 with regards to calculation agents.

Question 7: Principles for benchmark publishers

Do you agree with the principles cited in this section? Would you add or change any of the principles?

28. We agree with the principles cited in this section. It would however be instructive to provide best practice information with regard to publication standards. Where the benchmark publisher must confirm that submission validation processes have been followed, this needs to be precisely defined and possibly assured.

Question 8: Principles for users of benchmarks

Do you agree with the principles cited in this section? Would you add or change any of the principles?

- 29.** We agree with the principles cited within this section, but as mentioned in paragraph 8, when considering the restoration of integrity within benchmarks it is important to consider not only the immediate users of the benchmark (those deigning and selling products) but the ultimate end users who buy benchmark-referenced financial products.
- 30.** With regard to principle F2, we would question how much confidence a benchmark user could gain from administrator disclosure of compliance, and how they would satisfy themselves that the rate is appropriate for their product. We believe that this is this sort of area where assurance work could have real value.
- 31.** Ideally users would have a contingency plan should the benchmark be unavailable, but this may be very difficult, especially in the case of benchmarks which have a unique place in the market, like LIBOR, which does not really have an equivalent replacement. There will also be a problem if contracts referencing the benchmark do not allow for replacement.
- 32.** As part of the ICAEW Financial Services Faculty's wider restoring trust agenda we advocate not only that providers of financial produces have to act responsibly but also consumers. We feel this could be underpinned in principles about users. In principle, users particularly creating structured products referencing a benchmark should be expected to consider the reasonableness of that benchmark for their purposes based upon the published rules for that benchmark. Ultimate consumers should have knowledge of the key features of the benchmark. For example, a LIBOR linked interest rate may not be appropriate for a small business or a retail customer as it is a potentially volatile wholesale rate which reflects the credit risk of other banks, as opposed to an administered base rate set by a central bank.

Question 9: Practical application of the principles

Are there any areas of benchmarks for which the above principles would be inadequate? If so, please provide details on the relevant benchmarks and the reasons of inadequacy.

- 33.** We believe the principles are generally adequate for financial benchmarks. There will be disparities in the ease of application, but practically and in principle with complex benchmarks such as LIBOR presenting a greater challenge. We do not believe such a challenge to be insurmountable, but it should be acknowledged.

Question 10: Continuity of benchmarks

Which principles/criteria would you consider necessary to be established for the continuity of benchmarks in case of a change to the framework?

- 34.** A transparent and probably extensive process would be required, with contract frustration considerations paramount. Contributors, the administrator, regulators and stakeholders to the benchmark should be consulted ensuring widespread market support for a change in benchmark is present before any transition is undertaken. A substantial legacy book of financial contracts is likely to present large issues for transition, especially where the 'last calculated rate' is taken at a time of stress, making it more difficult to justify carrying such a rate forward for the life of legacy contracts. Identifying all legacy contract participants will also present a significant practical challenge.

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