Benchmarks – do you understand the risks?

Aimed at Heads of Risk, Heads of Compliance and Front Office management and staff, this paper is designed to give a clearer understanding of benchmarks. A few years ago no one would have predicted the amount of press coverage and regulatory attention being given to benchmarks. Hardly a week passes without news of another allegation, investigation or fine related to the manipulation of a benchmark.

Estimates indicate that there are more than one million benchmarks in the UK alone – ranging from the price of milk to the London Interbank Offered Rate (LIBOR). Imagine that number multiplied by the number of financial centres around the world, the number of benchmarks is very large indeed.

The majority of benchmarks either 1) track assets in the real economy such as commodities, or 2) were developed to facilitate borrowing and investing for retail, corporate or institutional clients. The direct relationship between financial benchmarks and the real economy fuels the public, political and regulatory interest in those benchmarks and also fuels the hostility regarding their potential manipulation. Financial benchmarks play a fundamental role in valuing millions of financial instruments and amounts of payments under many financial contracts such as interest rate swaps, student loans, personal loans and mortgages. The Investment Management Association (IMA) estimates that its members manage over £4.5 trillion of assets, a significant portion invested in funds which track specified benchmarks.

Precisely what constitutes a benchmark depends on who you ask. Markets in Financial Instruments Directive (MiFID) and Market Abuse Regulation (MAR) use one definition, Section 22 of the Financial Services and Markets Act (FSMA) a different one, and EU Benchmark Regulation differs again. Broadly speaking a benchmark is defined as “any rate, index or figure made available to the public or published that is periodically or regularly determined by the application of a formula to, or on the basis of the value of one or more underlying assets, or prices, including estimated prices, actual or estimated interest rates or other values, or surveys and by reference to which the amount payable under a financial instrument or the value of a financial instrument is determined”.

What went wrong?

The underlying allegations, which resulted in investigations and fines, suggest that conflicts of interest were overlooked and data and submissions were manipulated for personal gain. In the case of LIBOR it is alleged that individuals from numerous firms colluded in providing improper submissions to move the benchmark for their benefit.

In the case of WM Reuters it is alleged that groups of foreign exchange traders used Bloomberg chat rooms to share market-sensitive information and then execute strategies to move the benchmark. The foreign exchange investigation is rumoured to be even more extensive than LIBOR (60+ staff at Financial Conduct Authority), reflecting the number of banks under investigation. We understand that at least 15 banks have launched internal investigations or received regulatory requests, and a number of those have suspended traders. The Bank of England has suspended an employee and launched an internal investigation into allegations that its officials condoned or were aware of the manipulation.

Historic and existing legislative and regulatory arrangements

With the benefit of hindsight, it now seems inconceivable that benchmarks weren’t regulated. How could it be that LIBOR, the most frequently utilised benchmark for interest rates in the world, referenced in transactions with a notional outstanding value of at least US$300 trillion, was unregulated? Being a submitter or an administrator wasn’t regulated, spot FX isn’t a regulated instrument, and the manipulation of LIBOR was not deemed to be a market abuse offence. All that came as quite a shock to most market participants and led to embarrassing questions of the regulators.

What next?

Regulators and policymakers are critically evaluating financial benchmarks to develop their understanding of individual benchmark mechanics and determining approaches to reform.

The UK was the fastest to take action, introducing two new regulated activities and two new controlled functions for submitters and administrators (for LIBOR only). International Organisation of Securities Commissions (IOSCO) followed in July 2013, launching its ‘Principles for Financial Benchmarks’ and requiring administrators to report back by July 2014 regarding their compliance with the Principles.

At a recent industry conference (Infoline Market Conduct), Will Amos, FCA Director for Wholesale Banking and Investment Management, listed benchmarks and benchmark compliance a ‘top risk’ of wholesale conduct. The FCA’s Risk Outlook 2014 references ‘benchmark manipulation’ in several places.
All regulators are recommending a combination of:

- enhanced transparency and disclosure;
- enforced codes of conduct;
- management of conflicts of interests; and
- deterrence in the form of tough new sanctions for manipulation.

EC proposed benchmark regulation

The EC proposed benchmark regulation is to date the most far-reaching in terms of applicability and scope. It imposes onerous requirements on ‘administrators’ and ‘submitters’ and will require ‘users’ to review and potentially revise their arrangements in terms of particular benchmarks in light of the restriction in usage of non-EU benchmarks. The key issues for each are:

Administrators

- Authorisation requirement (expected to be by the local competent authority, but may be ESMA);
- Publication of/adherence to a code of conduct; and
- Requirement to monitor data submissions to identify market abuse.

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- Requirement to sign-up to codes of conduct;
- Disclosure of conflicts of interest; and
- May not be able to cease their contribution to so-called ‘critical’ benchmarks.

Users (authorised firms only)

- Cannot use or reference benchmarks administered outside of the EU unless approved by EC and ESMA.

What should UK authorised firms do now?

Action to take depends on the firms’ business, defined by its role in the benchmark process:

Administrators

Firms that act as benchmark administrators should review their processes and procedures against the IOSCO Principles for Benchmarks. Administrators are expected to state publicly their compliance or otherwise by July 2014. Note that IOSCO stated that not all principles apply equally. If your benchmark is bespoke, or used by only a smaller subset of the market, it may be possible to negotiate away some of the more onerous requirements.

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We recommend that firms (particularly wholesale and institutional fund managers) perform a structured review to:

a) Understand whether you are or could be regarded as an administrator based on your involvement.

- Identify and assess data that is or could be used to formulate a benchmark and;
- Understand the usage of the data (internal and external), i.e. could particular desks be inadvertently performing an Administrator role? If so, what are the risks and commercial implications?

b) Review your benchmark contribution procedures:

- Understand the processes and risks; and
- Design effective and proportionate systems and controls.

Users

Users of benchmarks need to fully understand the benchmarks used within their firms and for what purpose. The review should include:

- Understanding which benchmarks are relevant to your firm;
- Identifying which of these benchmarks might be caught by the EU Benchmark Regulation;
- Understanding which products, financial instruments or financial contracts your firm (on a desk by desk basis) uses in relation to each benchmark;
- Ensuring that you only use those benchmarks that you understand, and are comfortable with how they comply with the IOSCO Principles;
- That where firms have a dual role, i.e. they contribute to and use a benchmark, ensure that you have effective controls in place to manage any conflicts of interest.

The EC Benchmark Regulation is still the subject of debate, therefore if your firm is impacted, now is the time to lobby either through a trade body or directly. In parallel, as stated in the FCA’s recently published Risk Outlook, the FCA expects firms to assess their use of benchmarks in relation to market integrity and more precisely conflicts of interest, so don’t delay.

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