

IOSCO STATEMENT



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THE BOARD OF THE INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

Statement on Matters to Consider in the Use of Financial Benchmarks

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IOSCO is today publishing a statement setting out matters for users of financial benchmarks (benchmarks) to consider in selecting an appropriate benchmark and in contingency planning, particularly for scenarios in which a benchmark is no longer available.

Objectives:

Benchmarks play a key role in the financial system's core functions of pricing and allocating capital and risk. They impact enormous volumes of credit products (including loans, mortgages, structured products, short-term money market instruments and fixed income products) and derivatives and have other uses.¹ Raising awareness on the proper use of benchmarks as set out in the statement plays an important role in embedding sound benchmark practice in the financial system.

In July 2013, IOSCO published the Principles for Financial Benchmarks (Principles)² which addressed conflicts of interest in benchmark-setting processes, as well as other matters related to benchmarks. (The Principles and related work by the FSB are described in more detail below.) IOSCO's previous work focused on the responsibilities of administrators of benchmarks and submitters to benchmarks. The statement, in contrast, is directed at users of benchmarks. Users are encouraged to consider the matters covered by the statement, as appropriate.

The statement does not supersede existing laws, regulations, guidance or standards or relevant regulatory or supervisory frameworks in specific jurisdictions, including any IOSCO Principles or undertakings agreed with regulators relating to a specific type of benchmark or related action. Rather, the statement is intended to help inform benchmark users and to complement existing IOSCO Principles.

¹ LIBOR and EURIBOR alone are referenced by US\$ 400 trillion volume of contracts, in addition to their use for other purposes such as valuation, accounting, taxation, and trade finance, according to the FSB OSSG Report on Reforming Major Interest Rate Benchmarks, published in July 2014.
http://www.fsb.org/wp-content/uploads/r_140722.pdf.

² <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf>

The statement sets out matters for users of benchmarks to consider. These fall into two overarching categories. First, there are matters related to assessing the appropriateness of a benchmark, in both its initial selection and ongoing use. Second, there are matters related to contingency planning, such as if the selected benchmark becomes unavailable. In both cases, the statement recognises users' reliance on benchmarks, aims to increase awareness of the risks involved and encourages their mitigation, where appropriate.

The statement recognises that, in many instances, users of benchmarks may not be able to provide any input to the characteristics of a benchmark or the terms of existing financial instruments which reference them. In cases where a benchmark is used in a contract between a financial firm and a retail client, for example, the retail client is likely to have little ability to change contractual terms. The financial firm is likely to have responsibilities towards that client. In considering the matters set out in the statement, it would also therefore be appropriate for the financial firm to consider its client's interests in a manner consistent with those responsibilities.

Background:

The Principles were endorsed by the Financial Stability Board (FSB) and G20 Leaders at the St Petersburg Summit in September 2013 as global standards. They have been used as guidance by benchmark administrators and financial regulators. In addition, based on the findings of an implementation review in 2014-2015, IOSCO published high-level guidance on how administrators of benchmarks should frame their annual statements of compliance with the Principles.

In parallel, and complementary to IOSCO's work, the FSB, through its Official Sector Steering Group (OSSG), has undertaken work to strengthen existing benchmarks for key interbank offered rates (IBORs) in the unsecured lending markets and to promote the development and adoption of alternative nearly risk-free reference rates (RFRs) where appropriate. The FSB has also been encouraging work by market participants to increase contract robustness for various financial products by including fall back provisions to apply in case an IBOR is discontinued permanently.

While the situation may differ amongst markets, in the case of some IBORs (such as LIBOR), underlying reference transactions have continued to experience decreased activity, increasing concern about their long-term sustainability.³ In this context, the FSB's most recent report⁴ notes that work on contract robustness – for existing and future arrangements - has taken on an increased importance, and further work is warranted, both by the public and private sectors.

³ In a speech given on 27 July 2017, Andrew Bailey, Chief Executive of the UK Financial Conduct Authority (FCA), as the regulator of LIBOR, highlighted the concern. While he set out the FCA's plan to support LIBOR until the end of 2021, he advised markets that the FCA would not maintain the benchmark through use of its authority beyond that date. See the text of the speech at: <https://www.fca.org.uk/news/speeches/the-future-of-libor>.

For the euro area, a number of European authorities recently announced the start of new work to identify and adopt an appropriate RFR. See the announcement at: https://www.ecb.europa.eu/press/pr/date/2017/html/ecb.pr170921_1.en.html.

⁴ <http://www.fsb.org/wp-content/uploads/P101017.pdf>

Matters to Consider in the Use of Financial Benchmarks

1. Considerations of appropriateness

It is important that users select a benchmark⁵ appropriate for their own current and future needs, as well as (where applicable) those of their clients. Users are encouraged to consider how well a particular benchmark meets their own and their clients' needs or hedging strategies. Information published or made available by the administrators in line with the Principles is likely to be useful for this purpose. Benchmarks can serve a valuable role when they are used appropriately. For example, a benchmark may be useful to manage financial risks efficiently.

Faced with a selection from a range of benchmarks, users may need to balance different risks and benefits. Benchmarks referenced in more liquid hedging instruments may not map closely to the risk the user is looking to manage. On the other hand, benchmarks that more accurately reflect the risk a user is looking to hedge may not be referenced in sufficiently liquid instruments.

Examples of relevant considerations of appropriateness for a user could be, to the extent they are applicable:

- the way in which the benchmark is determined, including the size, liquidity and potential evolution of the market being measured by the benchmark and other aspects of the relevant methodology, along with the transparency of the methodology;
- whether the benchmark provides an appropriately accurate and reliable representation of the market it seeks to measure, and is likely to remain so, and how factors that might result in a distortion of the price, rate, index or value of the benchmark are eliminated or reduced;
- in the case of interest rate benchmarks, whether or not it is desirable or necessary for the benchmark to include a term risk or credit risk element;
- how the benchmark is disseminated to users;
- the governance of, and accountability for, the benchmark determination process;

⁵ The term "benchmark" is defined under the Principles, as replicated below, and references in the statement to "benchmark" should have the same meaning. Other terms defined under the Principles should have the same meaning when used in the statement. However, "benchmark user" and "use" are not defined terms under the Principles. Nevertheless, use of a benchmark is described in limb c) of the definition of "benchmark" and, for the purposes of the statement, use and a user have the meanings indicated.

Benchmark: prices, estimates, rates, indices or values that are:

- a) Made available to users, whether free of charge or for payment;
- b) Calculated periodically, entirely or partially by the application of a formula or another method of calculation to, or an assessment of, the value of one or more underlying Interests;
- c) Used for reference for purposes that include one or more of the following:
 - determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments;
 - determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument; and/or
 - measuring the performance of a financial instrument.

- the process by which changes to the benchmark’s methodology can be made, e.g. relevant consultation procedures;
- how the administrator deals with significant decisions affecting the compilation of the benchmark and any related determination process, including contingency measures in the event of insufficient or no inputs (e.g. the use of expert judgment), market stress or disruption, and failure of critical infrastructure;
- the provisions which could apply in the event of material changes to the benchmark and how they would operate in practice; and
- whether, and under what circumstances, provisions relating to cessation of the benchmark should apply.

The considerations may vary depending on the circumstances, including the characteristics of the user and the types of contract or financial instrument referencing the benchmark. Users are encouraged to assess the relevant considerations not only on the initial selection of a benchmark, but periodically on an ongoing basis, as circumstances indicate.

2. Contingency planning

Various factors, including external factors beyond the control of an administrator of a benchmark, might result in material changes to, or cessation of, the benchmark, including where an administrator is no longer able to determine a reference rate or other figure for whatever reason. Such a change or cessation of a benchmark could involve factors including, but not limited to, changes to market structure or product definition, any other condition which makes the benchmark no longer representative of its intended function or a situation relating to the financial creditworthiness or operation of the administrator. The cessation of a benchmark, in particular, could create uncertainty for financial contracts and instruments, and even, in some cases, render them invalid, causing losses to users (and their clients, as applicable), and an adverse impact to market functioning and financial stability.

Users should therefore consider their contingency plans in the event a benchmark is no longer available or materially changes in order to mitigate the potential risks involved. Users are encouraged to produce and maintain clear, comprehensive and robust written policies and procedures on actions they would take in such an event. Users should consider any regulation, guidance or views of relevant authorities in determining which policies and procedures are, or may be, appropriate in respect of a particular benchmark, ensuring they fulfil responsibilities towards their clients who may also rely on that benchmark. Factors which users may consider include whether the policies and procedures are proportionate to the estimated scope of existing and future financial contracts and instruments that reference a benchmark and the potential impact that might result from the cessation of, or material change to, the benchmark.

Where feasible and appropriate, contingency plans for the cessation of a benchmark should include users’ having sufficiently robust fall back provisions in their financial contracts and instruments. These provisions should ideally involve at least one alternative or fall back rate and/or other figure as a substitute for the benchmark originally referenced should it no longer be available. Users should also seek to reflect their contingency plans in their contractual arrangements.

Ideally, fall back provisions would be in place for existing, and should be put in place as well for future, contractual arrangements. While amendments to current contracts may be more difficult to achieve than including appropriate fall backs in new contracts, users should also consider adding appropriate fall backs to current contracts where possible.

The Principles, in particular Principle 13, deal with the scenario of a possible cessation of a benchmark, mainly in relation to measures for administrators. They also provide that administrators should encourage users to have robust fall back provisions in relevant contracts and instruments that reference a benchmark.

To complement measures taken by an administrator, the fall back provisions developed by users should apply in any potential circumstance where the measures taken by an administrator may fail to result in a sufficiently robust solution that meets users' needs. It is important that users understand how their fall back provisions (as applicable) would operate, if triggered.

The existence and operation of robust fall back provisions could help protect the users (and their clients, as applicable) against the risks of relying on a particular benchmark. They may help reduce or prevent potential wider market disruption. More specifically, if a permanent discontinuation of an IBOR or other benchmark occurs, the fall back provisions would need to be robust enough to prevent potentially serious disruption to markets and market participants (including users and their clients), and to safeguard the continuity of contracts, as a result.

In determining the suitability of a particular alternative rate or figure, factors that would be important for users to consider, as appropriate, include:

- how credible the alternative rate or figure would be, including how closely the alternative matches the original benchmark's characteristics, how economic differentials between the alternative rate or figure and the original benchmark figure are minimised, the extent to which an alternative rate or figure meets the needs of the parties and the availability of data on the alternative rate or figure;
- whether and how the original benchmark and the alternative rate or figure could be maintained in parallel for some time in order to accommodate an orderly transition to a new benchmark;
- the time at which the fall back rate or figure would start to operate, taking into account the term of the contracts and the tenor of the financial instruments referencing the benchmarks, and the adequacy of notice involved; and
- the impact on the economic value of the financial contracts and instruments referencing the benchmark, in particular ensuring that the alternative rate or figure would be reasonable and fair.

However, even where a close proxy of the original benchmark is not available, the user should consider having some form of fall back provision in place to mitigate the uncertainty and disruption which may otherwise arise.

More specifically, for IBORs, suitable fall back provisions could include a series of alternative rates or figures, using one or more of the following elements, as examples:

- the relevant RFR chosen by the group working with OSSG members to help identify alternative rates or figures for each relevant currency area, plus or minus a reasonable and fair designated spread, where applicable; and

- one or more other rates or figures,⁶ each of which might be used directly or by applying a reasonable and fair adjustment factor based on the historical relationship between the fall back rate or figure and the discontinued original rate.

Users are also encouraged to keep themselves informed about, and, as appropriate, to consider engaging in, market initiatives to develop contingency plans to be followed in the event of a material change to, or a cessation of, an IBOR or other benchmark. These initiatives may be helpful to users, particularly in considering fall back provisions which may be used in standard documents.⁷ Although users should not be unduly constrained by standards developed by other users or associations of users, they may find it advantageous to take account of the development of those standards. Advantages to wide adoption of similar solutions include the potential mitigation of basis risk to the extent that users opt for consistent fall back rates or figures.

⁶ They could include an alternative IBOR, if it is available, which has been successfully reformed in line with the Principles and the complementary FSB work and is not likely to be materially affected by the same issues that caused the cessation of the initially selected IBOR.

⁷ Where collective work to identify fall back rates or figures is undertaken, it should be conducted in as open a manner as is practicable, be based on clear, open and transparent criteria, and observe relevant competition law requirements.