Deutsches Aktieninstitut

Benchmark Regulation and Non-Financial Companies

Danger of serious market disruptions due to reduced availability of benchmarks

Position Paper on the Proposal of the EU Regulation on indices used as benchmarks in financial instruments and financial contracts, 23 October 2014

Introduction and General Remarks

This position paper of Deutsches Aktieninstitut[1] summarizes the view of German non-financial companies on the proposed EU benchmark regulation.

Non-financial companies regularly use financial instruments and contracts that are referenced to indices or benchmarks. Corporate bonds or credit agreements may be referenced to an interest rate benchmark in order to easily cope with movements of interest rates in the market. In addition, derivatives are widely used by non-financial companies to manage financial risks relating to operative or financing activities. These derivatives may be linked to interest rate, commodity price, foreign exchange and other benchmarks or even equity indices depending on the source of risk to be managed. Similarly, pension vehicles use benchmark-related instruments in their asset and risk management (e.g. equity derivatives to manage short-term risks stemming from an equity investment).

All these financial instruments and contracts would fall under the broad scope of the proposed benchmark regulation, so that companies of the real economy are indirectly affected.

In general and as end-users, non-financial companies are interested in indices and benchmarks being set in a transparent and reliable manner. At the same time, they wish to have a sufficient spectrum of indices available to meet the individual companies' needs. These two objectives of non-financial companies form the background of the analysis of this paper.

From Deutsches Aktieninstitut's point of view the proposed regulation will introduce a number of new and very detailed requirements. The high regulatory intensity will make it more costly to provide a benchmark to the market or contribute data to its calculation. Also the failure to comply with the requirements of the proposed regulation can lead to a prohibition to calculate the index (Article 7, paragraph 1 (c)), a refusal to grant a license (Art. 19, 20), the revocation of a license (Article 24) and to considerable administrative measures and sanctions (Art. 31) for the index provider. The use of indices not administered in the EU might even be generally banned for financial institutions in the EU (Art. 20).

[1] Deutsches Aktieninstitut (identification number: 38064081304-25) represents the entire German economy interested in the capital markets. The about 200 members of Deutsches Aktieninstitut are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt, Brussels and in Berlin. This position paper is based on discussions in the working committee on corporate treasury/corporate finance consisting of representatives of the treasury departments of German non-financial companies.

As a consequence, for example the valuation of derivatives could become significantly more difficult, if "neutral" and widely accepted benchmarks were missing on the market. Contract disputes would be inevitable in such a case. It is also unclear from our point of view what would happen to existing financial contracts/instruments in the case of the termination of an index, because rules on existing financial instruments appear to be widely missing. The possible restriction to examine objectively terms and conditions of financial instruments and contracts by the use of benchmarks, as well as the risk that existing financial contracts could lose ex post their contractual basis, is seen with great concern by non-financial companies.

Overall, there is the general concern among non-financial companies that the proposed benchmark regulation will have a number of unintended negative consequences for a wide range of financial contracts and instruments which are currently used by non-financial companies.

In particular, **non-financial companies fear that the proposed benchmark regulation could eliminate reliable and well-proven reference values of financial instruments and contracts**. This may happen when index providers retreat from the business due to cost and liability considerations. Or it may happen because they are forced to do so due to regulatory action. Besides, the regulation will likely lead to an increase of the costs for getting index data.

The risk of reduced availability holds particularly true for benchmarks administered outside the EU that may be banned completely due to the third country requirements of Art. 20 which should carefully be evaluated.

In addition to that, **non-financial companies may also be negatively affected by elements of the proposed regulation that govern the process of contributing to benchmarks** as they may contribute to commodity indices in some cases. In particular, the publication of input data will be highly problematic because business and data protection interests are not appropriately acknowledged. It should, therefore, be deleted.

Against this background, D**eutsches Aktieninstitut recommends a rather narrow scope of application and a generally lower regulatory intensity** in order to better balance the costs and benefits of the regulation.

More concretely, Deutsches Aktieninstitut recommends to give market participants more freedom to decide whether a specific benchmark will be used in a particular situation. Thus, **Deutsches Aktieninstitut believes that transparency of the process of benchmark calculation rather than detailed obligations with respect to this process itself** should be the ruling principle of the regulation. If the former was the guiding principle, the regulation would help market participants to make informed decisions but would not precedent the decision itself. In particular, regarding

benchmarks from third countries this would significantly lower the risk of reduced availability.

In addition to that, regulators should recognize the fact that the manipulation of benchmarks is already prohibited and any infringement of this prohibition are regarded as a criminal offense according to the revised Market Abuse Regime. Thus, there are already appropriate incentives not to manipulate index data as well as the process of index calculation. Against this background, it appears even more reasonable to choose a less strict regulatory regime in the benchmark regulation.

The remainder of this position paper clarifies and substantiates our arguments in detail.

1 Scope of application and Intensity of Regulation

Articles 2 and 3 define a very wide scope of application. Almost every combination of prices or other input data in a single number or ratio by applying a formula falls under the definition “index”(Article 3, Section 1 (1)). In addition, Article 3 paragraph 1 refers to the former, already very wide MiFID definition of a financial instrument. We assume that the reference will be changed in the future according to the new definition in MiFID II, which has just been finalized. The term “financial instrument” would have an even wider scope and thus would also cover a wider range of potential products. In particular, emission allowances would be covered. Moreover, the MiFID definition of commodity derivatives has been extended to derivatives with physical delivery.

From the perspective of non-financial companies there are **the following concerns** with regard to the scope of application:

- Firstly, a very broad definition will likely include rather customized indices. If all provisions of the proposed regulation were applied equally to all indices irrespective of how widely they are used, costs for calculating or risks for offering an index could easily (see above) rise to a degree turning the provision of the benchmark into something no longer economically justified. Deutsches Aktieninstitut would, therefore, prefer a narrower scope. The **scope should ideally be limited to the widely used indices which have been the cause of the regulation** ("critical benchmarks" (Article 3, Section 1 (21)).

- Secondly, the proposed regulation could be read as if also **benchmarks that are purely bilateral or only offered to a small group of users could be in scope**. An example are "baskets" which are used in the hedging of currencies. In our view, putting these benchmarks in scope would significantly alter the cost-benefit-analysis on the side of the providers, without providing advantages to a wider public. It should, therefore, be made clear in a recital that bilateral or specific agreements for limited numbers of users are not aimed at by the term “published or made available to the public” in Article 13, paragraph 1 (1) (a).

- Thirdly, **Article 15 and Article 18 (1) restrict the freedom of contract** and may therefore in the present form lead to restricted use of existing indices. According to Art. 15, it would be up to the index provider to determine under which circumstances the index may be used. Furthermore, according to Art. 18 (1), the financial institution would only be allowed to use the index in a financial instrument/contract if its suitability for the

customer had been assessed. We would appreciate the explicit clarification that the customer has a say in the course of this process, so that he decides on his own whether he wants to use a "benchmark" or not.

- Lastly, in our understanding the proposed regulation **also covers the fixing of exchange rates**. Here again, the same conflict arises: On the one hand, companies of the real economy have an interest that important reference exchange rates are determined in a reliable and transparent manner. On the other hand, too far-reaching regulations may have the unintended effect to decrease the participation in the voluntary process of the fixing and to displace such extremely important benchmarks from the market. This would have negative consequences for legal certainty and the practical application, which would also affect the determination of fair market values on key dates.

2 Transparency Instead of Prohibitions

Given the high degree of organizational requirements arising from the regulatory proposal, we are concerned that providers of indices (as well as the contributors supplying the data for the determination of a benchmark) could withdraw from the process. The European Commission seems to share this concern, because it has established an obligation to contribute to the process of index calculation for certain cases ("mandatory contribution", Article 14).

In general, non-financial companies would therefore prefer if index providers had to disclose whether they comply with the requirements of the EU Regulation. This would be less disruptive to the market. Users of a financial instrument or a financial contract could then decide for themselves how important the compliance with all requirements of the proposed regulation is to them. Companies of the real economy, which use financial instruments as professional users, are competent enough to make this decision. Thus, the question which index and which process of determination is accepted by professional market participants would be determined by market forces.

This process of market control can already be observed today. Companies are already using various alternatives to criticized indices such as LIBOR and EURIBOR. In contrast, under the current proposal it would solely be the supervisory authorities, the European Commission or the legislator who decides which index can further be offered to market participants under which conditions.

3 Third Country Equivalence

For non-financial companies the planned **provisions for benchmarks from third countries (Art. 20) are extremely problematic**. Article 20 states that benchmarks, which are calculated outside the EU, could only be used in financial instruments and financial contracts in the EU if the set of rules in the relevant third country successfully passes an equivalence test. However, **the EU regulation is very restrictive compared to international standards**. To our knowledge not many countries have shown any activities in this area to date. It can, therefore, be expected that supervised entities in the EU will no longer be able to reference most third country benchmarks, which could even include those of the U.S.

For companies of the real economy with operations worldwide this may, e.g., have the effect of a significant limitation of their hedging possibilities regarding the financing of foreign subsidiaries by "non-deliverable cross-currency swaps" referencing also foreign indices. But there would also be effects on financial contracts, which, e.g., draw upon U.S. interest rate indices or any non-European stock index, which could cause problems for the pension funds of companies.

For all financial instruments and contracts that reference a non-EU index European banks would be forced to withdraw from the business with customers. As a consequence, this would not only be a significant competitive disadvantage for European banks. It would also deprive many end-users from the use of beneficial financial instruments or at least significantly reduce the number of potential contractors and increase the cost of hedging. In addition, the liquidity of the products concerned may be significantly reduced which would translate into a less reliable pricing of the respective instruments.

It appears to be unlikely that there is the intention of the legislator of causing any of the abovementioned negative effects. They should therefore be avoided.

At least for non-European indices it should be sufficient to inform the customer that the index has not been set up under European index regulation. It would then be up to the end customer to decide whether he/she wishes to continue using the financial instrument/to leave the financial contract in place.

4 Contribution to Benchmarks

Normally, non-financial companies do not contribute input data to the calculation of indices/benchmarks. However, there are some exceptions from that rule with respect to commodity benchmarks in particular. Accordingly, **non-financial companies may also be affected by the rules governing the process of collecting input data**. There are at least the following concerns among non-financial companies that should be addressed in the final text:

- Art. 16 of the proposed regulation will oblige the administrator of a benchmark to publish **input data**. If this obligation indirectly uncovers sensitive information from financial or non-financial companies contributors will most likely stop the contribution to the benchmark in question. It is worth noting that delayed publication of sensitive data as proposed will not help in the relevant cases, because also under this condition competitors may get insights in confidential or otherwise sensitive information. Thus **Art. 16 needs to be deleted** or at least redrafted in order to avoid that other market participants could draw any conclusions on competitors or counterparties from the data published.

- **Non-financial companies** regard any contribution to a benchmark as purely voluntary. They are, therefore, **concerned that they may fall under the obligation of mandatory contribution** (Art. 14). This may happen if they were regarded as regulated entities according to Art. 3 (14).

- If non-financial companies contribute to indices/benchmarks they will also have to comply with the other duties of contributors. Among these complying with the code of conduct of administrators of indices/ benchmarks (Art. 9) and obligations with regard to the process or data provision (Annex 1, Section A) may cause problems. Regarding the former it should be **ensured that contributors have a voice in developing the respective code of conducts** so that administrators cannot “dictate” the compliance duties without any discussion. Regarding the latter the **obligation to separate front office functions and reporting lines before being permitted to contribute data goes too far** (Annex I Section A, Article 8 (b)). This obligation will reduce the quality of data provided as only front office employees have the deep knowledge about markets that will guarantee high-quality judgement of market developments that is particularly relevant in survey-based-benchmarks. In addition, it should

be noted that contributing to benchmarks is not the core business of non-financial companies so that any additional duty will reduce the willingness to contribute. A duplication of function will surely drive the cost-benefit-analysis into the negative.

5 Transitional Provisions

As mentioned above the regulation may lead to a situation where a benchmark ceases to exist or the provider chooses to stop the provision of the benchmark. Regulators should be aware that in case of a (forced) cessation of a benchmark an enormous number of contracts may lose their contractual basis or need renegotiation. Thus, the **transitional requirements need extremely careful evaluation**. In essence, at least long periods of continuity should be aimed at in order to avoid market distortions.

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