Comments

regarding the European Commission's proposal for a regulation on indices used as benchmarks in financial instruments and financial contracts

Register of Interest Representatives
Identification number in the register: 52646912360-95

Contact:
Dr. Reinhold Rickes/Dr. Holger Schulz
Telephone: +49/30/20225- 5303
Telefax: +49/30/20225-5305
e-mail: reinhold.rickes@dsgv.de

Berlin, 22. November 2013

The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

Coordinator:
German Savings Banks Association
Charlottenstrasse 47 | 10117 Berlin | Germany
Telephone: +49 30 20225-0
Telefax: +49 30 20225-250
www.die-deutsche-kreditwirtschaft.de

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On 18th September 2013, the European Commission released its proposal for a Regulation on "indices used as benchmarks in financial instruments and financial contracts". The German Banking Industry Committee (GBIC) has closely analyzed and assessed the proposed regulation. This process has given rise to a series of suggestions, which, in our opinion, would make the proposals in question more effective, but also more practicable. In this respect the following comments conform with the IOSCO standards as well as the principles pursued by the European supervisory bodies ESMA and EBA.

1. General assessment

The European Commission's legislative proposal is of great importance because indices play a significant role for a multitude of financial instruments and financial contracts. In view of their key economic importance as credence goods and in the light of the disclosed suspected attempts to manipulate key interest rate benchmarks, it is also in the market's interest to establish a uniform supervisory and regulatory framework in the EU as a basis for the future governance of benchmarks.

The German Banking Industry Committee welcomes the Commission's approach to use the instrument of a Regulation to create a legal framework for the market of publicly available benchmarks, which aims at obviating abusive behavior, enhancing stability and reliability, and strengthening the responsibility of benchmark administrators. In this respect, we also welcome the fact that the European Commission's proposals are in line with the measures which have already been implemented or are about to be implemented by administrators, contributors and supervisory authorities for benchmarks such as Euribor.

However, the provisions must not unintentionally impede the determination and provision of indices and benchmarks in such a way that customers' needs cannot be met and market functionality is impaired. This would be a possible consequence if the requirements imposed on administrators as well as contributors were so high that the provision of indices and benchmarks had to be ceased or could not be established in the first place. Especially in the case of "smaller" indices which are only used on a very individual basis, requirements regarding the contributors' and administrators' processes should leave more room for proportionality. We consider this absolutely appropriate and necessary.

Indices which exclusively serve to underlie financial instruments which are traded on a Multilateral Trading Facility should be exempted from the scope of this Regulation. At any rate, a grandfathering concerning the obligations of index providers for their already existing "strategy indices" which are only being used until existing financial instruments have expired, ought to be introduced.

The requirements for internal processes need to be practicable and proportional to the importance of the benchmark in question. For most benchmarks, the record-keeping of natural persons charged with the task of data provision is excessive. The same applies, mutatis mutandis, for the administration of own indices where data is provided internally. The continuity of existing contracts and financial instruments that use a particular benchmark as reference needs to be safeguarded in order to ensure legal certainty for the parties to the contract in question as well as for the issuers.

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We reject the newly proposed obligation for credit institutions - which is alien to the system - to provide advice to persons taking out consumer and mortgage credits regarding the suitability of the benchmark and of the credit itself as unfounded. Regarding the obligation to provide advice, it should be pointed out that the framework of the Consumer Credit Directive 2008/48/EC, dated 23.4.2008, has given a preference to an obligation to provide information and adequate explanations. This assessment has been corroborated by the text already agreed on by the European Parliament for the Directive on Credit Agreements relating to Residential Property. This assessment should be taken up in the Benchmark Regulation and should result in a decision to waive this obligation to advise.

The draft Regulation contains specific mechanisms designed to guard against the abuse of benchmarks. In our opinion, the intention of these prescriptions is embodied in the Explanatory Memorandum of the proposal[1], namely that an index cannot be categorized as a benchmark if third parties use it in an unauthorized manner without the index provider being aware of this fact. However, the rules laid down in the draft only protect administrators of already existing benchmarks, but not providers of indices which may possibly not qualify as benchmarks yet. In this field, either the existing proposals need to be calibrated or else the draft Regulation needs to be supplemented in favor of index providers.[2] Furthermore, the draft Regulation does not provide for protection of index providers who know that their indices are used by third parties as a reference for financial contracts, thus as a “benchmark”. They would unintendedly become “administrators” and fall within the scope of the draft Regulation.

The proposed notification process for obtaining approval to use indices is not compatible with the current practice of issuers of financial instruments. The draft Regulation should take this into account. The measures we are suggesting here (see point 7) would, in addition, be of relief for the competent authorities.

All in all, the German Banking Industry Committee sees the danger that especially market activities of administrators of publically available benchmarks, might be crowded out, if the draft Regulation were to remain in its present form. To avoid this it would be a welcomed step if the banking industry in Europe were to be broadly integrated into the discussion process. After all, the concrete provisions give rise to wide-ranging questions which will need to be clarified in further parliamentary deliberations.

2. Definitions (Article 3)

We welcome the uniform definitions of key terms by reference to already existing union law. This enhances the clarity and consistency of the provisions. The draft Regulation defines numerous market activities in relation to benchmarks which have already been defined in other legal provisions. It should be noted in particular that the definitions of "financial instrument“, "supervised entity“ and "financial contract“ set out in Article 3 of the draft Regulation are consistent with the definitions enshrined in MiFIR,

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[1] *„Finally, in some cases a person may produce an index but not be aware that this index is a benchmark because, for example, it is used as a reference to a financial instrument without the knowledge of the producer”*

[2] *The mechanism in Art. 4 protects only benchmark administrators. The mechanism in Art. 25 may protect indices, but refers to an "administrator", which is - strictly speaking related to benchmarks (Art. 3 Section 1 (4)) and not indices.*

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AIFM, UCITS and other union legal acts. Taking into account that the definitions refer, in some cases, to EU Directives which give member states leeway for implementation in national legal frameworks, it is of vital importance that a uniform EU-wide definition of the terms in question be obtained in order to safeguard a smooth functioning of the markets. A clear and unambiguous formulation of definitions is a relevant issue for all market participants. In the following section we would like to cover in more detail still undefined - or not clearly enough defined - terms.

a) "Benchmark" and "index"

The definitions of the terms "index" and "benchmark" in Article 3 of the draft Regulation are not precise enough. Applying a strict interpretation, the proposed definitions would even turn someone indirectly into an administrator of a benchmark who calculates a fixing for a floating rate bond (e.g. "3*Euribor+50bps*days; 30% of DAX performance in the period * days / 360" or "DAX performance minus STOXX performance * days / 360"), which he has to publish in the electronic Federal Gazette ("Bundesanzeiger") pursuant to the Transparency Directive (§ 30b Section 2 No. 2 German Securities Trading Act WpHG).

Furthermore, it would be necessary to specify the definition of the term "benchmark" (Article 3 Section 1 (2)) in order to prevent future interpretational misunderstandings. It would be necessary to clarify that the "determination" of the amount payable under a financial instrument or a financial contract or the value of a financial instrument means the direct referencing to an index.

We would also like to point out that the definition of the term benchmark deviates from the intended definition in Article 2 Section 1 (24) MiFIR. However, we consider conceptual consistency to be absolutely imperative in the case of the term "benchmark" and would therefore suggest that the MiFIR legislation, which is currently still going through the trilogue process, should be adapted. In the interests of improved readability, the sub-items in both Article 3 Section 1 (1) and Article 3 Section 1 (3) should be linked by an "and".

In addition, it is also of great relevance that terms within the draft Regulation should be consistent. For example, Article 4 defines the unauthorized use of a "benchmark". However, Article 25 suggests the assumption that what is actually meant in Article 4 is the unauthorized use of an "index". According to the Explanatory Memorandum introducing the proposal, the intention of this provision is that an index cannot be categorized as a benchmark through unauthorized use by third parties of which the index provider is unaware. A corresponding adjustment to Article 4 is therefore urgently required.

b) "Contributor"

The term "contributor"(Article 3 Section 1 (7)) requires a further clarification. A natural or legal person should not become a contributor solely because of the fact that the data collected and/or provided by them is used by a third party to establish a benchmark, even if this is not their intended purpose.

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Contribution can only be understood as an active process, in this case active communication to an administrator.

Financial instruments, however, often use publicly available data from neutral/official bodies - for instance statistical data from statistical offices or government agencies (e.g. price indices such as Germany's Harmonized Index of Consumer Prices, which is also used, for example, as reference in many rental contracts). Such data could, assuming a broad interpretation of the definition be construed as an index in the sense of Article 3 Section 1 (1) of the draft Regulation.

These neutral/official institutions do not provide data expressly as a reference for financial products. Therefore they cannot be regarded as "contributors" in the sense of Article 3 Section 1 (7). We understand that Article 25, according to which an index provider cannot be turned into the administrator of a benchmark against his will when the index in question is being used within the framework of a financial instrument, also applies to contributors.

On the basis of the existing definition laid down in Article 3 Section 1 (4) of the draft Regulation, it remains possible that a neutral institution as described above automatically becomes an administrator, provided that the data this institution provides is used as a direct reference for a financial product by third parties. However, such neutral institutions are often neither aware that the data they publish is being utilized by third parties nor of the purposes such third parties are pursuing. Independent data collection by the administrator is no alternative.

Therefore we would like to put forward the suggestion that, for such cases a category of indices should be established which is excluded from the Regulation’s scope. Our reasoning here is that a neutral body (like a statistical/government agency) cannot be made subject to the regulatory requirements of the proposal and to the concomitant contractual commitments simply because its data has been utilized to establish a benchmark. It would be an unreasonable imposition - not least because this would probably not be compatible with their tasks or could entail unforeseeable liability risks for them. As a result, economically highly relevant data may possibly not be available as a reference for financial products.

c) "User“ and "consumer“

The definition of the term "user“(Article 3 Section 1 (5)) is too broad and needs to be specified more precisely. This can be seen in the partial overlap with the definition of the term "consumer“ (Article 3 Section 1 (18). A person who is a “consumer” should as a matter of principle, not be considered as a "user".

3. Differentiation of the scope

The scope of the draft Regulation is very broad, especially with regard to the requirements for internal governance and control. On the one hand this approach takes no account of the variety of different benchmarks (and of the different ways in which they are determined); on the other hand, it could follow

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that the establishment and use of a large number of indices and benchmarks is simply no longer practicable. Although the draft Regulation provides for some gradations in its requirements, depending on the complexity and size of a particular benchmark, further differentiation ought to be considered in the interests of practical implementation and usability. It is important for us to emphasize that this does not mean in any way that supervision and control of benchmarks should be weakened. The point is that internal processes need to remain practicable and proportional to the importance of the benchmark in question.

It would, for example, be conceivable to introduce a **multi-category approach**, providing for a more proportionate use of specific provisions. What is beyond dispute is that a high degree of regulation needs to apply in the case of critical benchmarks. By contrast, transaction-based benchmarks (for more on this point please refer to the section "Input data" below) require less extensive governance and control regulations. “Strategy indices”, mentioned in point 1, which are only used in bilateral contracts, could be regarded as a further category and should be excluded from the scope of the proposed Regulation.

a) "Exclusion of UCITS and related management companies from the area of application"

The draft proposal in Article 3 Section 1 No. 2 incorporates benchmarks of UCITS (for example composed of 50% DAX / 50% REX) into the scope of the Regulation. The outcome of this would be that UCITS management companies would end up classified as administrators of benchmarks within the meaning of the Regulation. This is neither appropriate nor equitable. UCITS and related management companies should be excluded from the scope of the Regulation.

The proposal is aimed at the relation between the benchmark underlying, and the price relating to a given financial instrument. Such a relation is not in evidence in the case of UCITS. The net asset value (NAV) of a UCITS is independent of the benchmark in question. Rather, UCITS employ benchmarks to measure their own performance. Further, it should also be borne in mind that UCITS - and thus related management companies too - are already adequately regulated by ESMA (cf. the guidelines on ETF and other UCITS issues, ESMA/2012/832), which establishes precise requirements and conditions for the use and the transparency of indices and benchmarks relating to funds.

b) "Input data“

The draft Regulation explicitly demands the use of transaction-based data to determine benchmarks. However, the proposal should take stronger account of the specific features of transaction-based data in comparison to expert estimates. More specifically, the draft Regulation aims in particular at limiting the potentially negative influence of discretion and estimates when determining a benchmark. However, such discretionary leeway does not exist in the case of transaction-based benchmarks, or certainly not to such an extent. It is therefore too much of a “one-size-fits-all” approach to establish the same requirements regarding internal oversight control and governance. We regard existing procedures, such as the principle of double check (German law speaks here of the "four-eyes principle"), an exact documentation of the underlying transactions and the oversight of the calculation process by a neutral department, as being

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sufficient. We therefore believe that, in the case of transaction-based benchmarks qualitative reliefs concerning the governance and the control/supervision function (for example, when it comes to managing conflicts of interest) are necessary to find a solution which will prove practicable in the market.

We advocate that the ruling provided for in Article 7 Section 1 (c) should also be applied in the case of transaction-based data. However, we would furthermore suggest that it should be possible to utilize suitable statistical measures of competitiveness and concentration.

The specifications on accurate and sufficient data for interest-rate-benchmark, included in Annex II of the draft, raise many questions. Requirements concerning internal processes need to remain practicable. We believe that the record keeping of natural persons charged with the task of data provision is excessive. Furthermore, there is the question of how to deal with estimates and when exactly expert estimates or judgments can be used to determine a benchmark. For example, provisions such as "third parties to contributors in the same markets and expert judgment may be used to determine…" and further remarks on "sufficient and accurate data" with reference to Article 7, as well as in Annex II, are not clear and unambiguous. In the further legislative process, care should be taken to ensure that benchmark diversity is not unnecessarily curtailed.

Furthermore, it seems not meaningful to reproduce an unsecured interbank money market with the help of, for example, collateralized central-bank operations; precisely this appears to be intended by points 4 and 5 in Annex II.

4. Governance and controls

From the market's point of view, it is unclear how the governance and control requirements set out in Article 11 of the draft can actually be implemented, especially in the case of "close to the market" benchmarks. The logical consequence of the requirements concerning conflicts of interest would surely be that treasury and trading divisions in particular could not be permitted to be "submitters." And yet it is precisely in these departments that market-related expert competence has a considerably higher profile than, for example, at a "Controlling unit." In general, it must be possible that market experts in an institution participate in the process of contribution because after all, expertise can only be obtained by participation in the market. A complete functional and organizational separation, for example between "contribution of input data" and trading-related/market-related units (at a bank for instance) might be practicable only in a few cases, for example for contribution to critical benchmarks. For the majority of existing benchmarks this would not be manageable, also with regard to available internal resources. It would therefore be expedient to narrow down the concept of "conflict of interest" in the draft Regulation. At any rate, the formulation "any existing or potential conflict", used in Article 11 Section 1 (a), is too broad in scope, and ought to be restricted to business activities which are directly related to data reporting.

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5. Critical benchmarks

The definition of the term "critical benchmark" in Article 3 Section 1 (21) of the draft comprises a fixed nominal threshold to determine what a critical benchmark is. However, it is of no help to focus on a fixed nominal volume size. Depending on the market environment, the threshold of EUR 500 billion could be crossed (upwards or downwards) within a short time-frame. We would like to suggest using nominal volume as a minimum criterion and that other additional qualitative criteria should be used. Qualitative criteria for critical benchmarks play a central role in view of the latter's socio-political, and major economic, functions; they are tantamount to public goods. We deem for example the number of contributors and/or the ratio of contributors (and the market volume they represent) to the volume of the relevant overall market as an appropriate measure in order to be able to assess whether a particular benchmark is critical for the functioning of the given market.

With regard to mandatory contribution provisions (Article 14), it needs to be borne in mind that the cession of a critical benchmark can have far-reaching consequences. These consequences will likely reach far beyond repercussions on the financial instruments and financial contracts that are referenced to it. A continuation scenario must therefore be ensured which rests on an appropriate number of contributors. Mandatory contribution is not to be rejected outright, although it does certainly imply a significant impairment of institutional autonomy.

However, obliging an institution to contribute could expose this institution to liability and reputational risks and potentially high financial burdens could also result due to the internal adjustments that would have to be made in order to fulfill the structural and governance requirements established by this Regulation. Especially the liability risks for contributors being obliged to contribute ought to be appropriately taken into account. We consider the concrete proposal (mandatory contribution in the event of at least 20% of the panel members dropping out) as being unsuitable. The ability to represent a certain market is based not on relative changes but rather on an (absolute) minimum of participants (and, possibly, on the market share which they represent). This issue ought to already be addressed when it is a question of establishing the benchmarks in the Code of Conduct. We deem it also as critical that the competent authority responsible for the administrator should be given the power to oblige institutions to join a panel. In the event of banks being panel members, this decision should rather be taken by the bank concerned in co-operation with their competent national authority.

6. Assessment of suitability

A supervised entity (e.g. a credit institution pursuant to Regulation (EU) No 575/2013, Article 4 Section 1 point 1), which enters into a financial contract with a consumer is bound, on the basis of Article 18 Section 1, to obtain information indicating "...the consumer's knowledge and experience with respect to the benchmark, his financial situation and his objectives in respect to that financial contract" and to evaluate, taking into account the benchmark statement published in accordance with Article 15, "whether referencing the financial contract to that benchmark is suitable for him". Ultimately, this raises the question as to what "suitable for him (the consumer)" actually means.

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Consumer-protection measures relating to the sale of financial products fall within the scope of the Consumer Credit Directive and of the Directive on Credit Agreements relating to Residential Property, and have already been reflected in the relevant legislation. If the provisions in the draft Regulation under discussion were to deviate from these existing provisions, this would lead to inconsistencies which would jeopardize the coherence of the European regulatory framework. Such deviation should absolutely be avoided. An obligation to provide advice when granting loans results in grave difficulties for banking institutions, and it would therefore be wise to dispense with this. The same applies to benchmarks of authorized administrators.

Furthermore, in particular the requirement to evaluate the consumer's financial situation and the objectives being pursued by the financial contract concerned should not go beyond the requirements codified in the Consumer Credit Directive or the Directive on Credit Agreements relating to Residential Property. This means that the bank or savings bank in question supports the consumer by providing pre-contractual information and further appropriate explanations. There is no need for additional provisions; they should be dispensed with so as not to undermine the coherence of the legal provisions which are already in force.

Germany's Federal Supreme Court (Bundesgerichtshof, BGH) has likewise ruled in its leading decisions concerning the interest-rate-adjustment clause in credit agreements that specific requirements apply for suitable reference interest rates. Some of these requirements are that suitable reference interest rates need to closely reflect market activity; that the reference interest rates in question cannot be manipulated by the user in a one-sided manner; and that they must derive from a public source. Here too, it is evident that the draft Benchmark Regulation is formulating requirements which are already embodied in German legislation.

7. Notification to ESMA of use of an index in a financial instrument

The notification process provided for in Article 25 of the proposal is extremely complicated and does not fit the practice of issuing financial instruments. From the issuers' point of view, such a notification process constitutes a considerable obstacle when it comes to putting financial instruments on the market. A delay of 30 days can occur on a worst-case scenario. The notification process delineated in the draft runs into practical difficulties due to timing-problems: Regulatory intervention by the competent authorities is only provided for once an application for listing has already been submitted to a stock exchange. In practice, however, many financial instruments are already definitively placed in the capital market ahead of the stock-exchange listing by way of a public offering. On a worst-case scenario, i.e. if the administrator were to withhold his approval for use of his benchmark, an instrument already placed in the market and approved for stock-exchange trading would have to be delisted again. As a consequence of this, the procedure described in Article 25 of the draft Regulation would need to come into play earlier. Issuers need to have the opportunity to already call off the issue ahead of a public offering if there were legal misgivings to the effect that the underlying benchmark did not comply with the requirements stipulated in this Regulation. The possibility of the relevant competent authority requesting the delisting of the

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financial instrument concerned therefore comes too late in the process. In Germany, moreover, the national competent authority BaFin is not empowered to demand that a financial instrument be delisted from a stock exchange.

Since the purpose of Article 25 is supposed to be to inform administrators that indices they produce are being used as a reference to financial instruments (thus as a "benchmark"), an alternative provision could be used. Instead of the procedure laid down in Article 25, issuers should, before they create new financial instruments, obtain the written permission from the relevant administrator to use the latter's benchmark. This permission could be evidenced in the prospectus prior to prospectus approval. In addition, ESMA should publish a list of authorized administrators and their benchmarks (on the analogy of Article 21 covering administrators from third countries). These benchmarks published should then be excluded from the procedure of Article 25. Taking this step would also relieve competent authorities and ESMA considerably from administrative burdens.

8. Publication of transaction data

The publication of transaction data presupposes corresponding permission on the part of administrators which is currently, in principle, not covered by the existing licensing agreements. In order to be able to publish transaction data, providers require a kind of "unlimited reporting license", which would result in further burdens.

Even if the EU were to declare such data - independently of existing provider contracts - a "public good", this would not provide a general solution with respect to further-reaching administrative burdens. This is because providers from the United States, Japan, Singapore, and so on, would not be subject to this Regulation, and could even turn this situation to their own advantage by exploiting their market power.

9. Continuity and transitional provisions

As to the transitional provisions contained in Article 39 of the draft, it needs to be clarified that the introduction of the new rules pursuant to this EU Regulation does not, in the case of already existing critical benchmarks not establish new benchmarks. As we have already argued during previous consultations, the continuity of existing benchmarks to which existing contracts and financial instruments still outstanding are referenced is of utmost importance for all market participants. Legal certainty for existing contracts has to be absolutely warranted.

Article 39 has to be amended for financial instruments and financial contracts referenced to a benchmark, where the contractual term begins prior to the entry into force of the Regulation but end subsequent to the entry into force of this Regulation. Should an administrator fail to apply for permission to continue the provision of his benchmark after the entry into force of this Regulation, or should he fail to gain such permission, benchmark users must have the possibility to use this benchmark until the end of the contractual period.

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The stipulation embodied in Article 24 Section 1 of the draft - that national competent authorities are under certain circumstances, obliged to withdraw the authorization of an administrator - would have unforeseeable consequences for users of benchmarks. Again, the ongoing continuity of benchmarks utilized in the market needs to be guaranteed. The same applies, mutatis mutandis, to the measures outlined in Article 21 of the draft Regulation concerning the benchmarks of administrators resident outside the EU.

The rights proposed to be introduced for competent authorities in Article 30 Section 1 (g) and (h) (freezing of assets, suspension of trading) are too indeterminate. It is not clear in what cases it would be possible to freeze assets, which assets are meant, and when it would be permitted to suspend the trading of benchmark-dependent financial instruments. The suspension of trading can be dangerous from a risk-management point of view because this would simultaneously eliminate the possibility for hedging transactions.

10. Data storage

The data-storage obligation provided for in Annex II point 17 of the draft is imprecisely worded and contains no indication of how long data is to be stored. It is essential that details should be spelled out concretely on this score, as otherwise the upshot would be uncertainties and considerable additional costs. We would suggest that data (a term which needs to be defined more precisely) should be required to be stored for a period of five years.