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Client Alert News Flash

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ESMA Provides Its Input on the BMR Review

ESMA has published its response to the Commission's review of the BMR, which gives an indication of the areas where changes to the regulation are more likely to be made.

Key Points:

- ESMA's response to the European Commission's review of the EU Benchmarks Regulation captures many of the market's frustrations with the regime, and could help persuade the Commission to make changes in the relevant areas.
- ESMA also uses its response to offer some new guidance for market participants.

Background

The European Commission published a consultation on its mandated review of the EU Benchmarks Regulation (BMR) in October 2019. The consultation focused primarily on topics that the BMR itself required to be reviewed, such as the regime for critical benchmarks and the regime applicable to EU benchmark administrators. However, it also addressed some additional topics, such as the rules for third-country benchmarks and scope in general. The consultation closed at the end of 2019, and the Commission is due to submit a report on its findings to the Parliament and Council this spring. This report could ultimately lead to changes to the BMR legal text, however such changes are unlikely to be made until 2022 at the earliest due to the legislative process.

On 14 February 2020, ESMA published its response to the Commission's review, setting out ESMA's views on the issues raised by the Commission in its consultation. ESMA's comments focus on areas including critical benchmarks, the scope of the regime, transparency, and the regime for third-country benchmarks. Many of ESMA's remarks capture market sentiment around the challenges and difficulties with the BMR. Therefore, it is hoped that the Commission will take these points on board when formulating its final report and suggestions for changes to the regime.

Critical benchmarks

The Commission's consultation raised the question of whether national regulators should have wider powers to intervene in the administration of critical benchmarks, particularly in the context of IBOR reform. ESMA considers that national regulators should be given broader powers to require the administrator of a critical benchmark to change the methodology of the benchmark in the following defined circumstances:

- The critical benchmark is no longer representative of the underlying market or economic reality that the benchmark is intended to measure.
- The methodology or the input data are no longer considered BMR-compliant.
- Mandatory administration of the critical benchmark commences or is in progress.

ESMA also considers that administrators' benchmark cessation plans should be approved by national regulators, both at the time of authorisation and on an ongoing basis thereafter. ESMA suggests that the factors to be reflected and considered in these plans should be set out in legislation.

In relation to users' benchmark cessation plans, ESMA suggests that national regulators should take a risk-based approach to reviewing such plans, focusing on how the plans cover the use of critical benchmarks. Helpfully, ESMA does not agree that there should be an obligation for users to have their plans approved prior to any use commencing, noting that national regulators already have powers to request users' plans.

Finally, ESMA agrees that users should ensure their written plans cover the situation in which a critical benchmark ceases to be representative of the underlying market, but stresses that the trigger for this must be clear, as it may be difficult for users themselves to determine if this has occurred. ESMA suggests that a public declaration by the relevant national regulator that the critical benchmark is no longer representative would be an appropriate trigger and that user plans should define transparent triggers for when their contingency plans will apply (including where an administrator's authorisation is withdrawn).

Benchmark "families"

ESMA provides some new guidance on what constitutes a "family" of benchmarks. ESMA suggests that the scope of the current definition should be narrowed so as to prevent administrators from being able to provide one benchmark statement that covers large swathes of benchmarks. ESMA proposes that a family of benchmarks could be a group of benchmarks that have different variants linked to the maturity or tenor or currency but that measure the same underlying market or economic reality. However, it considers that the concept of a family should not encompass every different variant of the same benchmark.

ESMA proposes that the BMR should be amended to reflect this view. This would result in a challenge for current administrators that have broadly defined families, both in terms of changing their benchmark statements and adapting their processes to cater for more families that contain fewer benchmarks.

Climate benchmarks

Noting that at present the BMR only requires national regulators to assess compliance of benchmarks with the BMR requirements at the time of an administrator's authorisation or registration (in the case of EU administrators), ESMA suggests that the BMR should require the ongoing supervision of benchmarks. In particular, ESMA proposes that administrators should be required to notify their national regulator when they launch a new benchmark in a category of benchmarks that did not exist at the time of authorisation, for example if an administrator launches a climate-related benchmark (a new category of benchmark that comes with its own specific qualification requirements under the BMR). This may not represent a change for those administrators authorised by the FCA, where there is likely to be an expectation that the regulator is notified of changes of this nature.

Administrators considering creating new benchmarks in light of the EU's Sustainable Finance initiative in particular will want to take note of these proposals.

Scope of the regime

ESMA considers that a lighter-touch regime would be more appropriate for non-significant benchmarks. This would align better with the approach taken to benchmark regulation outside the EU, where regulation typically is limited to critical or systemically important benchmarks, and would help to create a more level playing field internationally for EU benchmark administrators.

ESMA acknowledges that the wide scope of the BMR not only puts EU benchmark administrators at a regulatory disadvantage as compared with their non-EU counterparts, but also may dissuade third-country benchmark administrators from making their non-significant benchmarks available in the EU. ESMA suggests that excluding non-significant benchmarks based on regulated data could significantly reduce the current scope of the BMR. It would also be helpful if the BMR review addressed the potentially narrow interpretation of "regulated data benchmark" to include those benchmarks which use only regulated data but do not currently meet the definition. This is a key watch point to see whether ESMA's suggestion impacts the scope of the BMR as it applies to non-significant benchmarks.

Transparency

In relation to the ESMA register for benchmarks and administrators, ESMA acknowledges the key flaw in that there is no common identifier for benchmarks. Benchmarks are identified by name in the register, but this is a free text field that is prone to errors and so is not a fail-safe way to identify a benchmark. Consequently, a crucial issue for benchmark users has been identifying benchmarks accurately from the register. Therefore, ESMA suggests that administrators and benchmarks should have identifier codes so that users are more readily able to identify which benchmarks they are permitted to use. This may help both users and administrators to streamline their internal systems to conform to this common identifier, rather than each institution using its own system for identifying and recording benchmarks, as is currently the case.

A further issue with the ESMA register is that it while it includes the names of EU administrators, it does not list out their individual benchmarks. However, for third-country administrators, each benchmark is listed on the register. Therefore, if a series of benchmarks is provided by an EU administrator that appears on the register, it is not possible to know which of its benchmarks are BMR-compliant. ESMA suggests that the register should include information on all benchmarks belonging to both EU and third-country administrators that are available for use in the EU. Further, ESMA proposes that the information on the register should be machine-readable, to enable users to check the register cheaply and efficiently.

This also appears to be an acknowledgement that benchmark administrators do, and are permitted to, run indices which are and are not BMR-compliant. This is helpful confirmation for those administrators that take this approach, where previously there has been some discussion that a split book may not be permissible.

Third-country benchmarks

The Commission's consultation raised the issue of whether the use of certain third-country benchmarks, namely FX spot rates for currencies that are not fully convertible, is widespread and economically important, especially for currency or interest rate hedging. It explained that these rates may not be eligible as reference rates for non-deliverable forwards once the transitional period for third-country benchmarks under the BMR expires.

ESMA considers that this is an important issue and that the Commission should consider introducing an exemption for such benchmarks in order for them to continue to be available. However, ESMA suggests that there may need to be a limit on any such exemption, for example if the benchmark meets the criteria for classification as a critical benchmark.

Noting that third-country benchmarks cannot be classified as critical benchmarks under the current BMR regime, ESMA suggests that third-country benchmarks that are used extensively in the EU and qualify for use in the EU via the recognition route ought to be subject to additional requirements. ESMA further suggests that the relevant EU national regulator should be given additional powers in relation to such benchmarks.

In relation to the recognition regime, ESMA suggests clarifications to the role of the legal representative. ESMA acknowledges that use of this route could be incentivised by a clear legal framework around the legal representative that minimises administrative burdens and additional costs, while ensuring appropriate oversight of the relevant third-country benchmarks. Therefore, ESMA proposes that the role of the legal representative should be defined in the BMR, along with its responsibilities and legal liabilities. Recitals could then be used to provide examples of the types of entities that are fit to take the role of legal representative.

This would be a welcome development as, on the one hand, the recognition route is attractive for many third-country administrators given that the approval is granted at administrator (not benchmark) level and therefore, once approved, the third-country administrator can launch benchmarks into the EU without considering the timing associated with further regulatory approvals. However, this route has sometimes proved unworkable in practice due to the strict basis on which global groups must identify their EU legal representative, which may prove to be an EU affiliate with no benchmark expertise, and the associated uncertainties concerning the potential regulatory liability of the legal representative.

For more materials on the EU Benchmarks Regulation, please visit Latham's London Financial Regulatory Portal.

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