You can’t trust your mortgage if you can’t trust the benchmark

EU benchmark regulation for financial instruments could prevent another Libor scandal, William Yonge writes

The pricing of many financial instruments and financial contracts depends on the accuracy and integrity of benchmarks. Benchmarks are used as reference rates in financial contracts, in particular mortgages.

They are also relied on for measuring the performance of investment and pension funds either for the purpose of return tracking, determining the asset allocation of a portfolio or computing the performance fees. Benchmarks can also be used to price commercial contracts.

Where a benchmark is not robust and is open to manipulation, doubts creep in about its integrity, accuracy and vulnerability to conflicts of interest. Its use may cause losses to investors, consumers and markets and distort the economy.

The 2012 market rigging scandals involving Euribor, Libor and Tibor, in Japan, are perfect examples. They revealed how the contributing banks exploited the distortion in the methodology of those benchmarks and attempted to manipulate the benchmark's levels, motivated by the conflicts of interest created by their derivatives trading or the need to signal to the market a favourable picture of their credit standing. The authorities considered that failures in governance and controls facilitated the manipulations and a lack of clarity about regulation had an impact on the ability of regulators to respond.

Mortgage repayments, investment fund and pension fund performance can be adversely affected by the manipulation of a benchmark to which they are linked. If benchmarks fail to measure accurately what they are held out to measure because they are manipulated or not representative, the price or payments will not be fair.

The European Commission introduced the idea of benchmarks regulation in September 2013, noting that within the EU only a few countries – including the UK – regulated benchmarks.

The International Organisation of Securities Commissions published a set of principles for financial benchmarks in July 2013 but they were so broad that a directly-applicable European regulation creating a uniform approach to those involved in the provision, contribution and use of benchmarks was required.

EU benchmark regulation took effect from the beginning of this year and its objective is to ensure benchmarks are robust and reliable and to minimise conflicts of interest in the benchmark-setting process. Index providers whose indices are used within the EU will be regulated under the new rules as benchmark administrators and be required to be authorised by the national regulator.

While benchmark regulation does not require the authorisation of contributors of data to benchmarks and users of benchmarks, it recognises that many will already

be authorised by their national regulators. The new measures subject them to additional relevant requirements specific to contributors and users.

Mifid II, the updated version of the Markets in Financial Instruments Directive 2004 which came into force on January 3, will work in tandem with benchmark regulation by enhancing market transparency and so increase the availability of more robust data.

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