ASIFMA Q&A: how Asia is facing the EU Benchmarks Regulation

Practice Insight speaks to John Ball, Asia Pacific managing director of GFMA's global FX division, on what the BMR means for non-EU benchmark providers and how the industry is preparing

The EU Benchmarks Regulation (BMR) attempts to introduce integrity and accountability to benchmarks. In the UK Financial Conduct Authority's words, it 'aims to ensure benchmarks are robust and reliable, and to minimise conflicts of interest in benchmark-setting processes'.

Most remarkable about the new framework is its extraordinary extraterritorial reach. Once it's implemented, EU market participants will only be able to use benchmarks that have received prior authorisation from European regulators. Yet as it's EU legislation, some non-EU administrators aren't even aware of its scope.

In February, the European Commission announced a formal two-year delay to full implementation of the BMR's transition period until 2021 for critical and third country benchmark providers. This decision was widely welcomed by the industry.

Here John Ball, managing director of the Global Financial Markets Association's FX division for Asia Pacific speaks to Practice Insight about the regulation's scope, the risks it poses, and how third countries are reacting.

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Practice Insight: What has happened since the European Commission conceded a two-year delay on the BMR?

John Ball: The additional two years have taken a lot of pressure off the market. A large number of benchmark administrators in Asia weren't ready.

Obviously the BMR is EU legislation, but it has huge extraterritorial reach and for a lot of those affected in Asia – before ASIFMA and Herbert Smith Freehills started work – they were probably blissfully unaware it even existed. Up until now the regulation of benchmarks outside of Europe was virtually non-existent, but that is starting to change.

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There is a group of third-country benchmark administrators that are incredibly important to European supervised entities, in particular the investor community, and many firms in Europe are highly dependent on being able to continue to use those benchmarks.

A significant portion of that group isn't necessarily aware of how, where or how often their benchmarks are used, and many don't operate a commercial business model, unlike the large providers in developed markets like Reuters, Bloomberg and S&P. Consequently, they haven't had the same urgency or commercial incentive to pursue any route of authorisation in Europe.

There are still some regulators and administrators in Asia that are of the view that this is a European piece of legislation that doesn't apply in their domestic market, so they don't plan to respond in any way.

Benchmarks Regulation: non-EU admins running out of time

We continue to raise awareness of the consequences of the regulation among administrators and regulators. There are some countries have taken more formal steps: Australia passed legislation in June to regulate a number of local benchmarks - the S&P/ASX 200 Index, Consumer Price Index, Australian Interbank Overnight Cash Rate, the Australian Bank Bill Swap Rate, and the ASX bond futures settlement price.

In Japan, similar legislation has been passed but it only regulates Tibor [Tokyo interbank offered rate], and in Singapore only Sibor and SOR are regulated.

Under the BMR's equivalence regime, any decision provided by the European Commission will only apply to domestic benchmarks that are regulated by local legislation. Consequently, an equivalence decision is likely to be quite specific and won't cover all products traded in Europe, particularly by asset managers, such as the Nikkei in Japan. Therefore, there will be an obligation on those third-country administrators to find an alternative route to authorisation, via either endorsement or recognition. Those are the only two other alternatives to achieving authorisation, and both require a legal representative in Europe who will take on a legal liability for the production of the benchmark.

In Korea, there's a piece of supervisory legislation currently with the National Assembly that will cover significant domestic benchmarks. We won't know exactly which benchmarks are included until the legislation is passed.

Meanwhile, the Reserve Bank of India has recently released draft directions for a supervisory framework and the creation of a benchmark committee, which will be responsible for determining what is considered a significant domestic benchmark.

There are some jurisdictions – Taiwan and the US, for instance – that have said they won't regulate domestic benchmarks. In the US, it's slightly different because many of the key domestic benchmark administrators have affiliates in Europe to act as their legal representative, so the process of authorisation for them is a lot simpler. If third-country administrators don't have a European entity, the cost of endorsement or recognition could be prohibitive – particularly for those who don't operate a commercial business model – because the legal representative will need to be compensated for the legal liability they take on.

Benchmarks Regulation: administrators don't know they're caught

What work are the industry associations doing to raise awareness and prepare the industry?

Via the Association of Financial Markets in Europe (AFME) and the International Swaps and Derivatives Association (ISDA), we were active in lobbying the European Parliament and Council to extend the transition period for third country benchmarks.

Fortunately, we had the support of other associations across Europe, particularly manufacturers who saw this as significant for their members, many of whom hedge large foreign currency exposures using products referencing third-country benchmarks. Because they bank locally in Europe, they wouldn't have been able to continue trading those products with European supervised entities, and it is unlikely that they would set up a new relationship with a non-EU provider. They were quite vocal, which obviously helped the industry's position.

The BMR requires the European Commission to submit a report to the co-legislators – the Parliament and the Council – initially by January 1 2020, but it's now been pushed back to April 1.

In that report they're obliged to review the functioning and effectiveness of the regulation and to determine whether there is a need to amend it. We would expect that the effectiveness of the various options for authorisation – endorsement, recognition and equivalence – will be part of that review.
We hope the Commission will recognise that neither endorsement nor recognition has gone according to plan. We have generally found the Commission responsive and proactive in trying to identify solutions for third countries.

Market woefully unprepared for Benchmarks Regulation

A big part of the problem is that this is an extremely complex piece of regulation. For instance, many third-country administrators still don't have a detailed understanding of MiFID II (MiFID). Yet the BMR references products that are traded on a trading venue (TOTV), submitted for TOTV, or traded via systematic internaliser (SI), which are all MiFID terms. There are not many third-country administrators that know what an SI is.

On top of this, there are inconsistencies between the two regulations. Under MiFID, the SI regime exists to create a level playing field between trading venues and investment firms. For instance, under MiFID, SIs have greater price transparency obligations that only apply to products that are TOTV. Yet under the BMR, any product that's TOTV, admitted for TOTV, or can be traded via an SI – which includes products that aren't TOTV – are in scope. The scope is that much wider.

When we were seeking guidance from the Commission, they suggested that because these products are in many cases inadmissible to TOTV, any SI who had registered as an SI for a particular class of products should deregister to avoid being prohibited under BMR.

That solution works for as long as there is no formal obligation to register as an SI. However, under MiFID, at some point in the future, it will become compulsory for firms to register as an SI bringing these products into scope. With no official register of SIs, it's quite difficult for people to understand, particularly those with no experience with European legislation.

[Read more on benchmark reform on Practice Insight]

What was the reaction among Asian benchmark administrators when the Commission announced the delay?

For those who were actively seeking authorisation, it has come as a relief. As an example, there are several key benchmarks in Hong Kong where the administrators are in the process of determining the most appropriate authorisation route. The Treasury Markets Association (TMA), for instance, is the administrator for Hibor [Hong Kong ibor] as well as for the USD/CNH and USD/HKD exchange rates. These are all quite widely used, so the extension takes the pressure off a bit.

It has also provided an opportunity for certain jurisdictions, such as Korea and India, to pass local legislation to enable an equivalence decision. That's a time-consuming process, so it's great they have both started.

The granting of an equivalence decision is not without its challenges. Australia passed its benchmark regulation in June 2018 and, along with Singapore, has only just been notified by the Commission of a draft equivalence decision. It all takes time. We understand that, going forward, the Commission will be considering the substance of the framework in place in third countries rather than its form, which will hopefully make the process less onerous.

There are several authorised European entities that are considering or have already started to offer endorsement services; I imagine they would have liked the regulation to have been implemented on time. There is a risk involved in providing an endorsement service. There's a significant legal liability arising from the administrator's performance, so providers need rigorous oversight of the control and production of the benchmark. That really means the administrator must cede control to the provider, which is generally not popular with administrators. Plus, no two administrators operate in the same way, so the provider needs to undertake due diligence on every benchmark individually.

It's possible that EU regulators didn't fully understand quite how far-reaching the extraterritorial impact of the regulation would be. It's further complicated by differences in interpretation among the national competent authorities in Europe – they are not all in agreement, which doesn't help.
And then we have Brexit. That's causing significant confusion because administrators don't know if they should be applying to both the UK Financial Conduct Authority and another competent authority in Europe. In this sense the extension is fortuitous.

ETF industry unconcerned by Libor reform

How the Benchmarks Regulation will stifle growth

The high-level concern we had with the encroaching deadline was threefold. First was the potential impact on market liquidity and fragmentation. We had previously surveyed our members to understand the use of non-deliverable foreign exchange forwards (NDF) in Europe and found that between 38% and 52% of global volumes traded in three Asian NDFs were traded by a European entity. If you exclude such a large proportion of the market from trading those products, liquidity will suffer: market participants won't be able to trade with as many liquidity providers as before, and costs will go up.
There's also a risk of fragmentation: if European entities can't trade a third-country benchmark, will they look for an alternative? That means potentially using different data points to calculate the benchmark which introduces an element of basis risk.

If European supervised entities are suddenly prohibited from using third-country benchmarks, those with local onshore exposures can no longer hedge their currency or interest rate risk. Do those European entities withdraw from those markets? If they do, will that have financial stability consequences?
We're also concerned where Asian entities raise funding from EU-supervised entities using swaps based on third-country benchmarks. Post-BMR, the EU-supervised entity will potentially be prohibited from trading those swaps, closing a source of funding.

Have those concerns been addressed?

Ultimately, we will have to wait for the result of the Commission's review due in April 2020. Hopefully, as part of this process they will consider simplifying the authorisation route, the role of the legal representative or the scope of products covered. But before that, we -- along with other trade associations -- will be responding to the consultation the Commission has said it will undertake.

Special report: Libor reform