Growing Asia's Markets

31 January 2019

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Re: Impact of the European Benchmark Regulation on Asian Financial Markets

Dear Sirs,

ASIFMA[1] and its members wish to highlight our concerns regarding the impact of the European Union's ('EU') Benchmarks Regulation ('BMR') on the continued use of key financial benchmarks provided by non-EU ('third-country') administrators, in particular those in the Asia-Pacific region ('APAC'), and the consequential threat to financial stability.

ASIFMA and its members are deeply concerned that a large number of third-country benchmarks will not be compliant with the BMR by the 1 January 2020 deadline due to timing issues and/or the difficulty in meeting the requirements of the BMR's third-country regime. An extension to the transition period until 1 January 2022 for third-country benchmarks is essential to resolve the timing issues and/or for third-country administrators to find a workable solution to the BMR's third-country regime as necessary.

The BMR is sweeping in nature as it sets out the authorisation process for EU and third-country benchmark administrators, establishes rules applicable to those who contribute or provide submissions to EU benchmarks, and prohibits the use of any benchmark by EU supervised entities that is not authorised or registered in the EU. The prohibition of use of an unauthorized benchmark is of particular concern as these entities will no longer be able to trade products referencing these benchmarks leading to market fragmentation and a consequential impact to the Asian markets.

While, the BMR took effect on 1 January 2018, third-country administrators benefit from a transitional period that allows the use of third-country administered benchmarks within the EU until 1 January 2020.

[1] ASIFMA is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

To date, there have been no successful applications by third-country administrators and considerable concern remains about how best to apply for registration and what the impact may be if they fail to do so.

Furthermore, the BMR requires that, from 1 January 2018, EU supervised entities put in place contingency plans for how they would handle the cessation of a benchmark they rely on. Where third-country administrators do not make significant progress towards registration ahead of the 1 January 2020 transition deadline, these contingency plans are likely to involve identifying alternatives for certain third-country benchmarks.

The broad scope of the BMR will impact a wide variety of foreign exchange, interest rate, security and commodity benchmarks as well as other indices referenced by financial instruments, contracts and funds in the EU, with indirect implications on markets and economies beyond Europe's borders. From 1 January 2020, EU investors and end-users may be prohibited from accessing the Asian capital and derivative markets potentially causing significant financial disruption in both the EU and Asian financial markets unless the transition period is extended to include third-country benchmarks.

More than 100 benchmarks administered in APAC are at risk of being unavailable.

A survey conducted by the Global Financial Markets Association's Global Foreign Exchange Division in May 2018, revealed that between 38% and 52% of global volumes in a number of key non-deliverable currencies are traded with EU counterparties - 38% of Korean Won volume, 52% of Taiwanese Dollar volume and 50% of Philippine Peso volume. Non-deliverable forwards (NDF) are widely used by EU investors and corporates to risk manage exposures in these markets.

If these benchmarks are not compliant at the end of the transition period, the inability for EU supervised entities to provide these financial instruments to EU end-users could disrupt trade and investment between the EU and the rest of the world.

The issue is not unique to these jurisdictions and their NDF benchmarks. Concerns exist regarding benchmarks and indices around the world.

- Market liquidity and fragmentation

The inability of EU entities to access third-country benchmarks will reduce liquidity in products that reference them as a substantial portion of the relevant market for such products will disappear. This loss of liquidity will adversely impact market participants regardless of their jurisdiction

Fewer third-country benchmarks is likely to result in EU entities switching to alternatives, where available, resulting in further fragmentation of the market. However, where there may not be a suitable alternative, EU participants could withdraw from the market.

- Hedging risk

The ability of EU banks, investment institutions and corporates to hedge interest rate, currency and other risks may be severely impacted as products now actively used for hedging will no longer be available. Market participants could choose not to bear this additional risk and cost and instead either pass the underlying and associated costs onto their commercial contractual counterparties or withdraw from the market.

- Funding issues

The BMR may cause funding issues for APAC banks where those banks raise funding from EU regulated entities through swaps based on third-country benchmarks.

Authorisation Options

There are three options for administrators to obtain registration for a third-country benchmark in the EU.

1. Equivalence: the European Commission ('EC') can adopt an equivalence decision that declares the legal framework and supervisory practice of the local jurisdiction "equivalent" to the regime established by the BMR. Alternatively, the EC may grant equivalence to specific administrators and/or indices. Certain APAC regulators have introduced legislation necessary to seek equivalence from the EC, others have indicated that they have no intention of implementing regulation.

   In jurisdictions where a legal framework has been implemented or is being developed, it relates only to a limited number of specific or systemically important benchmarks. In Japan, for example, only TIBOR is covered by the relevant regulation. This means that significant Japanese equities indices such as the Nikkei 225 or TOPIX will not benefit from any equivalence decision. These administrators will need to seek compliance via recognition or endorsement. Even if they were to seek recognition or endorsement, market participants have limited visibility as to their prospects of success.

   In some instances, in which an equivalence determination may be available, there does not appear to be sufficient time remaining for the EC to grant it in every case, particularly given the need to put in place a co-operation agreement with the relevant jurisdiction.

   As such, equivalence is unlikely to be a viable solution for a number of APAC administrators simply as a result of the limited time now available for regulators to put in place the necessary framework, agree a co-operation agreement and for the EU to grant an equivalence determination.

2. Recognition: EU Member State's regulatory authority can "recognise" a specific third-country administrator. This will require substantial compliance with the BMR; or

3. Endorsement: a third-country benchmark or group of benchmarks can be "endorsed" by an EU administrator, or another regulated entity within the EU that has a clear and well-defined role within the accountability framework of the relevant third-country administrator.

   Both recognition and endorsement require that a third-country administrator have a representative in the EU that is accountable to EU regulatory authorities for the conduct of the administrator. To date it has been difficult for third-country administrators without an EU affiliate to find anyone willing to take on this role. This is particularly likely to be the case for endorsement, given the significant obligations imposed on the EU representative.

   Furthermore, in the absence of a supervised affiliate, endorsement may require administrators to cede governance and control of their benchmark activities to a third party in the EU. Although we understand that some EU administrators may have started offering endorsement services, it is unclear whether the costs and terms for doing so will be acceptable or how many third-country administrators may use such a service. Given the very pressing legislative timetable, if such services cannot ensure compliance of third-country benchmarks to the BMR, or if such services are not economically viable, there will not be sufficient time to rectify the issue.

This uncertainty is compounded by the fact that there is no publicly available data to show how many benchmarks used in the EU today are not on course to qualify under BMR using one of these three routes, though it seems likely that the numbers may be significant. Today, the register of third-country benchmarks maintained by the European Securities and Markets Authority (ESMA) only shows successful applications and to date there have been none.

While some third-country administrators have made public statements as to their intention to apply for approval, this general lack of visibility means that market participants have no way of knowing whether many third-country administrators intend to apply or have no intention of applying. Therefore, they are unable to take informed steps in the event that a third-country administrator fails to apply, for example, by reducing their levels of exposure to a particular benchmark.

Recommended extension to the transition period for third-country benchmarks

In line with the ongoing efforts to extend the transitional provisions applying to EU critical benchmarks, we believe the transitional provisions applying to third-country benchmarks (some of which are considered critical in their country of origin) should be extended to allow more time for the EC to issue relevant equivalence decisions, and for third-country administrators seeking to comply with the Regulation. An extension to the transition period would:

1. Avoid potentially significant financial disruption through a reduction in liquidity and a fragmentation of markets given the extensive use in the EU of benchmarks administered in APAC;
2. Avoid putting European entities at a considerable competitive disadvantage when it comes to investing and managing their exposures abroad; and
3. Provide additional time for jurisdictions that wish to become equivalent to roll out appropriate regulatory frameworks.

We continue to recommend that:

1. EU authorities engage in further outreach with Asian regulators and administrators and have emphasised the importance of ensuring market certainty and confidence around the practical implementation of the BMR;
2. Third-country administrators and APAC regulators recognise the concerns outlined above and formulate a path forward. We have encouraged dialogue with the EC, as well as with ESMA, on these issues.
3. Third-country administrators disclose their plans to the market in an effort to help mitigate the impact of the BMR by reassuring users of benchmarks that the administrator is taking steps to comply with the BMR. Similarly, where regulators intend to introduce benchmarks legislation designed to achieve equivalence with the BMR, we believe it would be very helpful to publicly disclose that intention as soon as practicable to provide clarity to the market.

4. APAC regulators engage with ESMA and the EC regarding the difficulties associated with recognition and the requirement to put in place a co-operation arrangement where a third-country administrator is subject to regulatory supervision in its home jurisdiction.

In conclusion, we recommend that the FSB engage with ESMA, the EC and European National Competent Authorities (NCAs) to ensure that the potential financial stability concerns highlighted above are avoided. In these discussions, we would recommend highlighting the importance of ensuring market certainty and confidence around the practical implementation of the BMR third-country regime as well as an extension to the transition period.

Yours faithfully,

Mark Austen

Chief Executive Officer

ASIFMA