EU Benchmark Regulation: requirements and impact for securitisation and structured finance transactions

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Introduction

On June 30 2016 the EU Benchmarking Regulation(1) came into force, imposing new requirements on administrators, users and contributors to a wide range of interest rate, currency and securities commodity indices and reference prices in securitisations and structured finance transactions. The scope of the Benchmark Regulation is much broader than any existing EU framework and will affect activities and firms that use benchmarks, as well as those administering or contributing to benchmarks. Most of the provisions will take effect from January 1 2018 and will be directly applicable to EU firms that are benchmark users, administrators or contributors, without the need for national implementing legislation.

As implementing measures are still being worked out by the European Securities and Markets Authority (ESMA), this update does not analyse each provision in detail, but rather provides an overarching picture of the increased controls that the Benchmark Regulation will introduce and the elements that securitisation and structured finance market participants should start considering and responding to as benchmark users or originators or issuers of securitisations whose underlying assets consist of consumer credit loans or mortgages which reference benchmarks or use benchmarks to determine amounts payable by borrowers.

Benchmarks are used to price transactions in a variety of financial instruments and services, both domestic and cross-border, and are relied upon as a standard to measure the performance of an investment or security. The accuracy and integrity of a benchmark's underlying data and methodology are therefore highly relevant to the stability of the financial markets.

The impetus behind the Benchmark Regulation is to ensure the reliability of benchmarks in the wake of manipulation of the Euro Interbank Offered Rate and other critical benchmarks. There was much lobbying as the Benchmark Regulation was developed, partly due to the significant effect that a more stringent regulatory regime would have on the financial industry.

Aims

The Benchmark Regulation aims to establish a consistent and effective regime to address

vulnerabilities and restore market confidence in indices used as financial benchmarks by:

- improving the governance and controls over the benchmark process;
- improving the quality of input data and methodologies;
- subjecting contributors to adequate governance controls; and
- ensuring adequate protection for consumers and investors through greater transparency and rights of redress.

In effect, the Benchmark Regulation will limit administrators' ability to set benchmarks using their own discretion, and prohibit the use in the European Union of unauthorised benchmarks, including those prepared by unregistered administrators outside the European Union. The aim is to ensure the robustness and reliability of benchmarks and benchmark determination, thereby strengthening trust in the financial markets. The proposed framework will also give stakeholders transparency on how a benchmark is derived, enabling them to assess its representativeness, relevance and appropriateness for its intended use.

Distinct from the previous regime, a harmonised framework will now apply across the European Union. While the International Organisation of Securities Commissions principles for financial benchmarks previously applied as a global standard which allowed for flexibility in their scope and means of implementation, the new regulation will ensure a harmonised regime across the European Union, with no risk of divergence in scope and application.

The Benchmark Regulation constitutes the main piece of EU legislation governing the use of benchmarks, but is intended to work alongside the Market Abuse Regulation and the new Markets in Financial Instruments Directive and Regulation (MiFID2 and MiFIR). Both have been amended to bring benchmarks and benchmark manipulation within their scope, and MiFID2 and MiFIR will take effect shortly after the implementation date of the Benchmark Regulation.

Scope

The scope of the Benchmark Regulation is deliberately broad in order to establish a preventative regulatory framework.

A 'benchmark' is widely defined as:

> "*any index by reference to which the amount payable under a financial instrument or a financial contract, or the value of a financial instrument is determined or an index that is used to measure the performance of an investment fund with the purposes to track the return of such index or to define the asset allocation of a portfolio or to compute the performance fees*."

An 'index' is further defined as any figure that is:

- published or made available to the public; and
- regularly determined (either wholly or partially) by the application of a formula or any other method of calculation, or an assessment where determination is based on the value of one or more underlying assets or prices (including estimated prices, actual or estimated interest rates, quotes and committed quotes or other values or surveys).

Under the Technical Advice published by ESMA in November 2016, an index will be "made available to the public" if it is accessible to an "indeterminate number" of recipients. The key is that there will be an open group of recipients that could change in size and composition, regardless of whether this is a limited number of people or access is restricted by payment of a fee. Accordingly, even figures made available to investors in a specific instrument will be caught, given that investors typically trade their financial instrument and the group of holders changes over time. An indeterminate group in this context could obtain access to the index.

In addition, where an investor can derive an index value from published differentials, values of financial instruments and investment funds, strike prices or coupons, that value should be considered available to the public – a position that caused controversy during consultation. In this respect, the Benchmark Regulation goes further than what is typically considered to be an index under existing domestic regulation.

Obligations: benchmark users

The obligations placed on benchmark administrators, contributors and users will create a regime with much more stringent controls than those existing under national law.

Under the Benchmark Regulation, the concept of a benchmark user is widely drawn and encompasses anyone that:

- issues a financial instrument(2) that references a benchmark;
- determines the amount payable under a financial instrument or financial contracts, including certain consumer credit agreements and mortgages,(3) by referencing a benchmark;
- is a party to a financial contract which references a benchmark;
- provides a borrowing rate calculated as a mark-up of a benchmark; or
- measures the performance of an investment fund through an index.

While the Benchmark Regulation will affect all benchmark users, its obligations and restrictions apply only to users that are "supervised" entities, including:

- credit institutions;
- investment firms;
- insurers or reinsurers;

- alternative investment fund managers;
- undertakings for collective investment in transferable securities;
- central counterparties; and
- trade repositories.

Merely holding a financial instrument that references a benchmark does not constitute use of a benchmark.

Supervised entities may apply a benchmark only if it or its administrator appears on a register of eligible benchmarks maintained by ESMA. This register can include benchmarks provided by non-EU administrators which have satisfied the requirements for equivalence under the Benchmark Regulation.

Supervised entity users must also produce and maintain "robust written plans" setting out the actions that they will take if a benchmark that they use materially changes or ceases to be produced. These contingency plans must be reflected in client-facing documents and provided to the firm's regulator on request.

These changes will have an impact on future issuances. The prohibition on using unauthorised benchmarks could limit both buy and sell-side activities by restricting the types of security that EU-supervised entities can respectively hold and issue. This may have a particular business impact on bank issuers of structured products.

Non-EU benchmarks

Non-EU benchmarks can be authorised for use in the European Union by way of equivalence, recognition or endorsement, but in practice these methods will present challenges. For example, an equivalence decision is likely to be relevant only for a limited number of jurisdictions, which would not include the United States, and the ability to apply for recognition will exist only where such an equivalence determination is pending. The endorsement regime requires an endorsing EU administrator to take on direct responsibility for – and oversight of – the benchmark, meaning that it may be only non-EU affiliates that look to use this.

Non-EU administers will also have little incentive to seek such authorisation, particularly if they derive low licence revenues from the European Union.

Penalties for non-compliance

National competent authorities will have the power to impose a range of penalties, including fines and non-financial penalties, for infringement of the Benchmark Regulation or failure to cooperate with an investigation. For instance, the authorities will be able to:

- make cease and desist orders;

- order the disgorgement of gains arising through a breach; and
- issue public warnings.

The financial penalties for a breach of the requirements applicable to benchmark users will be:

- at least €500,000 for individuals; and
- the higher of either €1 million or 10% of the total annual turnover for companies and other legal entities.

Member states may grant their competent authorities power to impose higher levels of penalties, or elect to impose no administrative penalties where an infringement is subject to criminal penalties under national law.

Although the maximum penalties are high, national competent authorities must take into account all relevant circumstances when determining the appropriate form and level of penalty to apply. This will include taking into account:

- the gravity and duration of the infringement;
- the level of cooperation of the responsible person with the competent authority;
- any previous infringements; and
- any measures taken to prevent the infringement being repeated.

Implementation and grandfathering

For market participants, it is important that there is contractual continuity as the Benchmark Regulation is implemented and that benchmarks evolve in such a way that their rates remain commercially close to the current rate to avoid fallback provisions under standard bond terms and conditions being triggered.

Transitional provisions will apply to existing benchmarks. ESMA has clarified that this will include all benchmarks in financial contracts or instruments that are in place on January 1 2018, but has made no suggestion that this will extend to benchmarks pending authorisation. Accordingly, no benchmark can be created after January 1 2018 until it has been authorised.

A supervised entity user may continue to use an unauthorised benchmark until January 2020 or, if an application for authorisation is made and refused, until the date of such refusal. In addition, where the relevant national authority agrees that altering or ceasing a specific benchmark to fulfil the requirements of the Benchmark Regulation will result in a *force majeure* event or frustrate the terms of any financial instrument or contract, the benchmark may continue to be used under such instrument or contract until such time as is agreed by that authority.

No time limit has been imposed for these grandfathering provisions, which is welcome.

Impact on structured finance and securitisation transactions

Issuers, originators and service providers of securitisation and structured finance transactions must carefully consider their obligations as benchmark users under the Benchmark Regulation. The following issues are of note:

- Issuers will need to include in prospectuses published under the Prospectus Directive or the Undertakings for Collective Investment in Transferable Securities Directive a "clear and prominent" statement on whether the benchmark being used for the issued financial instrument is provided by an administrator included on the ESMA register of benchmarks and administrators;
- Consideration may be required as to whether provisions should be included in transaction documentation to ensure that calculation agents, cash managers and other service providers (eg, derivatives counterparties) comply with their obligations as benchmark users;
- When originating consumer credit and mortgage loans, appropriate due diligence and consideration may be required as to whether it is necessary to include representations in related transaction documentation to ensure that only eligible benchmarks are being used to determine the amounts owed by borrowers and to ensure that the underlying loan or mortgage agreement identifies the benchmark, its administrator and the potential implications for the borrower. Consideration should also be given as to whether it is necessary to include disclosure in the related securitisation prospectus, as well as representations and warranties in transaction documentation, to the effect that amounts owing under the underlying loans or mortgages are all determined using an eligible benchmark; and
- Where any of the transaction parties are supervised entity users, they must produce and maintain written contingency plans setting out the actions that they will take if a benchmark that they use materially changes or ceases to be produced. These contingency plans must be reflected in client-facing documents and provided to the firm's regulator on request.

Comment

The responses to the consultations held by ESMA(4) indicate significant support for the increased oversight of benchmarks set out in the Benchmark Regulation.

Ahead of the Benchmark Regulation taking effect, supervised entities in the securitisation and structured finance market should start to identify which of their business lines are engaged in activities that may constitute the use of a benchmark and consider how this may affect operations – for example, when issuing securities or entering into derivatives contracts. Market participants should plan for compliance and determine whether administrators will continue to provide benchmarks, particularly where these are outside the European Union.

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Endnotes

(1) EU Regulation 2016/1011.

(2) For example, transferable securities which are traded or for which a request for admission has been made to trade on a regulated market or multilateral trading facility, or an organised trading facility.

(3) Credit agreements under Article 3(c) of Directive 2008/48/EC and Article 4(3) of Directive 2017/17/EU.

(4) See, for example, responses made between May 27 2016 and June 30 2016 to ESMA's consultation paper on the technical advice at www.esma.europa.eu/press-news/consultations/consultation-paper-esma-technical-advice-benchmarks-regulation#TODO.

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