Module Laws and Regulations

A. Benchmark Regulation

- Background

In the financial industry benchmarks such as LIBOR and EURIBOR were used in many products and contracts to determine price or to measure performance. In the wake of their alleged manipulation, the European Parliament in conjunction with the Council have adopted new rules to improve the governance of benchmarks produced and used in the European Union. The Benchmarking Regulation (also known as the BMR) establishes a common regulatory framework, seeking to ensure benchmarks are produced in a robust and reliable manner, and to minimize conflicts of interest in the benchmark-determination process. The regulation impacts indices across asset classes, including fixed income, equity, interest rates, FX and commodities. The BMR entered into force in June 2016 and came into effect on 1 January 2018.

- Objective

In order to prevent conflict of interest and benchmark manipulation, the BMR defines controls for benchmark processes and sets requirements to advance the quality of input data and methodologies used for benchmarks.

- Scope

What is a benchmark?

A benchmark is an index used for two purposes as defined in the BMR.

1. The first category includes indices used to determine the amount payable under a financial instrument or financial contract, or the value of a financial instrument. Examples include adjustable mortgage loans and consumer loans, where the amount payable is often determined using a benchmark like the LIBOR rate.

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2. The second category includes indices used to measure the performance of an investment fund for the purpose of:
    - tracking the return, or
    - defining the asset allocation or a portfolio, or
    - computing the performance fees.

A very important characteristic of an index is that they are published or made available to the public. Availability to an indeterminate number of recipients is not necessary. Even when an index is produced to accommodate tailor made needs for a specific user, also known as customized benchmarks, they will come under the scope of the BMR if they are referenced by an investment fund.

An example is where an investment fund computes performance fees based on a benchmark index like the FTSE Emerging Markets for equity related investments in emerging countries. But tweaks the benchmark to exclude companies that do not align with their ESG criteria.

The scope of the Benchmarks Regulation covers benchmark administrators, supervised contributors and benchmark users.

BMR allows supervised financial companies to use only those benchmarks which are authorized, and thus included in the register of the European Securities and Markets Authority, also known as the ESMA. Before a benchmark can be listed in the ESMA register it will have to comply with requirements stipulated under the BMR. These requirements vary with the type of benchmark. The BRM distinguishes between regulated-data, significant, non-significant, critical, commodity and interest rate benchmarks.

A benchmark administrator is an entity that provides indices that are used in:

— financial instruments traded on trading venues in the EU
— mortgage or consumer credit contracts, or
— investment funds (AIF or UCITS).

Examples of well-known benchmark administrators include Euronext, MSCI, JP Morgan and Bloomberg.

A supervised contributor on the other hand is an entity authorized by a competent authority like the AFM to contribute input data:

- that is not readily available to the administrator, and
- that is required for the determination of a benchmark and is provided only for that purpose.

Examples include banks that provide transaction data that helps determine the interest rate for specific loans.

Lastly, you are considered a benchmark user if you are supervised under one of the EU regulations[1] as specified in the Benchmark Regulation and you:

- issue a financial instrument which refers to an index or a combination of indices
- determine the amount payable under a financial instrument or a financial contract by referring to an index or a combination of indices
- are a party to a financial contract that refers to an index or a combination of indices
- provide a borrowing rate calculated as a spread or mark-up over an index or a combination of indices and that is solely used as a reference in a financial contract to which the creditor is a party
- measure the performance of an investment fund through an index or a combination of indices for the purpose of (i) tracking the return of such index or combination of indices, (ii) defining the asset allocation, or (iii) computing the performance fees.

Examples of well-known benchmark users are pension fund service providers such as PGGM or MN, banks such as ABN AMRO or an investment firm such as De Giro.

What is not considered benchmark usage?

The act of simply holding products that refer to an index, in the case of investment funds referring to a benchmark for performance comparison or marketing purposes does not constitute benchmark usage.

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[1] This includes AIFMD, MiFID but many other regulations.

Products in scope of BMR

Not all financial products fall under the scope of the BMR. The most common financial products that are under the scope of the BMR include UCITS, AIFs, structured products, derivatives, and certain credit agreements. Examples of products not in scope include insurance products and cash deposits.

The Benchmark Regulation (BMR) imposes requirements on benchmark administrators (which effectively provide the benchmarks), contributors and users. Different requirements apply to each.

What are the requirements for benchmark administrators?

Benchmark administrators should:

- First obtain registration or authorisation with the administrator's applicable National Competent Authority, for the Netherlands this means the AFM
- Provide Benchmark Statements with applicable disclosure, including key elements of the methodologies
- Implement contributor codes of conduct, if applicable
- Maintain adequate systems, controls, governance and oversight, including managing conflicts of interest
- Ensure integrity and reliability of input data

What are the requirements for benchmark contributors?

Supervised contributors are required to comply with governance and control requirements, which translates to having codes of conduct and control frameworks in place.

What are the requirements for benchmark users?

As a benchmark user you will have to comply with various requirements on contingency measures, control framework enhancements and disclosures.

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Benchmark compliance

Benchmark users must ensure that they only use benchmarks that are provided by benchmark administrators included in the ESMA Benchmarks Register. This means you have to assess all your products to determine which of them come under the scope of the BMR. For in-scope products you should determine the benchmark providers / administrators and assess whether they are included in the ESMA Benchmarks Register. You should also establish controls around the use of benchmarks to ensure that only benchmarks provided by BMR-compliant administrators are used.

Contingency measures

When it comes to contingency measures users need to have robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided. Where feasible and appropriate, such plans shall nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives. This means, fi, that you should establish a process to ensure that an alternative benchmark is defined whenever a new product is launched. In addition, controls should be established to periodically review the suitability and BMR-compliance of the alternative benchmarks.

Benchmark disclosure

Benchmark users should also add a disclosure to the relevant product prospectuses stating that the benchmark is provided by an administrator included in the ESMA Benchmark Register.

What is the impact of the BMR on the financial markets?

When we look at the interest rate benchmarks for example, we observe that in 2019 all significant interest rate benchmarks, like EURIBOR and LIBOR, used in the EU have been recognized as BMR non-compliant. Therefore, these interbank offered rates (also known as IBORs) will be migrated to risk free rates (RFR) in January 2022. Currently, international regulatory initiatives and working groups in different jurisdictions are defining RFR candidates, like ESTER, as possible replacements to IBORs. The ESTER rate is based on actual volume-weighted transactions, which makes it difficult to manipulate. LIBOR on the other hand is determined as the average interest rate calculated through submissions of interest rates by major banks across the world. As we've seen during the LIBOR scandal banks were

falsely inflating or deflating their rates to profit from trades, or to give the impression that they were more creditworthy. Hence it makes sense to move towards benchmarks like ESTER in order to prevent future benchmark manipulation.

The transition away from existing IBORs has a wide impact for financial institutions due to its incorporation within a broad range of financial instruments used across various market participants.

LIBOR rates, for instance, affect us both as consumers and as investors. LIBOR is often the reference rate for many different types of loans, including: adjustable-rate mortgages, auto loans and credit cards. Unless a back-up rate is listed in a contract, the new rate and terms will need to be agreed upon between the borrowers and the lenders. Existing contracts therefore have to be converted to alternative benchmarks. As you can imagine this will come at a significant operational and legal burden.

The BMR will come (fully) into force when the transitional regime for the use of existing financial critical (interest rate) benchmarks of index providers that are not yet subject to supervision ends on 1 January 2022. This means that the existing benchmarks, even after possible reforms, are no longer suitable for use in long-term contracts. This applies to both existing contracts and to contracts that will be entered into as of 1 January 2022 on the basis of critical benchmarks. In addition, if benchmarks used in existing contracts will no longer be offered, a suitable alternative must be ready for use.

Therefore, identification is required for the complete population of products, contracts, models and activities that directly/indirectly depends on IBORs

In a survey conducted by the AFM/DNB market participants indicate that they perceive the transition to new benchmarks as a high-risk operation, involving significant operational and legal risks.

Given the uncertainties surrounding the transition and its impact on the different types of customers, most institutions are still reluctant to inform their customers about the transition.

To conclude, we would recommend parties affected by the BMR to conduct a qualitative assessment as a first step to determine the materiality of the impact. Based on this materiality assessment a further, more detailed quantitative impact assessment should be executed to consider exposures and number of impacted contracts, clients and trades and impact to systems, models and processes.

B. EMIR

- Background

The global financial crisis that started in 2007, gave the regulators the opportunity to investigate the causes of the financial crisis. They have identified over-the counter transactions in derivatives (also known as OTC derivatives) as one of the potential causes to the global financial crisis and therefore came to the conclusion that this market should be "secured". A derivative is a contract that derives its value from the performance of an underlying entity. This underlying entity could for instance be an asset, index, bond, currency or an interest rate. Derivatives can be traded on an exchange like the Eurex or over the counter between two contracting parties.

The consensus among regulators was to move all standardized derivatives contracts that were being traded over the counter to a Central Clearing Party (also known as a CCP). A CCP positions itself between the buyer and seller as soon as the transaction has been executed. The CCP thus becomes the new counterparty of both the buyer and the seller – hence the name 'central counterparty'. As a consequence, the relationship between the two original trading parties no longer exists.

The seller would sell the contract to the CCP and the buyer will buy the contract from the CCP. This will introduce an effective monitoring since the CCP can stipulate the required collateral and monitor the positions of the two parties under new regulatory rules. This new infrastructure implemented for the OTC Derivative market can reduce the global counterparty risk observed into the OTC market considerably.

How does this tie to European Market Infrastructure Regulation, also known as EMIR?

- Objective

EMIR, in a quest to be more transparent and reduce risk, has introduced new obligations for derivative-trading companies. These obligations include trade reporting of all derivative contracts, meaning, over the counter and exchange traded derivatives. EMIR has also introduced mandatory centralized clearing of standardized OTC derivatives, risk mitigation techniques for non-centrally cleared derivatives, and enhanced collateral requirements.

OTC derivatives are contracts that are privately negotiated between two parties, without going through an exchange or other intermediary. Products such as swaps, forward rate agreements, exotic options – and other exotic derivatives – are almost always traded in this way. Since OTC derivatives are privately negotiated contracts they typically lack transparency as any information concerning them is usually only available to the contracting parties. This create a complex web of interdependence which can make it difficult to identify the nature and level of risks involved. The financial crisis has demonstrated that such characteristics increase uncertainty in times of market stress and, accordingly, pose risks to financial stability.

It is therefore important that counterparties and CCPs report all details regarding derivative contracts they have entered into to trade repositories. Trade repositories are essentially entities authorized by national supervisors like the AFM, that centrally collect and maintain the records of OTC derivatives. As a result, information on the risks inherent in derivatives markets will be centrally stored and easily accessible for European oversight authorities, like the ESMA.

How has EMIR impacted the trade in OTC derivatives?

- Keep in mind that under EMIR 5 types of derivatives are recognized: Credit derivative contracts, Equity derivatives, interest rate derivatives, FX derivatives and commodity derivatives
- EMIR requires all standardized OTC derivative contracts to be cleared by a central clearing party.
- In addition, all OTC derivative contracts should be backed by collateral. EMIR requires collateral to have low levels of market risk and credit risk. Minimum criteria for eligible collateral of each asset class have been specified under EMIR.
- EMIR introduces stricter segregation criteria for client money, with clearing members and central clearing counterparties required to offer either omnibus segregation or individual client segregation at the minimum
- In addition, OTC derivatives that are not standardized, and hence cleared non-centrally should be subjected to enhanced risk mitigation techniques
- Finally, financial companies impacted by EMIR should report daily trade and position of all derivative contracts to trade repositories and derivative contract records will have to be kept for at least 5 years post-contract termination.

Under a new regulation, known as EMIR 2.2., that came into force in January 2020, the European Union tries to enhance the regulation of CCPs amid concerns regarding potential CCP failures given their increasing systemic importance. If you look the market for clearing of euro OTC derivatives, fi, London's LCH Clearnet is responsible for clearing 97 percent of euro-denominated interest rate derivatives. After BREXIT some of the CCPs, which are of systemic importance to the EU, will be located outside the Union's borders. That could be troublesome, especially when laxer regulation and supervision creates a favorable playing field for CCPs in third countries at the expense of CCPs in the European Union. So in a way, EMIR 2.2. is trying to level the playing field by preventing supervisory arbitrage.

How do parties active in the institutional investment market incur a counterparty risk when unwinding derivative positions?

Derivative transactions are settled at a later time than that at which the actual trade took place. If, in the intervening period, either of the two parties is unable to meet its obligations, this could cause problems for the other party. This is also known as counterparty risk. To see how this risk comes about you could imagine a bank that hedges its mortgage portfolio against interest rate risks with interest rate swaps. An interest rate swap is basically an exchange of interest rates between two parties, typically where you exchange a fixed rate for a floating rate or vice versa. The bank could agree to lock in a fixed rate to avoid exposure to interest rate fluctuations in the future. During the closing out the bank incurs some counterparty risk, as there is a chance that the swap counterparty might default on its contractual obligation.

How is this risk mitigated under EMIR?

- All OTC derivatives contracts (bilateral or centrally cleared) will need to be collateralized. Collateralization is the use of a valuable asset now to secure a future payment. If one party defaults on the future payment, the other party may seize the asset and sell it to offset the loss

- EMIR has also introduced new risk mitigation procedures for non-centrally cleared OTC derivatives. This means that parties should have arrangements in place to ensure timely confirmation of uncleared OTC transactions.

- Also, formalised processes need to be in place in order to reconcile portfolios, manage the associated risk and identify disputes between parties early and resolve them, and to monitor the value of outstanding contracts.
- Parties should mark-to-market on a daily basis to determine the value of outstanding contracts
- Lastly, they should have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts

To sum up, it should also be noted that EMIR is a very dynamic piece of legislation. While introduced back in 2012, it has been updated many times. A recent update known as ‘EMIR Refit’ is expected in June 2020 which essentially holds financial counterparties legally liable for the timely and accurate reporting of OTC derivatives contracts on behalf of both themselves and their non-financial counterparty clients that don’t meet the clearing threshold. This requirement raises several operational challenges and points to be considered by both financial counterparties and non-financial counterparties today.

To conclude, we would like to briefly touch upon the supervisory calendar for 2020. In other words, which topics are currently keeping supervisors like the AFM and DNB busy? And how are these developments likely to impact day-to-day practice.

The AFM and DNB have deemed a couple of supervisory themes as priority themes for 2020

1. digitization: although digitization is considered a good thing, it also demands attention to the risks involved. On the one hand, we see that financial services in the digital domain are always available, information and products can be personalized to the customer and the threshold for ongoing contact between the seller and buyer is low. This entails convenience, lower costs and possibilities for a better fit between supply and demand. On the other hand, increasing digitization also raises supervisory concerns, for example around the ethical use of data.

2. **increased focus on products and services with long-term effects to protect consumers in vulnerable situations**. Secondly, supervisors will pay more attention to products and services with long-term impact in order to protect consumers in vulnerable situations. Supervisors will enter into a dialogue with the

credit lending sector to avoid future problems with interest-only mortgages. The influence of a low interest rate environment on lending to consumers will also be examined. Credit providers can expect tighter supervision of compliance with their duty of care.

3. **sustainable business model for asset managers**

Furthermore, the supervision of individual entities will shift in the coming years towards the asset management market as a whole. Also, the cost structures used by asset managers and risks involved in the outsourcing of activities by asset management parties will receive increased attention. The objective for 2020-2022 is to ensure asset managers have a sustainable business model and to ensure their clients are treated carefully.

4. **climate risks**; Lastly, DNB will increase its focus on climate risks as part of its supervision on the

internal risk assessment of banks, insurers and pension funds. Where appropriate, climate risks will be made part of future on-sites and DNB will continue to raise these issues in the regular supervisory interviews.

APPENDIX

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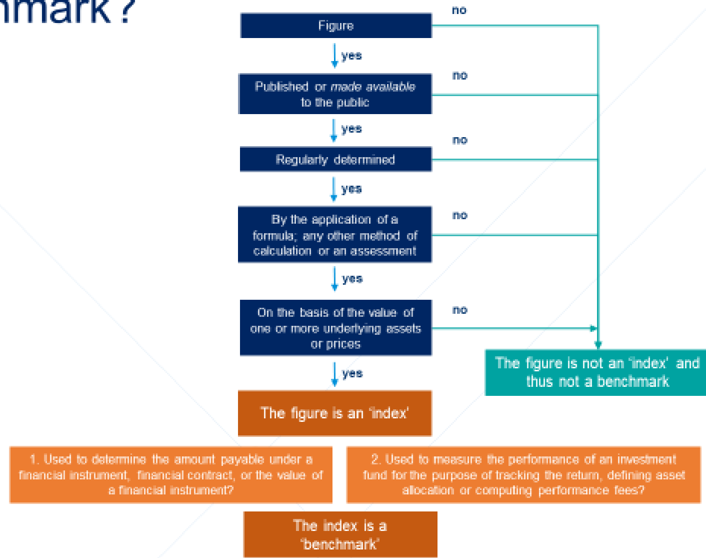
What is a benchmark?



Source: BMR Art 3.3

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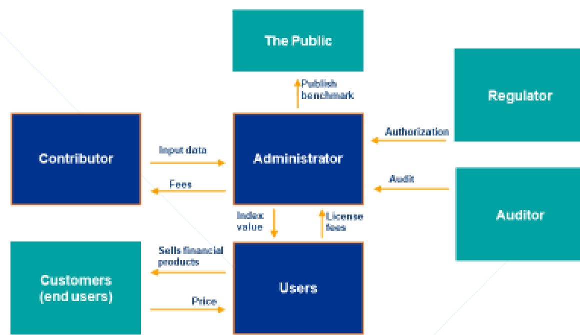
Benchmark roles

Legend



Source: EU Benchmark Regulation

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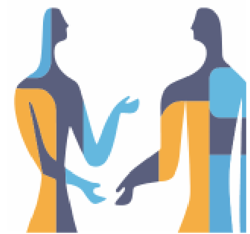
Benchmark types



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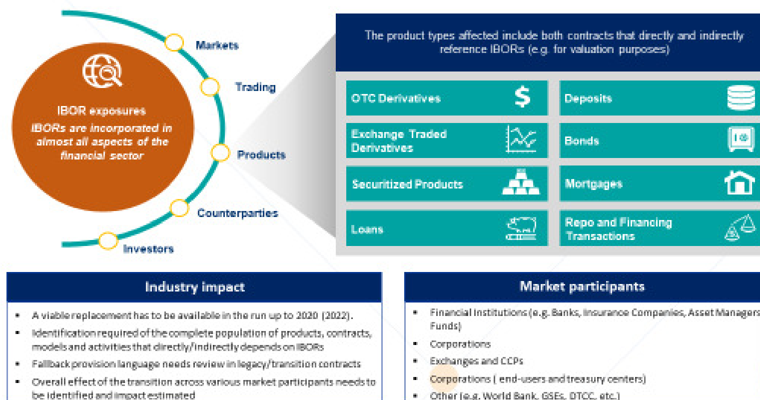
Impact of the IBOR transition

The transition away from existing IBORs has a wide impact for financial institutions due to its incorporation within a broad range of financial instruments used across various market participants. An overview is provided below.



Industry impact

- A viable replacement has to be available in the run up to 2020 (2022).
- Identification required of the complete population of products, contracts, models and activities that directly/indirectly depends on IBORs
- Fallback provision language needs review in legacy/transition contracts
- Overall effect of the transition across various market participants needs to be identified and impact estimated

Market participants

- Financial Institutions (e.g. Banks, Insurance Companies, Asset Managers, Funds)
- Corporations
- Exchanges and CCPs
- Corporations (end-users and treasury centers)
- Other (e.g. World Bank, GSEs, DTCC, etc.)

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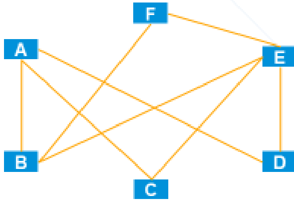
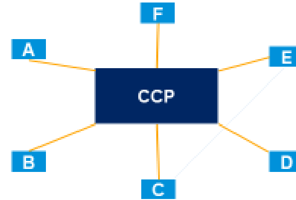
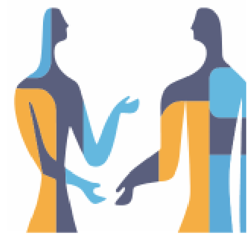
Bilateral vs. central clearing





- Complex interdependence between parties
- Lack of transparency
- Nature and level of risks unknown

- Central clearing entity
- Increased transparency
- Nature and level of risks known



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EMIR overview

EMIR (European Markets Infrastructure Regulation) is a European legislation aimed at increasing stability and enhancing transparency of the OTC derivatives market.