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D1655B-2012
17.09.2012

Euribor-EBF response to the European Parliament public consultation on Market Manipulation: Lessons and Reform post Libor/Euribor by ECON

Identity of the Contributor

- **Name of the person and/or organization responding to the questionnaire:**

Euribor-EBF

- **Description of the main activities of the organization:**

Euribor-EBF is an international non-profit making association under Belgian law founded in 1999 with the launch of the Euro and based in Brussels (56, avenue des Arts, 1000 Brussels). Its members are national banking associations in the Member States of the European Union which are involved in the Eurozone and the Euro-system[1].

Euribor-EBF has a mission of informing its members, other organizations, the European authorities and the national regulatory authorities on issues relating to the interbank rates. It develops and supports activities related to the Euribor (Euro Interbank Offered Rate), the USD Euribor, the Eonia (Euro OverNight Index Average), the Eurepo (benchmark rate of the large Euro repo market) and the Eonia Swap Index (derivatives market reference rate for the Euro).

It also supports other practical initiatives, fostering the further integration of the European financial market. These initiatives include the improvement of the liquidity and transparency of the short term commercial paper markets, by means of a harmonized framework for short-term European paper 'STEP', in collaboration with the European Central Bank.

Please indicate whether you object to the publication of the identity of the contributor:

☐ Yes, I object ☒ no, I do not object

[1] The list of Euribor-EBF National Members Associations is available at http://www.euribor-ebf.eu/assets/files/euribor-ebf-members.pdf

Introduction:

Euribor-EBF welcomes the opportunity to answer the European Parliament public consultation on Market Manipulation: Lessons and Reform post Libor/Euribor by ECON Vice President and Rapporteur Arlene McCarthy MEP.

Euribor-EBF response will only focus on the questions directly related to the benchmarks, and in particular Euribor.

Key Points:

- Libor and Euribor must be differentiated. Assimilating the two benchmarks could lead to confusion and therefore to inadequate measures regarding their evolution.

- Euribor-EBF believes it is appropriate to have a common set of core principles for benchmarks governance but underlines the need for specific responses at a technical level.

- Considering the disruption in the fixing that a real transactions-based index may generate, Euribor-EBF supports an evolution of the benchmarks based on enhanced governance and public supervision rather than on calculation changes, thereby limiting the impact on existing legal contracts and customer loans as well as potential litigation due to such definition amendments.

- In view of the volume of outstanding contracts based on these benchmarks, and the final impact on consumer loans, any change to their features need to be carefully assessed.

Background documentation:
Euribor Code of conduct: http://www.euribor-ebf.eu/assets/files/Euribor_code_conduct.pdf
Euribor Technical Features: http://www.euribor-ebf.eu/assets/files/Euribor_tech_features.pdf
Euribor Panel Composition: http://www.euribor-ebf.eu/euribor-org/panel-banks.html
Frequently Asked Questions about Euribor:
http://www.euribor-ebf.eu/assets/files/Euribor%20FAQs%20Final.pdf

Response to Consultation Questions:

TOPIC 1: TACKLING THE CULTURE OF MANIPULATION

Q1: What action should be taken to ensure these forms of market abuse are tackled?

Euribor-EBF believes that actions must be taken at a number of levels in order to tackle these forms of market abuse:

High level core principles for benchmarks should be decided at European level, with a **harmonized supervisory framework** and improved coordination between supervisors at both national and European level. Euribor-EBF supports the introduction of European public supervision on benchmarks.

Controls on the submission process for benchmarks should be reinforced, ensuring that panel banks respect the so-called "Chinese Wall". As an example, in July 2012, all Euribor panel banks have been requested to return a signed Euribor management certification form, in which they certify that *(1)* all internal procedures are set up to ensure a robust process for the submission of contributions, excluding any internal and external influences, *(2)* that all submitted contributions are the bank's appreciation of the evolution of the interbank market in the Eurozone according to the Euribor definition and *(3)* that the Euribor Code of Conduct is fully respected when contributing to the fixing.

Further enhanced governance measures should be taken, in order to maintain the credibility of the benchmarks. The Euribor Steering Committee recommends the following governance enhancement measures (those proposals would need to be further discussed with the appointed supervisor):

- **Inclusion of a Supervisor representative as member of the Steering Committee**: a European Supervisor should be represented within the Steering Committee.
- **Supervision of the calculation process:** A 'four-eyes principle' (double checking of the contribution process by different parties) on the calculation process run by the calculator agent should be performed by the European Supervisor.
- **Legal obligation for banks to contribute:** A number of banks by country could be designated to contribute to the fixing by the European Supervisor. The advantage of this option would lie in the large number of panel banks. The Steering Committee

believes that the larger the panel is, the more representative and credible the fixing is and is seen to be.

- **Increase the number of Steering Committee meetings to at least 6/year:** The number of Steering Committee meetings should be increased to at least 6 meetings a year, alternating physical meetings and conference calls, in order to reinforce the monitoring of contributions and of the level of the fixing.
- **External audit on panel banks' processes:** Panel banks' processes should be audited annually by independent auditors. To achieve this, the criteria on which the audit process will lie must be clearly defined and harmonized at European level.
- ***Ex-post* controls:** Panel banks should be randomly visited by the European Supervisor and the Secretariat and explain their quotation on specific days.
- **Review sanctions for misbehaving banks:** The review process of sanctions should be held at European Supervisory level.

Finally**, sanctions** for indentified and confirmed market abuse of either index should be uniform in their composition and execution across Europe and should be coordinated between the National and European supervisors to ensure enhanced global credibility of these benchmarks.

Q2: What action should be taken to ensure the integrity and quality of all benchmarks, financial instruments and markets?

a. Do both benchmarks and those entities that input into the setting of the benchmarks need to be regulated?

Euribor-EBF is in favour of a general framework for benchmarks at European level. Nevertheless, each benchmark has its own features and assimilating the two benchmarks could lead to confusion and therefore to inadequate measures regarding their evolution.

The main features differentiating Euribor from Libor must be taken into account:

Definition: Euribor is the rate that each panel bank believes one prime bank is quoting to another prime bank for interbank term deposits within the Euro zone. It is an offered rate as opposed to a borrowing rate considered in LIBOR. Additionally, panel banks do not quote a price reflecting their own position in the market which considerably reduces the incentive to quote inappropriate rates for reputational reasons ("stigma effect").

Panel composition: The Euribor panel is composed of 44 banks. The 15% highest and 15% lowest contributions are excluded from the calculation. The fixing is an average of the remaining individual quotes. Furthermore, it should be noted that panel banks are widely diversified geographically, and represent all banking sectors: commercial banks, cooperative banks, investment banks, large and small banks, local and international banks. On that basis, Euribor is a very diverse and credible representation of the general banking market in Europe.

Structure and monitoring: Euribor-EBF is an Association representing the national Associations of banks, not banks directly, thus giving a wider representation and a more challenging and neutral discussion environment. Additionally, the Euribor Steering Committee, composed of nine experienced market practitioners who must be independent and not subject to instructions from the companies or organisations to which they belong and chaired by the Chief Executive of Euribor-EBF, gives full transparency of its activities. The composition (name and company) of the Euribor Steering Committee and the minutes of the meetings are published on www.euribor-ebf.eu.

In light of those differences, **Euribor-EBF believes it is appropriate to have a common set of core principles for benchmarks governance but underlines the need for specific responses at a technical level. In this context, Euribor-EBF supports the introduction of European public supervision on benchmarks.**

b. Are traded rates as opposed to offered rates a better basis for input? Or should a 'hybrid' approach be adopted?

Contrary to Libor, Euribor quotation is not based on the "borrowing cost" of a contributing bank, but on the estimate of the rate at which one prime bank is offering funds to another prime bank in the Eurozone. In other words, panel banks do not show their cost of funding, but an estimation of the funding cost in the interbank market. There is consequently no "stigma effect" that discourages panel banks from being required to contribute their actual funding cost and encourages them to submit lower levels (*vs* the rate that they actually pay dependent on their name in the market). In our view, the Euribor should remain an estimation of the market by a panel bank, as it was originally conceived.

Moving to an interbank lending rate based on real transactions would raise a number of issues which would affect in unpredictable ways the fixings and, by extension, consumers:

- In the current environment, **the number of interbank lending transactions is particularly limited for medium to long-term maturities**. If the fixing was based on real-transactions, it is highly likely that, due to credit constraints on banks, there would be no quote for some maturities, which would have an impact on the existing contracts based on Euribor.

  Usually, in case of a corporate or a retail loan, there is an alternate calculation method, which could be something like "if no Screen Rate is available for the Interest Period of that Loan, the arithmetic mean of the rates (rounded upwards to four decimal places) as supplied to the Facility Agent at its request quoted by the Reference Banks to leading banks in the European interbank market, as of the Specified Time on the Quotation Day for the offering of deposits in euro for a period comparable to the Interest Period of the relevant Loan and, if such applicable Screen Rate or arithmetic mean is below zero, EURIBOR will be deemed to be zero". Depending on the definition of Reference Banks, the rate may vary considerably. The outcome would largely depend on the exact wording of each contract but it is more likely that a jolt in the level of the rate may occur.

  In the case of a derivatives contract, one should refer to ISDA documentation, which in turn is very varied because it is often negotiated on a bilateral basis. Should the above definition be applied to a 10y IRS transaction, there could be a difference in mark to market in the range of 8%/9%; such an impact would be reflected directly in the banks' Balance Sheets and Profits and Loss Accounts.

- A 'real transactions' based fixing is likely to result in a **significant spread in the prices amongst countries participating in the fixing**. Banks operating in peripheral countries have a floor, in their cost of funding, based on domestic government bills. The cost of funding for banks is very rarely below that of the Sovereign state in which it is domiciled. In general these banks fixings based on actual transactions would be at a premium to their domestic government issuance and therefore lead to a generic shift higher in fixings from these regions. When a country suffers from a widening in the spread *vis-à-vis* the so-called "core countries", their cost of borrowing rises immediately. If the index was based on real transactions, systemic banks in peripheral countries would necessarily contribute higher rates, whilst core countries would contribute lower or unchanged rates. Taking Greece/German government bills as an example; this spread in 6 month would be around 4.5% (Italy/Germany at 1.20%, Portugal/Germany at 1.40%, Spain/Germany at 1.60%; all spreads as of 11/9/12). For the above-mentioned reasons, banks would trade at higher spreads, thus contributing a very diverse range of rates for the same period. The implications of such should not be underestimated.

- **Real transactions-based rates might rise drastically**, depending on a series of features: Would the final rate be the simple average of all transactions for a specific tenor? Would it be a weighted average and, if so, which weights would be used? If there is not transaction for a specific tenor, which rate would be used? Which statistical model would be used for interpolation, if it is the case? All these questions would need to be carefully assessed. Depending on the parameters employed, very different rates might be calculated, with the possibility of resulting in an inverted interest rate curve (e.g. 3m rate at 2% and 6m rate at 0.50%), or very volatile rates, even day-to-day.

- **The fixing time might also be an issue**. Currently, the Euribor is published at 11.00 CET, whereas overnight effective rates like Eonia are published at close of business (6 pm CET). In this case, Exchanges would need to change their calendar for futures and options. Additionally, middle and back offices in banks may be forced to work long hours to settle deals. Finally, in relation to the US Open time, if Euribor was fixed at 6pm CET, then many trades would have to be settled with half a day less time compared to the current situation and American banks' activity may impact the fixing directly.

- **Finally, a transaction-based approach is not risk-free**: particularly in current market conditions, there could be an incentive for manipulation through collusion of banks exchanging liquidity in order to obtain at high or low rate for a specific tenor. This kind of manipulation would be very difficult to detect since the rates would be based on real transactions.

Hybrid approach may also be considered, nevertheless:

- A wider inclusion of products beyond interbank lending could consider on-balance sheet instruments such as CD/CPs, and/or commercial lending and letters of credit. Yet, same robustness concerns on a smooth and continue interest rate curve rise.
- When hybrid approach would mean using both traded prices and estimations in order to create a curve, we do not feel that this approach would increase the confidence in

the accountability and enhance the transparency, especially when proposed to the general public.

In this context, **Euribor-EBF recommends an evolution of the Euribor based on enhanced governance and public supervision as described previously rather than on calculation changes, thereby limiting the impact on existing contracts and, therefore, on customer loans, and potential litigation issues due to changes in the definition and implementation of any such amendments.**

c. **Should the posters of rates be granted anonymity? What would be the potential downside to such an approach? Would such status add or diminish the integrity of prices?**

It is unlikely that anonymous contributions would materially affect the final fixing of Euribor as panel banks contributing provide an estimation of the market, not their own actual funding cost, which prevents conflicts of interest in their estimation of the bank's rate postings.

Meanwhile, Euribor-EBF considers that transparency is crucial and that, in the current market conditions, the name of the contributors along with their submissions should remain public in order to preserve the integrity of and confidence in the benchmark.

TOPIC 2: ESTABLISHING INTEGRITY AND TRUST POST LIBOR/EURIBOR

Q3 (sub-question): How can legislators ensure continuity between existing contracts on Libor/Euribor (some $500 trillion of contracts) and future contracts?

Considering the volume of outstanding contracts based on these benchmarks, and the final impact on consumer loans, any change to their features need to be carefully assessed.

Should a new benchmark be created, Euribor and the new reference might co-exist until all existing contracts based on Euribor are closed while new contracts would be based on the new benchmark. Otherwise, an approach based on the legacy transactions adopted when domestic reference rates were replaced by Euribor® and national legislation and convention were adapted to facilitate the changeover might be envisaged.

Additionally, some existing contracts based on Euribor having very long maturities (decades), the transition to any new reference must be handled smoothly and on a very long period of time.

Meanwhile, as expressed previously, **Euribor-EBF recommends an evolution of the benchmarks based on enhanced governance and public supervision without radically change the calculation process, in order to reduce the impact on existing contracts and customer loans as well as potential litigation due to such definition amendments.**

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