European Benchmarks Regulation

Sell Side in the Crosshairs

The European Benchmarks Regulation (BMR) has been part of the European capital markets landscape for some time now, but its various tenets continue to throw up challenges for financial services firms within its purview. Initially, it was the buy side under pressure to comply, but now the sell side is in BMR’s sights.

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When it comes to dealing with rules and regulations, especially those pertaining to the capital markets, the devil is in the details. This idiom is especially pertinent to the financial services industry and the European Benchmarks Regulation (BMR), which slipped almost unnoticed into the European regulatory landscape at the start of January 2018, overshadowed by the fanfare accompanying the launch the same month of the revised Markets in Financial Instruments Directive (MiFid II)—arguably the most significant piece of legislation ever introduced to the bloc.

In its first few months on the European statute books, there was a widely held belief that BMR—officially, Regulation (EU) 2016/1011—only really affected the buy side. And for good reason: the asset management industry has traditionally used benchmarks to underpin a variety of functions that play a pivotal role in firms’ day-to-day business activities, while from a purely regulatory perspective, European buy-side firms were required by the European Securities and Markets Authority (Esma) to comply with BMR’s various tenets from the get-go. And so it was only natural for the spotlight to fall on the buy side in the immediate wake of the regulation’s introduction.

But as market commentators and the industry’s various constituents have noted in recent months, now that buy-side firms are largely out of BMR’s crosshairs—with anecdotal evidence suggesting that most asset managers within its purview have made the necessary moves to comply with its provisions—it is the sell side that is having to get its house in order. That said, it is important to note that, while buy-side firms have been under BMR’s purview since the start of 2018, their challenges in terms of complying with the regulation—specifically, compiling their benchmark inventories and identifying those that have and have not been approved by Esma—haven’t simply disappeared. Yes, their benchmark inventories might be more modest in number compared to the sell side, but they are by no means out of the woods in terms of BMR compliance.

This scenario was always likely to arise: the transitional period that Esma built into the regulation in essence means that many of BMR’s requirements do not become fully effective until January 1, 2020. EU-based benchmark administrators—entities that have control over the provision of a benchmark and its index methodology—should therefore already be well underway with their BMR preparations, given that Esma’s grace period is fast coming to an end. At the same time, administrators of critical benchmarks (including Euribor and Eonia) and third-country benchmarks (those administered by entities based outside the EU) have until the end of December 2021 to comply.

For its part, Esma appears happy with the state of play across the European capital markets and expects all European benchmark administrators to be fully compliant with BMR by the end of this year. “The transitional period is still running, so we are seeing a gradual adoption of the regulation, which has been implemented at different levels depending on the types of benchmarks used,” explains Michele Mazzoni, a senior officer in the Markets Department at Esma in Paris. “The transitional period was recently extended by EU legislators with reference to critical and third-country benchmarks, which will allow those administrators until the end of 2021 to apply for registration. We have seen an increase in the number of European administrators included in our register, and there has been a substantial increase in the number of third-country benchmarks in our register since the beginning of this year. So we think the implementation is gaining momentum, and we...
expect all European administrators to have implemented the regulation by the end of this year,” he says.

Introduction

BMR was introduced by the European Commission, inter alia, to improve governance and controls around benchmark and index processes, specifically to ensure that administrators avoid conflicts of interest, the likes of which were illustrated by the series of investigations during the course of 2012 into alleged fraudulent practices across the European and North American capital markets associated with Libor. It was also adopted to improve the quality of input data and methodologies used by benchmark administrators and to ensure that contributors—to benchmarks—and the data they provide are subject to adequate controls, oversight and transparency.

Now that the dust has settled somewhat since the original go-live date, has the regulation delivered the levels of transparency and reforms it was intended to, notwithstanding the fact that, as Mazzoni explains, a number of the most significant changes to the use and provision of benchmarks and indexes still lie ahead?

“That’s a difficult question to answer, but I think we have observed a profound increase in the awareness of what a benchmark administrator’s functions should be, what is important for users to know, and I think it has also led to some generally accepted industry best practices, especially in important areas like interest-rate benchmarks and exchange rates,” explains Jochem Kimman, senior supervision officer at the Dutch Authority for the Financial Markets (AFM). “Those are the positive elements. But at the same time, I don’t think the transparency has materialized to the extent to which we had hoped, probably due to the fact that there was a transitional period in the BMR and that transitional period has been extended.”

Feeling the Pinch

Sell-side firms have their work cut out to be fully compliant with BMR as 2019 ticks over to 2020, says Kimman, but AFM, as the competent authority for the Dutch capital markets, has observed an apparently concerted effort from firms within BMR’s purview to take whatever steps are necessary, even though operational and technological challenges remain.

“It is a challenge, but I have seen a lot of momentum created over the last couple of months as the transitional period is drawing to an end,” Kimman explains. “I think this has made those banks that were not where they needed to be in terms of their preparations aware that when the new transitional period ends, they will have come to grips with the large numbers of benchmarks and indexes that they use across their organization. I can imagine that it’s a really big challenge for them.”

Steve O’Brien, head of sales engineering at RIMES Technologies, echoes Kimman’s assessment, basing his evaluation on what he has noticed within both buy-side and sell-side firms that require assistance with their BMR compliance efforts. “For BMR, there has definitely been a lot more interest from the sell side than the buy side—the sell side appears to be more engaged, but I guess that comes down to the fact that sell-side firms have a lot more indexes in their inventory than buy-side firms,” he explains, reiterating Kimman’s take that the crux of the challenge facing sell-side firms is one primarily of scale. “What we are seeing is that buy-side firms have much smaller lists of benchmarks in scope under BMR, whereas the sell side has much longer lists because they are writing and creating products.”

Sell-side firms’ initial task is to accurately identify their entire benchmark inventories, says O’Brien, an undertaking that is anything but trivial, given the diversity in asset class use, multiple and often siloed business units, extensive use of third-party technologies, and of course legacy platforms, which all banks rely on to some degree. “What does their inventory look like?” he asks.

**WHAT TO LOOK FOR IN A BMR PARTNER**

A handful of technology/data firms offer BMR-focused services to buy-side and sell-side firms. As with almost every business process across the capital markets, the ultimate success or failure of a project often comes down to the choice of provider/partner and the quality of that relationship.

The first consideration for capital markets firms is whether or not they can derive any value for themselves, or pass any value on to their clients by way of BMR compliance efforts. Most would argue that BMR compliance is a necessary evil—a cost of doing business—and not an area where they can derive value or differentiate themselves. When it comes to BMR compliance, therefore, it makes sense to look to partner with a third-party specialist rather than manage what can be a costly, complex and laborious process in-house. The advantages are obvious: user firms stand to gain significantly from a provider’s experience, and while the responsibility for complying with the regulation cannot be outsourced to a third party, much of the complexity and grunt work around identifying the often vast numbers of benchmarks and indexes residing in disparate systems and siloes across the business can be. When considering the outsourcing option, the first rule of thumb is this: the provider has to be able to manage the process at least as well or better than it is currently being managed in-house, or outsourcing cannot be an option.

Other considerations include the outsourcing provider’s specific domain experience; the extent to which it understands the complexities and nuances of the client’s business; the extent to which the relationship can be expanded in the future if the client is looking for additional datasets or specific data management expertise; and the extent to which the provider tailors its products and services to each of its clients so that they receive a service that reflects their requirements exactly.

Contrary to what most capital markets firms believe, large numbers of other firms across the industry are grappling with exactly the same challenges. Speak to them. Did they use a third-party provider and, if so, what was a positive experience? What mistakes were made along the way and how were they dealt with? To what extent did the provider share the burden and collaborate when it was needed, and how responsive were its personnel?

And finally, signing new clients only tells part of the story when it comes to third-party technology and data providers. Retaining those clients is the really tough part and any provider worth its salt will have a high retention rate—in excess of 90 percent.
“How many indexes fall under BMR? Is it 500, is it 1,000 or is it 50,000? We’re seeing some very long lists from sell-side firms and a lot of that data is not traditional benchmarks. There are a lot of derivatives and cash rates, including Libors, total return swaps and interest rates swaps—and because they are using an underlying benchmark, that benchmark falls under the scope of BMR.

“For large sell-side firms, the challenge is capturing the information about what exactly they are writing their derivatives against and knowing whether those benchmarks are in scope or out of scope [in respect of BMR]. Collating those lists, some of which are in excess of 50,000 benchmarks, is a huge project.”

Kimman goes a step further than O’Brien and suggests the nettle that sell-side firms are currently having to grasp amounts to more than just one of scale. The challenge, he says, is exacerbated by the lack of industry-accepted identifiers when dealing with benchmarks and indexes, rendering their inventory efforts unnecessarily laborious and complex. “One of the key issues is that benchmarks or indexes do not have unique identifiers—they have a name, but there is no generally accepted naming convention,” he explains. “For example, if you look at the names of the standard S&P and MSCI indexes, sometimes they are longer than 350 characters, they also have all sorts of special characters, and there is no consistent way to identify them. So knowing your benchmarks is a real challenge: who exactly is the administrator, what is the exact name and version, and what is its status under BMR?”

O’Brien’s analysis of the identifier issue facing market participants mirrors Kimman’s, although he points out that it is not exclusively a sell-side challenge. Buy-side firms, he says, also struggle when it comes to establishing whether the benchmarks they are using have been registered with Esma or not. “Buy-side firms have to get this information together as well, although their universe is much smaller, say, up to 500 benchmarks as opposed to 50,000,” O’Brien explains. “But the challenge is also identifying the various benchmarks, because Esma doesn’t have any identifiers that allow firms to cross-reference their benchmarks, which makes it hard to know whether a benchmark is approved by Esma or not.”

Interestingly, the view from Esma’s Mazzoni differs markedly from Kimman’s and O’Brien’s on the acuteness of the respective challenges facing the buy side and the sell side, most notably when it comes to bulge-bracket sell-side firms. Mazzoni suggests these are well placed to meet their compliance obligations, given that their financial commitments in order to comply with BMR are relatively smaller than those facing buy-side firms. “Larger players appear to be on track in terms of implementation and are able to take advantage of economies of scale—their costs are relatively small compared to their activities,” he says. “With some smaller firms, the awareness in terms of the requirements [under BMR] does not necessarily appear to be that high yet.”

**The Way Forward?**

Given the scale and complexity of the challenge facing buy-side and sell-side firms in compiling their benchmark and index inventories, what are their options to ensure the procedure is managed transparently, efficiently and accurately? The most obvious recourse is managing that process in-house. This has its benefits and drawbacks: for smaller firms that typically use a modest number of benchmarks, assigning the responsibility to a staff member or small group probably makes sense, but such an undertaking quickly becomes unmanageable when benchmark numbers start escalating. “Some of the smaller firms have 50–100 benchmarks, and they can appoint a single person to handle that,” O’Brien explains. “But once you go north of that, it becomes much harder. Due to the nature of the regulation being applied at the index variant level (return type and currency), you must understand benchmarks to ensure that you are tracking the correct index that has been approved by Esma.”

An integral part of RIMES’ BMR offering revolves around the initial mapping of clients’ inventories to benchmarks that are in scope under BMR and those that are out of scope. RIMES has compiled a global repository of benchmarks from its data partners—in excess of 250 index-related data providers—allowing it to quickly identify whether a benchmark is authorized or not according to Esma, and what the regulator’s plans are for registration for the end of this year. “That piece is crucial in order to help clients get a grip on their inventories,” O’Brien says. “The second phase [of the RIMES offering] is the ongoing service—that can be through a RIMES RegFocus BMR datafeed—and then there’s also a desktop product, RIMES RegFocus BMR. Control, which is more for the compliance team, allowing them to identify the risk associated with a particular benchmark and to select a substitute or alternative should that benchmark stop being produced.”

O’Brien explains that there are alternative services on the market where vendors provide a feed, although they tend to be generic feeds and not customized to the clients’ requirements, a quality RIMES is synonymous with. He says: “RIMES typically customizes its feeds according to the client’s inventory, which is a key value-add so that the client doesn’t have to do the mapping—RIMES does the mapping and helps them in that respect.”

**KEY TAKEAWAYS**

- Ostensibly, it might appear as though buy-side firms are coping well with their BMR obligations, but closer scrutiny indicates that, while their benchmark inventories tend to be smaller than those on the sell side, they still have their work cut out in terms of managing their various BMR processes in-house.
- Sell-side firms’ challenges tend to be greater than those facing the buy side, given the large number of benchmarks and indexes they usually use, and the fact that benchmarks and indexes do not currently have unique identifiers, making it difficult for firms to ascertain whether then are in scope or out of scope under BMR.
- Establishing a benchmark and index inventory can be managed in-house if the numbers are small, but once they exceed 500, that undertaking becomes significantly more complex and laborious.