AFM Market Watch

Benchmarks

September 2022, edition 7

1. Introduction

This Market Watch aims to increase knowledge about the relevance of benchmarks for the financial markets and AFM's supervisory role vis-à-vis benchmarks. After an overview of what benchmark supervision by the AFM entails, three important types of benchmarks will be highlighted: i) ESG (Environment, Social, Governance) benchmarks because they are a key driver for the development of sustainable finance, ii) commodity benchmarks and iii) IBOR (interbank offered rates) benchmarks, including the market-wide transition away from IBORs to newly defined risk-free rates triggered by several manipulation scandals.

In recent years, benchmarks have become increasingly important due to an enormous growth of the number of passive investments. Index-tracking funds now account for one-fifth of the EUR 9.4tn European investment market, following a surge that has led to passive investing doubling its share of the pie over the past decade according to Morningstar. Many investors use trackers or ETFs (Exchange-traded Funds) to invest over a long-time horizon. Benchmarks are used as standards against which the performance of stocks, bonds, trackers and all other kinds of financial instruments can be measured, and/or determine the composition of financial instruments, for instance in the case of trackers or ETFs on an index. Benchmarks have become fundamental elements of financial markets' infrastructure and, ultimately, financial stability.

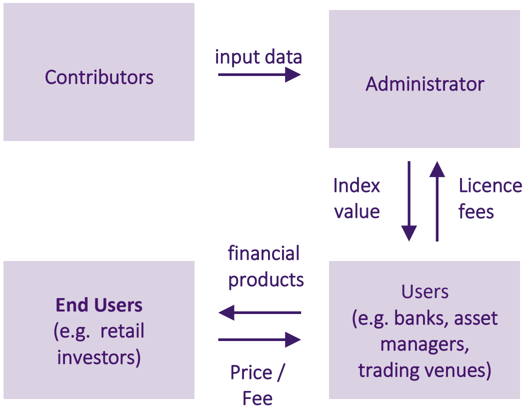
Currently, the AFM has 11 benchmark administrators (out of a total of 84 in the EU) under its supervision, based on the Benchmark Regulation (BMR). For example the AEX index and S&P 500, together with thousands of other benchmarks, are provided by benchmark administrators – often also called index providers – which are under AFM supervision. The BMR, introduced in 2018, applies to all kinds of benchmarks. Following a couple of amendments since then, the current review (which has been consulted on this summer) could result in a more significant amendment of the BMR with regard to the Third Country regime and the scope of the BMR. Both ESMA and the AFM provide input and feedback to consultations on BMR reviews.

This Market Watch consists of two parts: (i) a lead article about benchmarks and (ii) a short facts & figures section about repo transaction data.

2. What is a benchmark?

The BMR defines a benchmark as *an 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 purpose of tracking the return of such index or of defining the asset allocation of a portfolio or of computing the performance fees.*

The BMR system:



Benchmarks are critical to the efficient functioning of financial markets and can be used in various ways. They are used to price financial products, serve as reference rates for fund managers, and increase price transparency for investors. For instance, financial instruments can be issued which refer to an index (e.g. an ETF linked to a certain index). The amount payable under a financial instrument or financial contract can also be determined by referencing an index, for instance in mortgage contracts. In some financial contracts, such as option contracts, conditions are set by referencing an index. Borrowing rates can also be defined by calculating a certain mark-up over an index. Benchmarks are also used for constructing an investment portfolio. And very often indices or benchmarks are used to measure the performance of an investment fund.

In the EU, benchmarks enhance the facilitation of a common internal financial market. Benchmarks limit transaction costs because they provide universal cross-border pricing. Moreover, benchmarks in the EU can be used to price financial products in one country, which are sold or used by consumers in other EU countries.

Obligations for benchmarks - The Benchmark Regulation

The BMR has been applicable since 1 January 2018. It sets requirements for benchmark administrators, contributors, and supervised users. The BMR establishes a regime for benchmark administrators that ensures the accuracy and integrity of benchmarks.

The Benchmark Regulation aims at

(i) improving the governance and controls over the benchmark process, in particular to ensure that administrators avoid conflicts of interest, or at least manage them adequately;

(ii) improving the quality of input data and methodologies of benchmarks;

(iii) ensuring that contributors to benchmarks and the data they provide are subject to adequate controls, in particular to avoid conflicts of interest;

(iv) protecting consumers and investors through greater transparency and adequate rights of redress; and

(v) ensuring that supervised entities have robust written plans in case of cessation or material changes of benchmarks.

Under the BMR, a supervised entity located in the EU may use a benchmark or a combination of benchmarks: (i) if the benchmark is provided by an administrator located in the EU included in the ESMA register of administrators or (ii) if the benchmark is provided by an administrator located outside the EU (so-called third-country administrator) and the benchmark is included in the ESMA register. This latter requirement will become applicable as soon as the transition period ends, currently set at 31 December 2023, with a possibility for the European Commission to extend the period by another two years until 31 December 2025.

Today, benchmark administrators must apply for a licence (authorisation or registration [a lighter regime for administrators providing non-significant benchmarks] for EU administrators, recognition for third country (non-EU) administrators; third country benchmarks can be endorsed) at one of the National Competent Authorities (NCAs) to supply and manage benchmarks in the EU for EU users. The AFM is responsible for granting licenses, processing the registration and monitoring compliance with the BMR. The main objective of the regulation is to ensure robust and reliable benchmarks. This is crucial for the effective functioning of financial markets – an important objective of the AFM. As of 1 January 2022, ESMA is the supervisor of EU critical benchmarks administrators and EU recognised third-country administrators under the BMR.

3. Benchmark administrators under AFM supervision

A benchmark administrator is a natural or legal person that has control over the provision of one or more benchmarks. Benchmark administrators that at the time of writing (September 2022) are subject to supervision by the AFM are shown in table 1, with a few examples of their benchmarks in the last column.

Table 1: Benchmark Administrators subject to AFM supervision

EU Benchmark Administrators; Authorisation under Article 34 BMR.		
Name of Administrator	**Number of benchmarks**	**Examples of administered benchmarks, including ESG (E) or Commodity (C) indices**
Argus Benchmark Administration B.V. (PRA)	4	Gasoline Eurobob oxy NWE barge (C) Coal API 2 index (cif ARA) (C)
ICIS Benchmarking Europe B.V. (PRA)	8	TTF assessment (C)
Platts Benchmarks B.V. (PRA)	>10	Crude Dated Brent (C) Naphtha European Cargoes CIF NWE basis ARA (C) Fuel Oil 3.5% FOB Rotterdam Barges (C) Marine Fuel 0.5% FOB Rdam Barge (C)
S&P DJI Netherlands B.V.	>700	S&P Eurozone 50 Net Zero 2050 Paris-Aligned ESG Select Index (E) S&P Europe 350 S&P 500 Net Zero 2050 Paris-Aligned ESG Index (E)
Markit N.V.	-	(currently not providing benchmarks)
EU Benchmark Administrators; Registration under Article 34 BMR		
Name of Administrator	**Number of benchmarks**	**Examples of administered benchmarks, including ESG (E) or Commodity (C) indices**
Cboe Europe Indices B.V.	>100	Cboe Netherlands 25 Cboe Europe 50
Euronext Amsterdam N.V.	>140	AEX AEX ESG index (E)
Global Property Research B.V.	~20	GPR Europe ESG+ Index (E)
ING Bank N.V.	<10	ING Sustainable Europe Low Risk Equity Index (E)
Robeco Indices B.V.	~15	Robeco Global Sustainable Multi-Factor Equities Index (E)
Third Country Benchmark Administrators; Endorsement under Article 33 BMR		
Name of Administrator	**Number of benchmarks**	**Examples of administered benchmarks, including ESG (E) or Commodity (C) indices**
S&P Dow Jones Indices LLC	>4,000	S&P 500 Dow Jones Industrial Average S&P GSCI Gold

A large number of financial instruments are linked to benchmarks under AFM's supervision. In table 2 a few examples are shown of the number of financial instruments with a benchmark with an ISIN (many benchmarks do not have an ISIN code themselves) as underlying, from a benchmark administrator under AFM supervision.

Table 2: Examples of the number of financial instruments linked to a benchmark

Name of Administrator	Name of benchmark	Number of financial instruments linked to this benchmark
Euronext Amsterdam N.V.	AEX	>7,000
S&P Dow Jones Indices LLC	S&P 500	>40,000
S&P Dow Jones Indices LLC	Dow Jones Industrial average	>40,000
Cboe Europe Indices B.V.	Cboe UK 100	>1,000
Cboe Europe Indices B.V.	Cboe France 40	>1,000

4. AFM supervision

Why supervision?

Imperfections such as information asymmetries, inadequate competition, market power, barriers to entry, switching costs and externalities may prevent markets from working well. Deficient methodologies and conflicts of interest can lead to market abuse. When the benchmark process is subject to manipulation (as referred to in Article 12(1)(d) of the Market Abuse Regulation), the calculated or assessed benchmark values are inaccurate and do not reflect true market fundamentals. This can result in a loss of confidence in established benchmarks and a decline in the level of integrity of financial markets and thus a risk for financial stability. The concern of benchmark manipulation has been highlighted most prominently by the LIBOR scandal. These risks motivated the market and the EU to develop its own European regulation for benchmarks to ensure integrity and reliability (see the separate text box on page 2).

Supervision of BMR requirements

The BMR sets out a series of governance and management rules that benchmark administrators must comply with in order to provide benchmarks in the European Union. It also sets rules for contributors and users.

The AFM is responsible for supervising compliance with the BMR and thoroughly assesses administrators' governance arrangements during the application process. Once benchmark administrators start providing benchmarks, the AFM supervises ongoing compliance with BMR rules. In addition, administrators are required to provide the AFM with updates on any material changes to the benchmark methodology and governance related changes.

Governance

In the first half of 2022, the AFM's supervisory activities focused on the benchmark administrators' governance and controls. In particular, the AFM looked into the daily workings of management, board of directors and other governance structures of benchmark administrators under its supervision. The AFM concluded that for some administrators there is room for improvement in their oversight functions and control frameworks. For instance, some oversight committees were only involved to a certain extent in the annual review of the methodologies. Another finding was that more attention could be paid to monitoring compliance with the Conflicts of Interest Policy on a regular basis, to ensure the identification of conflicts are top of mind for all employees.

International collaboration

The AFM works closely together with the European Securities and Markets Authority (ESMA), for example through the BMR network, in which all EU national competent authorities (NCAs) participate. The BMR network, for instance, responds to the consultation on the BMR review by the European Commission on further potential improvements in the functioning of the BMR, specifically regarding the rules applicable to non-EU benchmarks (also called third-country benchmarks) and the impact on market participants of the full entry into force of the third country regime as of 1 January 2024.

More information can be found at the AFM website: Benchmarks Regulation | Topics AFM | AFM Professionals. For questions or feedback, please call +3120 - 797 2453 or mail to: benchmarks@afm.nl. Market participants can also signal disruptions, incidents and/or abnormalities by making a notification via benchmarks@afm.nl.

5. ESG Benchmarks: additional disclosure requirements

ESG (Environment, Social, Governance) benchmarks are an important base for many investment funds and ETFs. Within the BMR, there are even more specific transparency obligations for “ESG” or “sustainable” benchmarks. Benchmark administrators must disclose additional information about specific ESG factors that have been used to select or exclude certain constituents in the benchmark, in their benchmark statement and benchmark methodology. Examples of this are for the “E”: greenhouse gas intensity of the benchmark; for the “S”: percentage of benchmark constituents in the tobacco sector; and for the “G”: ratio of female board members; or the percentage of independent board members.

Climate-related benchmarks

The BMR was amended (effective by April 2020) to introduce two climate-related labels for benchmarks: EU Paris-aligned benchmarks (EU PABs) and EU climate transition benchmarks (EU CTBs), as well as ESG disclosures applicable to all benchmarks. These new categories of climate-related benchmarks aim to reallocate capital towards a low-carbon and climate resilient economy. Their underlying assets are selected in such a manner that the resulting benchmark portfolio’s Greenhouse Gas (GHG) emissions are aligned with the long-term global warming target of the Paris Climate Agreement.

Administrators of these benchmarks must disclose additional information, as required in delegated regulation 2020/1818. The EU CTB is a benchmark where, among other conditions, underlying assets are selected, weighted or excluded in such a manner that the resulting benchmark portfolio is on a decarbonisation trajectory (7% reduction of GHG intensity on average per year). The EU PAB is a similar benchmark, but with even more ambitious emissions reduction goals and stricter exclusion criteria. For instance, GHG intensity or absolute GHG emissions of an EU PAB should be 50% lower than the investable universe, whereas this figure is 30% for EU CTBs. In addition, certain companies must be excluded from EU PABs, such as companies involved in the production of tobacco or controversial weapons.

AFM focus on ESG benchmarks administrators

The transition towards a sustainable society is one of the most important challenges of our time. The AFM recognises the importance of this transition and encourages financial institutions to play their part (see also this infographic). As part of its mission, the AFM is actively supervising ESG benchmark administrators. In the past year, several Benchmark Statements and Benchmark Methodologies of administrators under AFM’s supervision have been reviewed. In general, most benchmark administrators are on the right track in terms of mandatory ESG disclosures. However, there is clearly room for improvement.

- ESG information is generally disclosed in both the benchmark statements and benchmark methodologies, but there is a large difference between administrators. It can be found easily on the website of some administrators but might be dispersed across many different documents at other administrators.
- Whereas most obligatory ESG information can be found on their website, the BMR templates are not always used, making it difficult for users to find the information and to compare ESG benchmarks of different administrators.
- For users, it is still difficult to judge the contents and quality of the information.

The AFM sees a clear improvement by benchmark administrators since the introduction of these disclosure requirements: more and more data points are published. Conclusions of both reviews have been, and will be discussed with the relevant benchmark administrators, several other NCAs and ESMA.

It is expected that benchmark administrators will further improve their ESG- and Climate-related benchmarks, both in terms of disclosures and of governance. This will help towards the goal of safeguarding confidence in the integrity of ESG benchmarks, and to limit the risk of greenwashing in this segment. This will contribute to a sustainable, fair and transparent financial market in the Netherlands.

6. Commodity Benchmarks

Commodity benchmarks (or commodity price assessments) are benchmarks that reflect physical commodity markets. These benchmarks are provided by so-called Price Reporting Agencies (PRAs). PRAs gather input data for their price assessments through daily interactions with market participants about trading interests (bids / offers) and market developments, and by observing transactions in the market and on trading venues. The PRAs fall under Annex II of the BMR (based on the IOSCO Principles for PRAs) and therefore have a different BMR regime compared to the other benchmark administrators. The AFM currently has three PRAs under supervision (ICIS, Argus and S&P Global Commodity Insights (previously S&P Global Platts)) which provide, for example, price assessment reports about important commodities such as Dated Brent and Gas TTF.

7. IBOR (Interbank Offered Rate)-transition

In the aftermath of manipulation scandals of LIBOR (London Interbank Offered Rate) and EURIBOR (Euro Interbank Offered Rate) and in view of the downward trend in volumes traded in interbank markets, the Financial Stability Board (FSB) encouraged market participants internationally to transition away from IBORs by adopting alternative transaction-based risk-free rates from 2014 onwards. For an overview for major jurisdictions, see table 3. National supervisors and central banks have been monitoring this transition, while national working groups composed mostly of financial institutions and industry organisations have determined alternative risk-free rates and worked out fallback language for amending financial contracts. The most well-known IBORs were EURIBOR and LIBOR, denominated in several currencies. While LIBOR has ceased to exist in almost all currencies (the USD LIBOR will be stopped in 2023), EURIBOR was successfully reformed in 2019 and continues to be published. Its administrator, the European Money Markets Institute (EMMI), is registered in the ESMA Benchmarks Register. Another major rate, the EONIA (Euro OverNight Index Average), was also discontinued and replaced by the newly developed €STR (euro short-term rate) calculated and published by ECB. The €STR is also considered as the fallback in EURIBOR contracts should the latter cease to exist in the future.

The financial, operational, and legal risks of this transition could be substantial for market participants concerned and their customers. The accumulation of such risks could endanger the financial stability of the whole sector due to the scale at which interest rate benchmarks are used. Therefore, the AFM together with DNB monitored closely how the market operationalised this transition. Specifically, a sample of Dutch financial institutions was regularly surveyed to analyse the pace of the transition and how various risks were addressed. Moreover, the AFM issued recommendations to limit behavioural risks of the benchmark transition for market participants.

1 January 2022 marked the end of most LIBOR settings as well as the EONIA benchmark rate. Shortly before, a legislative fall-back mechanism was established in the EU by amending the BMR that enables the European Commission to select replacement rates for ceasing benchmarks. The EC used this power in the case of discontinuation of EONIA and CHF LIBOR. Contracts without a fallback mechanism were automatically converted to a statutory replacement rate.

Table 3: Overview of benchmark landscape for major jurisdictions

	EU	UK	USA	Japan	Switzerland
IBOR	EURIBOR, EONIA, Euro LIBOR	GBP LIBOR	USD LIBOR	JPY LIBOR	CHF LIBOR
Alternative index	Euro Short-Term Rate (€STR)	Sterling Overnight Index Average (SONIA)	Secured Overnight Financing Rate (SOFR)	Tokyo Overnight Average Rate (TONAR)	Swiss Average Rate Overnight (SARON)
Administrator	European Central Bank	Bank of England	Federal Reserve Bank of New York	Bank of Japan	SIX Swiss Exchange

Looking to the future, an important point of attention remains the development and the implementation of robust fallback language in all products and contracts referencing interest rate benchmarks. This is particularly the case for contracts linked to currently published synthetic rates as these are not guaranteed to be maintained in the long run.

Financial markets internationally navigated this transition on time and with minimal disruption. The smooth transition occurred thanks to industry efforts in repapering legacy contracts and adopting fallback language, to regulatory initiatives in providing clear communication to financial markets, and to the formation of a safety net for contracts without fallback language by means of synthetic rates.

Research by the AFM among a group of selected financial institutions in the Netherlands showed that these Dutch market participants were prepared for the IBOR transition and have taken appropriate action to ensure their business and clients were appropriately prepared. The termination of certain IBORs generally did not cause disruption. This was also due to actions taken by the public sector such as the statutory replacement rates and the synthetic rates.

Facts & Figures

In July 2019, the European reporting obligation under the Securities Financing Transactions Regulation (SFTR) commenced. The AFM is responsible for the supervision of the reporting obligation and its data quality for Dutch counterparties. Repo transaction data gives us insights with a view to financial stability related themes. Securities lending and margin lending data allows us to monitor the functioning of markets and the behaviour of their participants.

Every month approximately three million transactions are processed. About 5% of these are new transactions. The other submissions are primarily related to modifications and collateral positions.

Repo & Reverse Repo data

Figures 1 and 2 are taken from a subsegment of the Dutch interbank 1-day repo market (from SFTR data). Figure 1 shows the fluctuation in repo turnover and there are some very clear observations:

- The Russian invasion of Ukraine on 24 February 2022 led to a doubling of the repo activity by turnover. This is not surprising given that in times of uncertainty and market volatility the demand for cash and high-quality collateral jumps to secure liquidity buffers, for example to meet margin calls.
- After three weeks of elevated activity, markets returned to pre-invasion levels

Figure 1: Daily new transaction turnover by value date (principal amount in billion EUR); source: SFTR data

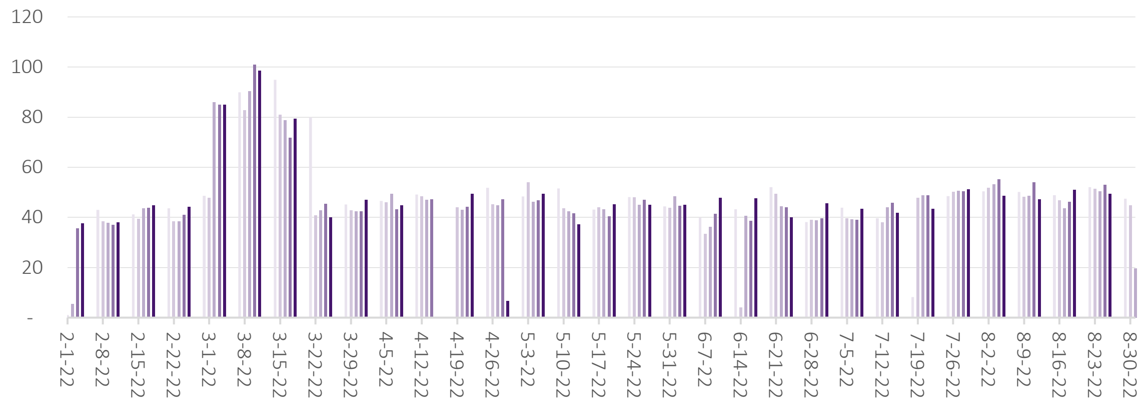
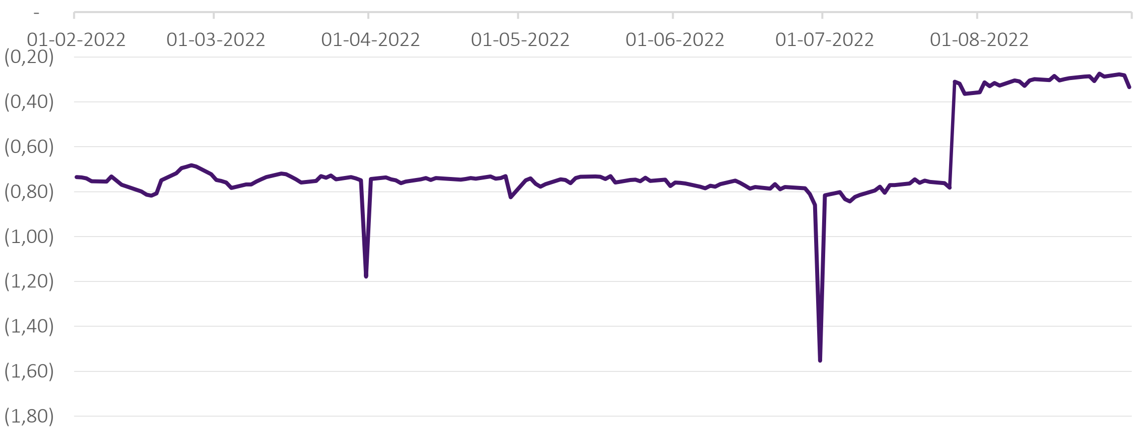


Figure 2 shows the fluctuations in the repo rate. The repo rate can be an indicator of market stress on the cash or on the collateral side:

- The repo rate shows higher volatility in the days prior to the invasion. A high repo rate usually signals demand for cash, for example for margin purposes.
- The downward spikes on 31 March and 30 June 2022 coincide with Basel III quarter end reporting metrics, which incentivises some banks to make balance sheet adjustments. A low repo rate often signals increased demand for high quality collateral. The high demand for this collateral makes the bond buyer willing to accept low repo interest over the cash leg.
- The ECB's interest rate hike as of 27 July 2022 is clearly visible.

Figure 2: Average daily repo rate for repo transactions with a maturity of 1 day (%); Source: SFTR data



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