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More work needed: financial benchmarks – FCA thematic review of oversight and controls

The FCA's continued focus on benchmarks is again illustrated with the publication of a thematic review of oversight and controls for financial benchmarks (TR15/11). One of the key messages from this paper is that the FCA is not just looking at how firms treat the specified benchmarks which are regulated in the UK. Instead it is an assessment of how firms look at the wider definition of benchmarks set out in the IOSCO principles and the processes in place to capture these activities. This may come as a surprise to some firms who have been concentrating on their processes and procedures for the eight UK regulated benchmarks. One particular criticism from the FCA is that some firms are not aware of when they are acting in a capacity as a submitter to a benchmark. This is seen as a serious failing by the regulator.

The FCA has explained that the thematic review was carried out between August 2014 and June 2015 on twelve banks and broking firms to provide an assessment of whether firms had learnt the lessons from previous failures around benchmark activities and taken appropriate action in response. The FCA considers that although there have been positive changes around governance and controls surrounding benchmark activity, significant work is still needed to ensure that all risks are managed appropriately. There is also a warning shot to senior managers that they should take heed of the findings and take the necessary steps to identify and resolve outstanding issues. The FCA found that all firms reviewed had made changes to their approach to benchmark activities but that no firm had fully implemented those changes and there is still work to do.

The FCA discussed in some detail the IOSCO Principles for Financial Benchmarks which firms are encouraged to implement if they are involved in benchmark activity. The thematic review used the IOSCO definition of benchmarks which is far wider than for UK regulated benchmarks and is set out in the text box below.

The FCA expects all firms, not just those who were part of the review, to identify, manage and control the risks arising from benchmark activities and to put in place appropriate oversight and controls. There is emphasis on embedding a culture in which market integrity and consumers' interests are at the heart of the business.

IOSCO definition of benchmarks

Prices, estimates, rates, indices or values that are:

- Made available to users, whether free of charge or for payment.
- Calculated periodically, entirely or partially by the application of a formula or another method of calculation to, or an assessment of, the value of one or more underlying interests.
- Used for reference for purposes that include one or more of the following:
  - Determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments;
  - Determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of the financial instrument;
  - Measuring the performance of a financial instrument.

Key FCA findings

- **Uneven change** - there was evidence that enforcement fines levied in relation to benchmarks had been effective in instigating change in firms. Banks came out on top against brokers and the FCA acknowledged that the banks reviewed had more structured and fully developed programmes to improve oversight and controls. Conflicts of interest and the issue of segregation had been given due consideration in some firms. Unsurprisingly, the most significant examples of change were in those firms where there had been previous failings.

Potential conflicts of interest and structured products

In-house benchmark administration: Potential conflicts of interest arise when the trading desk designs and manages an in-house benchmark that is referenced to a structured product that it has issued. Conflicts may arise, for example, where the firm exercises discretion and is able to change the components of an in-house benchmark. There is an incentive therefore for the trader to design this in a way that economically benefits the firm. ***This is an area of significant concern.***

- **Change has lacked urgency** – the FCA concluded that progress has been slow and the lack of urgency is disappointing.

- **Inconsistent benchmark identification and follow up** – the FCA found inconsistencies in how firms identified benchmark activities within their firms and how change programmes were applied across business areas. Only a handful of firms reviewed sought to broadly interpret the IOSCO definition of benchmarks. Some interpretations meant that strategic in-house benchmark business was not captured. Consequently the FCA considers that firms did not give sufficient consideration to establishing a relevant governance framework around in-house benchmark business.

- **Identifying and managing conflicts** – the FCA highlighted that firms had failed to apply lessons learnt in relation to one benchmark to others, through a combination of not using IOSCO principles to identify benchmarks as well as standalone business structures. Firms need to review all the processes linked to benchmark activities and identify where conflicts may manifest themselves.

- **Withdrawal from benchmark activities** – the FCA acknowledged that many firms had made commercial decisions to withdraw from benchmark activities but that such decisions, either to enter or exit from a benchmark activity, and in particular the consequences that a withdrawal would have, were not given sufficient consideration.

Six key FCA messages:

1. Firms need to ensure that they identify all of the activities that constitute a benchmark activity or that could affect a benchmark.
2. Firms' senior management need to act quickly to improve any outstanding gaps in their approaches to benchmark activities.
3. Firms need to strengthen their governance and oversight of benchmark activities.
4. Firms need to continue to identify, raise awareness of and manage conflicts of interest in relation to benchmark activities.
5. Firms should ensure they establish robust controls and oversight for any in-house benchmarks being used.
6. When exiting benchmark activities, it is essential that firms give due consideration to the wider impact of their actions.

FCA examples of good and bad practices

Benchmark approach and strategy	
X most firms had interpreted the IOSCO definition too narrowly	√ most firms had developed a formal benchmark strategy to ensure they had adequate oversight and controls around benchmark activity
X some firms had not given sufficient consideration to the proper identification and controls around their benchmark activities	√ some firms had proactive engagement by senior management on conduct risks, relevant training and appropriate MI for benchmarks
X some firms had not considered the impact that their trading/broking activity had on benchmarks where they were not a direct submitter but their transactional data may have an impact on a benchmark	√ some firms had forward looking improvement plans

X some firms did not give due consideration to market integrity and impact on clients when deciding to exit a benchmark activity	√ some firms had assessed the importance of benchmark activities to their business models (including the decision to exit certain activities)
X some firms did not have a documented, forward looking benchmark improvement plan which would mean it was difficult for firms to monitor and track their progress	√ some firms had adopted a risk based approach to remedial work, tackling the areas perceived to be highest risk

Oversight and controls	
X not all firms had appropriate oversight functions to manage their benchmark activities	√ some firms had committed further resource to surveillance and monitoring
X firms did not have a formalised approach to reviewing and strengthening their controls for contributing to or administering benchmarks	√ some firms had specifically introduced oversight and controls at desk level to reduce the risks associated with submissions to benchmarks including monitoring inappropriate submissions or trader/broker behaviour
X some firms did not have an overarching governance framework	√ some firms had established overarching governance committee structures
X one firm had no oversight of the data sent out by the firm that could be used for valuation purposes	√ some firms had introduced a global benchmark policy (for example with an annual review of the decision to submit to a specific benchmark)
X some firms had no documented policy or procedure for benchmark activities	√ some firms had engaged with a variety of stakeholders during the design of benchmark controls, e.g. front office staff, requirements on trading around a fix, and implementation of post trade surveillance

Conduct	
X some firms had manual processes which could give risk to malpractice or misconduct	√ some firms had controls around their automated submissions to ensure they were caught and checked before being sent to a benchmark administrator
X some front office functions did not have a good grasp of conflict of interest issues	√ some front office staff were actively engaged in managing conflicts of interest
X training programmes generally only covered LIBOR and not any other benchmark	√ most firms had compulsory training programmes for relevant staff

In-house benchmarks	
X firms generally could not demonstrate awareness of the IOSCO recommendations for their in-house benchmark administration activity	√ one firm had published an IOSCO Compliance Statement

X not all firms had processes in place to manage risks associated with internally generated inputs to calculate in-house benchmarks	√ some firms had a governance committee in place to ensure independent ownership and oversight of the design, management, marketing, maintenance and cessation of their in-house benchmarks
X some firms could not identify whether ownership of in-house benchmarks rested with the front office or a committee	√ some firms conducted back-testing and independent price verification to ensure compliance with the in-house benchmark calculation methodology
X one firm had no process in place to address or escalate any challenge from a client for the calculation of an in-house benchmark	√ one firm had automated the process for sourcing/collecting internal data and employed an independent function to carry out the calculation process

Next steps

The FCA has stressed that all firms should consider the findings of this report and act upon them appropriately. There are a number of domestic and international developments taking place in relation to benchmarks, such as the European Benchmark Regulation, and clearly the FCA is making the statement that firms must be aware of these and ensure that their processes and procedures are fit for purpose.

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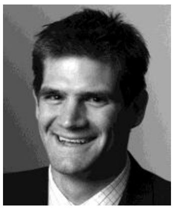

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