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# Bashing the benchmarks

Feature

**Financial indices have come under close scrutiny following scandals involving some of the major benchmarks. Questions are also being asked about whether they are truly reliable and representative of the market they are supposed to measure. Regulators are stepping in, but any new rules need to be carefully thought out.**

This article looks at current regulatory and technical issues relating to indices. Despite recent criticisms about their role and usefulness, reports of their demise have been greatly exaggerated.

## Li(e)bor

In June 2012 came the bombshell announcement that several major global banks had been accused of manipulating one of the main benchmarks, the London Interbank Offered Rate, or Libor. The rigging had been going on for years and affected the entire world economy, since Libor is used to set rates for a vast range of products, from commodities to mortgages, and also underpins financial contracts worth trillions of dollars and euros.

## Editorial

Without a rapid return to growth, there will be no end to the crisis. But to generate growth, companies need to be able to finance their development at a time when Basel 3 and Solvency 2 are challenging the funding model they have always relied on. These issues are pointed up in the Gallois report on competitiveness. They are all the more acute because France will be unable to refocus its abundant supply of domestic savings within the necessary timeframe. Relying more heavily on international markets is not an option for everyone, especially our small and medium-sized companies. Even so, this raises a fundamental question of sovereignty, namely the ownership of our companies.

What to do under these circumstances? There is more than one solution. Initiatives such as the Public Investment Bank and the Entrepreneurial Exchange (see p. 6) are obviously key. In addition, savings need to be channelled into instruments, especially equity, that provide companies with financing for the long term. But we also need to ensure that capital related to long-term liabilities is used first and foremost for this long-term funding.

That is where a Fund for Financing the French Economy (FFEF) comes into its own. AMAFI has been working on this project for several months. The fund would be a collective solution, operating under public supervision and with joint governance, for reallocating assets. It would quickly free up several tens of billions of euros to finance economic activity, and a significant portion of the money would go to small and mid-caps, which are the true engines of growth. Creating an FFEF is a public interest project that demands the involvement of all stakeholders, from industry participants to public authorities.

**Philippe Tibi**
AMAFI Chairman

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It is published daily by the British Bankers' Association and basically reflects how much it would cost banks to borrow from one another overnight. The computation is based on quotes submitted by a panel of large banks; the extreme values are discarded and the remaining quotes are averaged. This is all well and good, provided the numbers are reliable. One of the big problems, however, is the absence of regulatory oversight: everything depends on input from private sector entities. A number of panel banks allegedly tinkered with the data and manipulated the rate for their own benefit. Libor quickly became known as Lie-bor. Similar problems of manipulation have been encountered with other banking indices, including Tibor, the benchmark for the Japanese market, and Euribor, which sets interest rates for eurozone banks.

Alongside these interest rate benchmarks are a number of stock indices, which measure changes in a group of stocks representing a portion of the overall market. The best known are the Dow Jones Industrial Average and Nasdaq in the United States, the FTSE 100 in the UK, the CAC 40 in France, the DAX in Germany, the pan-European Eurostoxx 50, and the Nikkei and Hang Seng in Asia. When the media reports on the good or bad performance of a particular market, they do so in terms of its leading index. There are thousands of other indices, tracking various regions and industries, up to and including a stock-car fund that tracks companies which sponsor NASCAR teams!

One sign of this increasing reliance on indices is the rapid growth of so-called index investing, which involves vehicles – usually funds – that replicate the component stocks of a particular index. The underlying thinking is that it is impossible to outperform the market without incurring greater risk. So, "if you can't beat it, join it!" A wide range of products are being designed around indices of various kinds, including exchange traded funds (ETFs), which are bought and sold on stock markets in the same way as shares.

## Look out for pro-cyclical effects

Stock indices are not all computed in the same way, but the objective is the same, namely to reflect the overall direction of a country's market and, more generally, its economy. There are two basic types of index: price-weighted, in which the index value is based on the price of each component stock, and capitalization-weighted, based on the market value of each component company's outstanding shares. The key difference is that a price-weighted index is based only on the price of the stock; it does not take into account the size of the company, in contrast to a capitalisation-weighted index. The DJIA and Nikkei 225 are price-weighted, while the CAC 40, the FTSE 100 and the Nasdaq Composite are capitalisation-weighted.

In each case, the calculation methodology is much more transparent and closely scrutinised than that used for Libor. For example, the composition of the FTSE 100, launched in January 1984, is examined four times a year by a committee of independent market experts. And France's CAC 40, introduced four years later in June 1988, is reviewed quarterly by a NYSE Euronext steering committee. Companies are chosen to represent sectors but also trading volumes. Yet despite this openness, there are still questions about how to calculate benchmarks so that they closely reflect their market without overweighting certain sectors and engendering procyclical effects. The choice of stocks may ultimately prove moot. One of the main issues is the number of components needed to achieve proper representation of the overall market. The greater the number of small companies, the harder it is to replicate an index. According to some observers, the CAC 40 is procyclical. As for the DJIA, it has just 30 components and, moreover, is price-weighted, meaning that price movements of small companies have greater influence than those of larger ones.

## Alternatives

These shortcomings, and the proliferation of indices, have prompted growing calls to rethink the way benchmarks are put together. One leading Paris-based fund manager points out that the CAC 40 over-represents the largest companies, so that when their share prices move, the whole index moves in lockstep. As a result, inexperienced investors are likely to believe that the index is a sound investment in French companies as a whole, without realising that their investment will go only into stocks that are rising. This increases the threat of a market turnaround. Even those investors who opt for ETFs, say on the FTSE 100, in the belief that these funds will always track the market to the upside may be in for a disappointment. A big percentage of the UK benchmark is made up of a few stocks, so if these underperform, ETF investments will not grow.

Experts are currently working on more sophisticated yardsticks that can overcome some of these drawbacks, concentrating either on the value and expected returns of the constituents or on greater diversification. NYSE Euronext, for example, is looking into indices based on metrics other than market capitalisation or benchmarks that reflect companies' intrinsic value.

In terms of interest-rate indices, Liborgate has prompted a series of proposals for more transparent and tamper-free alternatives. These include repo indices; a measure based on the overnight indexed swaps market, which uses an overnight lending rate; and B-Libor, proposed by Bloomberg, consisting of the risk-free rate plus a credit premium obtained by monitoring quotes on credit-related transactions on a daily basis.

The jury is still out on these initiatives but one thing is certain: indices will be around for some time to come. Hence the closer scrutiny being exercised by regulators and, notably, the European Commission.

Feature

### The Commission steps in

In light of the rigging scandals, regulators have been taking a closer look at the role of benchmarks and how they are computed. In the UK, the government organised an independent review of Libor under Martin Wheatley, managing director at the Financial Services Authority. The International Organization of Securities Commissions set up a Board Level Task Force on Financial Market Benchmarks. And in July this year, the European Commission decided to expand its review of the Market Abuse Directive to include a section on benchmark manipulation, for which there was no specific regulatory framework.

The French financial community naturally believes that index-rigging is inadmissible and must be punished, but it is nonetheless concerned with the Brussels initiative. The proposed definition of indices is so broad – "any commercial index or published figure calculated by the application of a formula to the value of one or more underlying assets or prices [..]" – that it apparently encompasses not only major benchmarks such as Libor, but also the proprietary indices created by individual firms, often for a specific client or transaction. What is more, the Commission's aim is not simply to punish manipulation but to get involved in the actual nuts and bolts of index composition. Naturally, this could provide markets and investors with additional guarantees of reliability and probity – on condition that the new rules are properly thought out.

**Anthony Bulger, Olivia Dufour**

## Q&A with...

**Philippe Tibi,** Chairman of AMAFI and professor of finance at École Polytechnique

**What do you think of the current debate on indices?**

Indices are simplified guideposts for making financial markets accessible to the general public. They provide a yardstick for measuring the promise made to investors. From a theoretical standpoint, investing in an index is based on the principle of portfolio diversification, which protects the risk/reward trade-off.

In practice, a closer examination shows that they do not reflect a country's economy as accurately as they may seem to do, especially if the number of constituent stocks is limited. The way they are designed – taking into account component companies' free float and market capitalisation – creates a selection bias. In particular, they tend to capture financial bubbles. Before the technology bubble burst in the 2000s, for example, the indices were heavy with technology, media and telecoms stocks, most of which subsequently fell out. The same thing happened in 2007 with the banking and energy sectors.

**Does the CAC 40 need to be rethought?**

In any event, we need to be aware that the CAC 40 does not precisely reflect the market it seeks to represent. It has lost between 40 and 50 per cent in recent years, unlike the S&P, which has 500 constituents, or the Dow Jones, which comprises only 30 stocks but is calculated in a less sophisticated way that limits the rate of turnover of its constituents. That is why designers are currently working on models that make indices less sensitive to bubbles, for instance by underweighting highly volatile stocks. This would give retail investors a portfolio that is more stable because it prices in volatility risk. The asset management industry has anticipated these initiatives and is now selling funds based on these principles.

**Shouldn't the importance of indices be downplayed, in the same way as credit ratings?**

According to financial theory, the index cannot be beaten. And yet a whole segment of the investment management industry is predicated on offering above-benchmark returns. So there is a divide between theory and practice. In actual fact, choosing stocks or sectors on the basis of strong convictions is one of the reasons for the success of alternative investing. The same applies to the promise of returns that are not correlated with index performance. In sum, indices are a necessary evil because they structure the products and services offered by the investment management industry.

International

News

## Market surveillance

The International Organization of Securities Commissions (IOSCO) this summer launched a public consultation on a report titled "Technological Challenges to Effective Market Surveillance Issues and Regulatory Tools".

Responding, AMAFI upheld IOSCO's recommendations but argued that technological change does not necessarily create new problems of market surveillance for regulators. It does, however, raise questions about the ability to process data, which is expanding continuously in increasingly fragmented markets *(AMAFI / 12-46)*. And while surveillance certainly depends on regulators, it also depends on market professionals and firms themselves. AMAFI urges IOSCO to take these two categories of participant into account when working on this issue.

**Emmanuel de Fournoux**

## ICSA and SROCC Interim Meetings, Istanbul, 5 – 6 November 2012

The International Council of Securities Associations, (ICSA) and IOSCO's Self-Regulatory Organizations Consultative Committee (SROCC) held their Interim Meetings in Istanbul on 5 and 6 November 2012. AMAFI was represented by Chief Executive Pierre de Lauzun, and Director of European and International Affairs Véronique Donnadieu.

The first part of the ICSA meeting was an opportunity for dialogue between members and the guest speakers, especially David Wright, IOSCO's new Secretary-General and former head of EU policy for financial services regulation. Mr Wright stressed that he wanted IOSCO to play its full role in regulating and supervising financial markets and hence to acquire the necessary resources. He also urged ICSA to actively voice the industry's views. The second part of the meeting was reserved for ICSA members and dealt with internal issues, notably work organisation.

At the SROCC meeting, aside from addressing topical issues of market surveillance and regulation, delegates debated with David Wright on the future organisation of SROCC, which is due to become the Affiliate Members Committee in order to better reflect the diversity of its current membership. In addition, a sub-committee of self-regulatory organisations is to be set up.

**Véronique Donnadieu**

News

Europe

## Market abuse

The review of the Market Abuse Directive is well under way. The ECON Committee of the European Parliament adopted its final report on 9 October and the trialogue with the European Commission and the Council is due to start shortly.

The two issues on which AMAFI has been most active, accepted market practices (which underpin the use of liquidity contracts) and pre-soundings *(see AMAFI Newsletter No 17)*, have been incorporated into the proposals for a Regulation of the Parliament and the Council. However, there are major differences between the two drafts. And there is still legal uncertainty stemming from some of the Regulation's fundamental provisions. This applies in particular to the definition of inside information, especially when applied to commodity derivatives, the concept of attempted insider dealing or market manipulation, and the scope of the Regulation, which has been broadened to include financial instruments not currently covered by transparency requirements.

Meanwhile, attempts to harmonise member states' market abuse sanctions have so far led to substantive differences between the Parliament's proposal and the Council's compromise texts.

**Stéphanie Hubert**

## Transparency Directive Review

AMAFI is closely monitoring ongoing discussions at European level on the review of the Transparency Directive. It would seem that delta-adjustment of cash-settled derivatives, a proposal that the Association strongly supported *(see Info AMAFI No 104)*, has been accepted, but there are still concerns about the method used to compute the 5 per cent exemption for the trading book. AMAFI has taken several initiatives to highlight its position on this issue, which could be addressed through the trialogue now underway among the European institutions.

**Sylvie Dariosecq**

## Short selling

A few weeks before Regulation 236/2012 on short selling and certain aspects of CDS came into effect on 1 November, the European Securities and Markets Authority (ESMA) published a consultation paper containing guidelines for interpreting the exemptions for market making activities and primary market operations under the Regulation.

AMAFI objects to the particularly narrow approach adopted by ESMA when defining market making. This is especially true since that definition, which is vitally important for European financial markets and necessary for harmonisation purposes, should not be set at Level 3 but via the European co-decision process *(AMAFI / 12-44)*. AMAFI also takes a dim view of the timetable for implementing the Regulation. One month before it came into force, firms still did not have all the information needed to adjust their activities accordingly and develop the infrastructure needed to comply with the new rules.

The Association also regrets that the harmonisation expected of ESMA on the question of short selling has been only partially effective, since European regulators have adopted different approaches to communicating about and implementing the Regulation.

**Emmanuel de Fournoux, Stéphanie Hubert**

News

France

## Entrepreneurial Exchange

Based on the recommendations on its Strategic Planning Committee for SMEs, NYSE Euronext has announced plans to launch an Entrepreneurial Exchange especially for small and medium-sized companies. The announcement follows the release of the committees' final report and an industry consultation in July on an interim report, which AMAFI broadly welcomed *(AMAFI / 12-41)*.

NYSE Euronext's announcement confirms the points put forward in the final report:

- NYSE Euronext's federal business model will be maintained;
- A subsidiary dedicated to developing the SME market will be set up, with an open governance structure including a Board of Directors representing stakeholders in NYSE Euronext markets;
- Critical mass will be achieved by incorporating NYSE Euronext's B and C segments, although some companies will be able to opt out under certain conditions;
- Liquidity and market attractiveness will be improved by adopting a range of concrete measures.
- Listing and transfer fees for SMEs will be reduced.

AMAFI, which fully endorsed the final report, welcomes the creation of the new exchange as a step in the right direction for developing long-term financing for small and mid caps. Going forward, the precise content of each point will have to be discussed collectively, notably as regards the governance structure, in which investors, issuers and intermediaries should all be involved.

In another development, the government published on 6 November a Growth, Stability and Employment Pact, based for a report prepared by Louis Gallois, which confirmed the need for the Entrepreneurial Exchange and also provided for the creation of an equity savings plan intended specifically for SMEs.

**Emmanuel de Fournoux**

## Money laundering Beneficial owners of investment funds

After issuing guidelines on beneficial owners (notably persons owning more than 25 per cent of a company's shares) the Autorité de Contrôle Prudentiel now plans to publish sector enforcement principles for identifying beneficial owners of investment funds. AMAFI has tabled several draft amendments with the ACP's consultative committee on AML/CFT, on which it sits.

The main problem at this stage lies in interpreting the principle of a risk-based approach to identifying these beneficial owners. The proposal put forward by the ACP would force firms to systematically identify each fund managed by their client management companies without taking into account the companies' regulatory frameworks, which may be more or less stringent. Since the operational consequences of this proposal are highly significant, AMAFI has sent the ACP a discussion paper on the matter *(AMAFI / 12-51)*.

**Stéphanie Hubert**

News

## Taxation

### Financial Transaction Tax

**Mechanism applicable in France – Work by AMAFI**

AMAFI has focused considerable attention since the beginning of the year on the conditions for implementing France's financial transaction tax (FTT). In particular it sought to address a large number of queries and problems, in collaboration not just with AMAFI members involved in the issue but also with other stakeholders, notably the Tax Legislation Directorate (DLF) and the Treasury Directorate (DGT). On 8 November the Association published a paper, in French *(AMAFI / 12-52)* and English *(AMAFI / 12-52 EN)*, containing information for a clear and detailed understanding of the new mechanism. Some interpretational issues remain, however, which AMAFI has referred to the authorities *(AMAFI / 12-48)* and which add to the in-depth deliberations already published about the problems of identifying the ultimate taxpayer. A new version of the paper containing the latest clarifications (especially concerning American Depositary Receipts, which came under the tax on 1 December) is due to be published in the coming weeks.

AMAFI also forwarded an initial assessment of the FTT to the DLF and the DGT two months after the tax came into force *(AMAFI / 12-47)*. From an operational standpoint, and although the observation period is too short to draw objective conclusions at this stage, there has been a relative decline in the volumes of FTT-liable securities compared with equivalent international securities. One of the likely reasons for the decline is that some market participants have stopped trading French securities owing to the legal uncertainty which, in their view, stems from the tax. Another notable development is that some foreign firms have stepped up their offering of substitute products, such as contracts for difference.

**European projects**

The European Commission approved on 23 October 2012 the legal framework for a European FTT, which the Council may decide to introduce under the enhanced cooperation procedure. Eleven counties have already announced their intention of adopting the European mechanism, while Italy, Spain and Portugal have said they plan to introduce a domestic tax in the near future.

In AMAFI's view, an FTT adopted by just 11 countries must necessarily differ in technical content from the tax proposed in September 2011 for all EU members. Close attention will need to be paid to territoriality criteria and the types of financial instruments liable for the tax – notably the inclusion of derivatives, in contrast to the French mechanism – so as not to distort competition against firms operating within the cooperation area. The danger is that the FTT may eliminate certain businesses and consequently end up producing a negative yield.

**Eric Vacher, Emmanuel de Fournoux**

### Transfer duty

Recent statutory and tax policy amendments to the rules on transfer duty have prompted questions from members of AMAFI's Corporate Finance Committee regarding their routine transactions. These concern bonds convertible, exchangeable or redeemable in shares; equity warrants; bought deals; and accelerated book building with backstop. Joint initiatives have been undertaken with the Tax Affairs Committee to determine the tax regime applicable to these transactions, in terms of both transfer duty and the financial transaction tax on acquisitions of securities.

AMAFI recently sent its members an outline paper including charts summarising the result of these initiatives *(AMAFI / 12-58)*.

**Sylvie Dariosecq, Eric Vacher, Julien Perrier**

Amafi Highlights

## New Members

**Accenture Investment Processing Services**, an investment firm whose main business is order reception/transmission for third parties. Its senior managers are Jean-François Gasc (Chairman) and Guillaume Thurel (Chief Executive).

**BRED Banque Populaire**, a credit institution (a BPCE Group regional bank) offering all banking transactions and investment services. Its senior managers are Steve Gentili (Chairman) and Olivier Klein (Chief Executive).

**Saxo Banque (France)**, a credit institution whose main business is providing online investment services (order reception/transmission for third parties, order execution for third parties, dealing for own account, and investment advice) to institutions and retail clients. Its senior managers are Pierre-Antoine Dusoulier (Chairman) and Thomas Jegu (Chief Executive).

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**www.amafi.fr**
Most of them, notably AMAFI's responses to public consultations, are freely available, but some are restricted to members only.

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