

Developing Financial Benchmarks: the Way Forward

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Financial benchmarks are used as references in various financial products such as loans and derivatives contracts. Investors and asset management companies also use financial benchmarks to track the performance of their portfolios. These important roles of financial benchmarks emphasize the need to ensure their credibility and reliability so that the functioning of financial markets remains sound and efficient.

This article provides basic knowledge on what financial benchmarks are, examples of key financial benchmarks in the Thai financial market, and why good reference rates matter. It also provides an update on the new international standards set by the International Organization of Securities Commissions (IOSCO)¹ on financial benchmarks, as well as the Bank of Thailand (BOT)'s efforts to ensure two key interest rate benchmarks are in line with international best practices.

What are Financial Benchmarks?

Financial benchmarks are prices, estimates, rates, indices or values that are used for reference to determine the interest payable under financial contracts or instruments, to determine the value of a financial instrument, or to measure the performance of a financial instrument².

In general, financial benchmarks could range from bond indices, stock indices, commodities indices and interest rate benchmarks. In the case of Thailand, examples include BIBOR (Bangkok Interbank Offered Rate) and THBFIX (Thai baht implied interest rate) which are short-term interest rates benchmark, bond indices provided by the Thai Bond Market Association (ThaiBMA) such as the composite index, the government bond index and the investment grade corporate bond index. Likewise, the Stock Exchange of Thailand (SET) also provides SET index series consisting of SET index, SET industry group index, SET sector index, SET50 index, SET100 index and SET high dividend 30 index. Investors usually evaluate the performance of their portfolios in comparison to these indices. Also, these benchmarks can be used as references in other financial instruments such as 5Y government bond futures and SET50 index futures provided by the Thailand Futures Exchange (TFEX).

For interest rate benchmarks, their administrators, providers of such benchmarks, usually compile the rates surveyed from contributing financial institutions (submitters) and then use certain calculation methods to come up with the benchmarks. The underlying interest rates of some benchmarks may be liquid enough for their administrators to use the

transaction-based methodology. In Thailand, there are two key short-term interest rate benchmarks – THBFIX calculated and administered by Thomson Reuters and BIBOR produced by the Bank of Thailand (BOT). THBFIX is the implied Thai baht interest rate calculated from the swap premium of the USDTHB foreign exchange swap transactions that banks contributed to Thomson Reuters for THB-FIX calculation. BIBOR is the rate at which contributing banks offer to lend Thai baht funds to prime banks on an unsecured basis in the Bangkok interbank market just prior to 11 AM. These benchmarks can be referenced in various types of financial products, ranging from loans and deposits to derivatives instruments such as interest rate swaps (6MTHBFIX IRS, 3MBIBOR IRS) and interest rate futures (3MBIBOR Futures). Besides, BIBOR is currently used as reference in the Bank of Thailand's floating rate bonds.

In this article, the emphasis will be placed on interest rate benchmarks, as they are directly in the interest of the Bank of Thailand in ensuring the development of well-functioning money markets.

¹ The International Organization of Securities Commissions (IOSCO), established in 1983, is the acknowledged international body that brings together the world's securities regulators and is recognized as the global standard setter for the securities sector. IOSCO develops, implements, and promotes adherence to internationally recognized standards for securities regulation, and is working intensively with the G20 and the Financial Stability Board (FSB) on the global regulatory reform agenda.

IOSCO's membership regulates more than 95% of the world's securities markets. Its members include over 120 securities regulators and 80 other securities markets participants (i.e. stock exchanges, financial regional and international organizations etc.).

² As defined in the IOSCO's Principles for Financial Benchmarks (Jul 2013)

Why Good References Rates Matter?

As interest rate benchmarks are usually used to determine the payoff in financial contracts or the value of financial instruments, the credibility of these benchmarks are crucial in that their mispricing will have negative impacts to market participants and undermine their credibility. Such loss of market confidence can finally lead parties to stop transacting in instruments that reference these benchmarks which will in turn impair the functioning of the financial system. In addition, market participants should deserve the rights to gain an explanation on the determination of benchmarks so that they can choose the right benchmarks which are suitable for them.

For these reasons, regulatory authorities, such as the BOT for interest rate benchmarks, acknowledges the virtues in strengthening the credibility of financial benchmarks, promoting market transparency, and protecting investors' interests.

IOSCO's Principles for Financial Benchmarks

To develop internationally recognized standards regarding financial benchmarks, IOSCO's Task Force on Financial Market Benchmarks released its final report on Principles for Financial Benchmarks in July 2013 with an aim to articulate policy guidance and principles for benchmark-related activities.

IOSCO developed 19 principles as a set of recommended practices that should be implemented by benchmark administrators and submitters. However, the application and implementation of the principles should vary according to the nature of each benchmark and may be adjusted to the changing market conditions. These Principles can be summarized as follows:

- **Governance:** As the administrators retain primary responsibility for all aspects of the benchmark determination process, the administrators should ensure the integrity of the benchmark by establishing appropriate governance arrangements, managing conflicts of interest, assigning an oversight function and overseeing any outsourcing of functions to third parties.
- **Quality of Benchmark:** IOSCO proposes the guidelines regarding the benchmark design, data used to construct benchmarks and transparency of benchmark determination. For example, there should be an establishment of clear guidelines regarding hierarchy of data inputs and the exercise of expert judgment used for the determination of benchmarks. While the

benchmark should be anchored by observable transactions, a variety of data may be appropriately used to construct a benchmark, as long as the data sufficiency principle is met.

- **Quality of the Methodology:** The Methodology used to make benchmark determinations should be published, including any material changes in the methodology and its rationale. Internal controls over data collection should be imposed; for instance, the process for selecting the source, collecting the data and protecting the integrity and confidentiality of the data. If a benchmark is based on submissions, IOSCO suggests the administrators to develop 'Submitter Code of Conduct', outlining responsibilities that should be undertaken by submitters to address vulnerabilities in the submission process such as potential conflicts of interest.
- **Accountability:** Benchmark administrators should establish accountability mechanisms covering complaints policy, independent internal or external audits and the retention of written records. When a benchmark is based on submission, IOSCO also provides a list of information that should be kept record by submitters for five years.

There are now ongoing efforts to reform financial benchmarks in major financial centers such as the UK, EU, Singapore, as well as many other countries, more or less in line with the above Principles.

Ensuring Better Reference Rate Setting: The Case of Thailand

Taking into account international best practices guided by IOSCO and the developments of other jurisdictions, the BOT currently works closely with market participants to improve both key interest rate benchmarks in Thailand – THBFX and BIBOR.

Due to the considerable number and size of financial transactions referencing THBFX, the BOT together with contributing banks and Thomson Reuters have decided to minimize the use of discretion in the benchmark determination process by shifting its submission methodology away from survey-based to transaction-based methodology by the end of this year. The number of maturities has been reduced from 9 to 6 since the beginning of 2014.

Unlike THBFX, BIBOR-based transactions are not sizeable enough for the move to transaction-based methodology at this stage. Therefore, to ensure the reliability of the survey-based BIBOR fixings, the BOT plans to issue a robust code of conduct for contributing banks within this year as a guideline for rate submission methodology and procedure as well as the establishments of governance

and control process. In addition, the provision of 9M BIBOR will be ceased due to its illiquidity.

The BOT anticipates that the application of IOSCO's Principles will not only reduce systemic risk in the Thai financial markets and enhance market stability but will also boost confidence of both domestic and foreign market participants.

Summary

Financial benchmark reform has been a global trend and Thailand as a member of international financial market inevitably has to bring ourselves up to par with international good practice standards. The reform efforts to strengthen the reliability of financial benchmarks may induce some burden and costs to market players, but its long-term benefits such as market fairness, public confidence, and financial stability would undoubtedly lead to a better functioning market hence, fruitful return.