



GROUPE CONSULTATIF ACTUARIEL EUROPEEN
EUROPEAN ACTUARIAL CONSULTATIVE GROUP

SECRETARIAT, MAISON DES ACTUAIRES, 4 PLACE DU SAMEDI
B-1000 BRUSSELS, BELGIUM

TELEPHONE: (+32) 22 17 01 21 FAX: (+32) 27 92 46 48

E-MAIL: groupe@gcactuaries.org

WEB: www.gcactuaries.org

Position Paper on the Regulation of Indices

Groupe Consultatif Actuariel Europeen (the 'Groupe') is pleased to present a position paper on the Regulation of Indices in response to the Consultation Document issued by the European Commission. The Groupe represents the actuarial profession in Europe with its member associations accounting for about 20.000 individual actuaries practising in various fields. European Actuaries have a long history of involvement in index construction, notably in the UK where the Actuarial Profession developed and produced for some years the set of indices for the UK equity and gilt (government bond) markets now produced under the FTSE label. Actuaries are currently both users and providers of indices and the Groupe is committed to promoting the public interest.

The Groupe supports an initiative to ensure that the process of producing indices is robust and transparent. Ultimately, it is the users of indices who need to decide whether an index suits their particular requirements. Understanding precisely what the index is measuring, its construction process and any inherent limitations it may have should help users make the correct decision as regards choice of index and give them confidence in its use. The Groupe therefore welcomes the publication of the Consultation Document as a useful insight into issues relating to indices for both providers and users.

As the Document indicates, indices are produced by a wide range of providers to satisfy the needs of a very wide range of users. A key determining factor in a user's choice of index will be the use to which it will be put. Many indices will be produced with the intention merely of informing the user and perhaps raising the profile of the provider rather than as a reference in the pricing or valuing of financial products or instruments (defined as 'Benchmarks' in the Document). Users are likely to be more concerned about the rigour and integrity of indices to be used in applications such as pricing products than, for example, in evaluating performance. There is also a third category of indices that are mandatory to use for regulatory purposes and where the user has no choice to avoid them. We believe that it is important to differentiate between these categories of indices, particularly if a regulatory solution is chosen. There are likely to be more severe consequences in the event of failure to satisfy high production standards in the case of Benchmarks. Nevertheless, it is desirable that the production of all indices meets certain quality standards so as to give users confidence in them.

Question 7 in the Document asks which factors are most important in choosing a reliable benchmark. The Document suggests many factors that users might wish to consider in choosing a benchmark, all of which are more or less relevant depending on the situation. We would suggest the following core attributes of a reliable benchmark:

1. Independent (no conflicts of interest between provider and users)
2. Representative (covers what it purports to cover, free of biases eg survivorship bias)

3. Calculation method reflects reality (eg if prices underlying a price index rise and then fall back to the starting level so should the index)
4. Transparent (a comprehensive set of rules for the index construction including detail as to the sources of data and a robust process for altering the rules, should be documented for users to see)
5. Objective (indices should as far as possible rely on hard data and where providers' discretion is required, this should be disclosed)
6. Timely (the frequency of production will vary depending on the nature and use of the index and timeliness should be defined in relation to this)

While we believe it is important that indices are transparent, we also believe that where intellectual property exists in the index construction process, it should be protected. If providers are required to disclose their intellectual property to all users it may create the unintended consequence of stifling innovation.

Question 12 asks for views on specific transparency and governance arrangements to ensure integrity of benchmarks. These are more important where either data suppliers or benchmark providers exercise an element of discretion regarding either the data used to calculate the benchmark or the calculation method. To provide transparency and build confidence in such a benchmark it is desirable that the producer discloses where discretion has been exercised and the process for managing potential conflicts of interest resulting from exercising discretion. For all indices, transparency will be enhanced if users have access to enough information about the construction of the index to judge whether it is aligned with their particular needs. In the event of imperfect alignment, users should also be able to judge from the information provided what biases are likely to be experienced by the index relative to their own specific application.

Question 13 asks for views on the advantages and disadvantages of imposing governance and transparency requirements through regulation compared to self-regulation. Regulation normally imposes a higher cost burden than self-regulation. Costs imposed on providers invariably flow through to users in cases where there is a contract between the two. In other cases where indices are freely available, providers may choose to discontinue production if burdened with extra cost. We therefore urge the Commission to consider carefully whether the imposition of the extra cost and potential cessation of some indices is justified or whether the same degree of protection can be achieved in other ways. Many index users (particularly those offering customers products whose value is referenced to an index) are already regulated and it may be more efficient to extend their existing regulatory requirements than to impose regulation on index providers. In any case, whether an index is a Benchmark may change from time to time. It might be easier to ensure that any regulatory objectives are satisfied if the user has to demonstrate compliance in index selection. If a regulatory solution for index producers is chosen then we would recommend that it primarily targets Benchmarks, because of the potentially negative effects a regulatory solution might create if it also targets non-Benchmarks. Self-regulation of index producers backed by a code of standards offers a potentially more proportionate response for most or all non-Benchmark indices. A possible half-way house might be for the Commission to promote some specific external standard (e.g. an ISO or European equivalent) with index producers then encouraged or required to state whether they adhere to this standard. Any eventual solution should also, in our opinion, be structured so that it does not hamper individual researchers from producing indices largely or wholly for their own (non-Benchmark) research purposes, i.e. it should take account of the purpose of the index and how it is or might realistically be used in practice.

Question 33 asks for comments on who should be responsible for ensuring that indices are fit for purpose. In the case of mortality and morbidity tables which have been produced by the actuarial profession, it has always been our firm view that it is the users of such tables who are responsible for ensuring that they are fit for the purpose being used. Users of mortality and morbidity tables –

primarily insurance companies and pension schemes – use them in the knowledge that they are likely to need adjustment for the circumstances of any particular insurance product or pensions calculation. Users must decide firstly which published table provides the most suitable starting point for their particular actuarial calculations, and secondly what if any adjustments should be made to it for their purposes. We would therefore suggest that regulation of such tables specifically may be of limited benefit.

In case of indices that are mandatory to use for regulatory purposes (like e.g. ‘ratings’) the provider should bear the full responsibility and should be covered by the regulatory framework.

The Consultation Document contains many excellent best-practice suggestions for ensuring the integrity of benchmarks and these could form the basis of a Code of Standards for index providers to follow. Gaining market acceptance for such a code should improve users’ confidence in the integrity of those indices which demonstrate compliance with the code.