Response to FCA Consultation on the proposed policy with respect to the exercise of its powers in relation to LIBOR Transition

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Financial Markets Law Committee[1]

This paper has been drafted by the FMLC Secretariat[2]

1 In view of the role of the Bank of England, the Financial Conduct Authority and HM Treasury in finalising and implementing legislation and regulation affecting benchmark transition at this time, Rob Price, Karen Levinge and Peter King did not comment on this paper or take part in the preparation thereof

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1. INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. In July 2017, the FCA announced that it would not guarantee the survival of the London Inter-Bank Offered Rate ("**LIBOR**") after the end of 2021. After the announcement, industry groups established by the Bank of England, the Federal Reserve and the Swiss National Bank each identified a preferred Risk Free Reference rate for interest rates payable on transactions in their respective currencies. The transition from LIBOR to other chosen risk-free rates has occupied the derivatives, securities and loan markets and early market engagement around the question of establishing term rates has proven particularly challenging. Authorities around the world have grappled with possible methods by which they may help the market to transition away from LIBOR, especially in relation to those legacy contracts which may not contain a fallback clause or be easily amended.

1.3. In the U.K., public policy to manage the transition of these so-called "tough legacy" contracts coalesced around the introduction of new powers under the Financial Services Bill 2019-21 (the "**Financial Services Bill**") which would be granted to the Financial Conduct Authority ("**FCA**") to help it manage an orderly "wind-down of critical benchmarks".[3] The Financial Services Bill amends the existing framework governing benchmarks, provided under Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the "**BMR**") which was brought onshore and amended by the Benchmarks (Amendment) (EU Exit) Regulations 2018 (together the "**U.K. BMR**") under the European Union (Withdrawal) Act 2018 so as to make adjustments to the BMR for the purposes of Brexit. The Financial Services Bill, if enacted in its current form, would introduce a new Article 23A into the U.K. BMR, which would enable the FCA to designate a critical benchmark that had become unrepresentative, or was at risk of becoming unrepresentative, as an "Article 23A benchmark". The designation, under proposed Article 23B, introduced by the Financial

[3] On 23 June 2020, the Chancellor of the Exchequer made a statement in which he encouraged firms to continue planning actively to transition their contracts away from LIBOR and announced legislation which would help the small pool of "tough legacy" contracts for which transition was more tricky. Rishi Sunak (The Chancellor of the Exchequer), Financial Services Regulation: Written statement - HCWS307, (23 June 2020), available at: https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2020-06-23/HCWS307.

Services Bill, would give rise to a prohibition on the use of that benchmark by U.K. supervised entities. Proposed Article 23C allows the FCA to provide an exemption from the prohibition on the use of the designated benchmark in respect of, for example, "tough legacy" contracts. The designation would also empower the FCA, under proposed Article 23D, to take certain actions including requiring changes to the benchmark's methodology for any continued use. Thereafter, in respect of a designated benchmark, the FCA is given the power to make rules concerning its continued use in certain legacy contracts.

1.4. The FCA has now published a Consultation setting out the factors that it proposes to take into account when determining whether and how it would designate a critical benchmark as an "Article 23A benchmark".[4] The FMLC would like to draw attention to legal uncertainties that may arise in relation to the exercise by the FCA of its powers under proposed Article 23.

2. ISSUES OF LEGAL UNCERTAINTY

The practicalities of intervention and the scale of the "tough legacy" contracts

2.1. The FMLC has written extensively about the risks which may arise in relation to existing contracts upon the withdrawal of a benchmark—with or without the introduction of a new replacement one.[5] The frustration of contracts is a remote but not negligible concern. The Common Law recognises implied contractual terms which may assist in some cases to transition a contract away from a failed benchmark and onto a successor rate. Contracts will not be frustrated where the parties can be said to have allocated the risks of withdrawal by establishing fall-backs, by incorporating relevant termination provisions or by allocating liability.

2.2. In this regard, the FCA's new powers would permit the publication of a "Transition LIBOR" in respect of the wind-down of legacy contracts. While this may create a welcome safety net, there is also an evident risk that it may—if not planned carefully—give rise to mixed messages in regard to successor rates, setting Transition LIBOR up against other successor rates being used by market participants.

[4] FCA, Consultation on proposed policy with respect to the exercise of the FCA's powers under new Article 23D, (November 2020), available at: https://www.fca.org.uk/publication/policy/consultation-exercise-fca-powers-new-article-23d.pdf.

[5] For an overview of the FMLC's work, please see http://fmlc.org/libor-transition/.

2.3. LIBOR, for example, in addition to being an overnight rate, is a term rate produced in maturities of one week, one month, two months, three months, six months and 12 months. The input data in each case is transactions of the relevant maturity. Thus, the LIBOR six month daily fixing is calculated—subject to the availability of transaction data—on the basis of funding transactions between banks with a maturity of six months. The view of the Working Group on Sterling Risk-Free Reference Rates ("**RFRWG**"), which was published in a paper on the use cases of benchmark rates in January 2020, is that in most markets where instruments might once have referenced a forward-looking term LIBOR tenor, new contracts should reference a risk free rate ("**RFR**"), like SONIA, compounded in arrears over the life of the contract.[6] By definition, however, an overnight rate will always be calculated on the basis of overnight transactions and that means the rate, even after compounding, will be economically different than a rate calculated on the basis of transactions with greater maturity (which carry greater credit exposure and opportunity cost). The effect of this divergence between LIBOR term rates and contractual rates tied to the RFR is predominantly a market one in the case of new contracts and a legal and operational one in the case of legacy contracts but at the heart of both issues is the question of what credit spread or other adjustments will be introduced in order to reduce the divergence between LIBOR term rates and the RFR. In the paper on use cases referred to above, the RFRWG recommended the development of a "**TSRR**" or Term SONIA Reference Rate which could be used in certain markets which would be difficult to transition to compounded overnight rates. Four data companies were subsequently mandated to produce a TSRR for testing over a six-month period and further scrutiny by the RFRWG.[7]

2.4. In a world of multiple alternatives to LIBOR, disagreement may arise between the parties in situations in which the existing contract refers generally to a "successor rate" or where a term as to the interest payable should necessarily be implied as a matter of business efficacy. That disagreement might involve a strong view in favour of SONIA compounded in arrears plus a fixed or floating spread adjustment (long talked about as

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[6] See, *Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives* (Bank of England, January 2020), available at: https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/use-cases-of-benchmark-rates-compounded-in-arrears-term-rate-and-further-alternatives.pdf

[7] *Ibid.* On 11 January 2021, ICE Benchmark Administration announced the launch of its ICE Term SONIA Reference Rates (ICE TSRR) as a benchmark for use in financial instruments by licensees. The ICE TSRR are designed to measure expected (i.e. forward-looking) SONIA rates over one, three, six and 12 month tenor periods, and are based on a Waterfall Methodology using eligible prices and volumes for specified SONIA-linked interest rate derivative products. ICE, Press Release: "ICE Benchmark Administration Launches ICE Term SONIA Reference Rates as a Benchmark for Use in Financial Instruments", (11 January 2021), available at: https://ir.theice.com/press/news-details/2021/ICE-Benchmark-Administration-Launches-ICE-Term-SONIA-Reference-Rates-as-a-Benchmark-for-Use-in-Financial-Instruments/default.aspx.

"Synthetic LIBOR"), or a preference for the TSRR or Transition LIBOR. The parties might disagree as to which choices are reasonable. Such a splintering of successor rates to LIBOR may be inevitable but, if managed carefully, its impact on individual hedging arrangements and the matching of "back-to-back" contracts might be limited. Equally, attempts to engineer convergence can leave parties with a wealth transfer that they did not intend and to which they have not consented, potentially exposing public authorities to judicial review or to claims that a party's rights have been infringed by a disproportionate deprivation of its property. This is a remote but not entirely negligible possibility which, it may be argued, could be delimited further by the careful and seldom use of the FCA's powers under proposed Article 23.

2.5. There are likely to be differing views around the delimitation of the phrase "tough legacy" but, in light of the FCA's apparent policy preference to transition the market away from LIBOR and towards the adoption of an RFR, reliance on a Transition Libor with a methodology which does not reflect this preference should be discouraged and the definition of "Tough Legacy" circumscribed tightly accordingly. It should be noted, however, that authorities in the U.K. will be unable to influence both the meaning of LIBOR adopted by parties to contracts governed by other jurisdictions as well as regulated entities in overseas jurisdictions, which should be taken into account when the FCA exercises its Article 23 powers (see further comments on this subject below). In this context, it may be important to note that the administrator of LIBOR, ICE Benchmark Administration ("**IBA**"), has announced its intention, subject to confirmation following consultation, to cease the production of euro, sterling, Swiss franc and yen LIBOR panels at the end of 2021.[8] It has stated, however, that one week and two month USD LIBOR settings will cease at end-2021, and the USD LIBOR panel will cease at end-June 2023.[9] While the FCA welcomed IBA's announcement,[10] the FMLC notes that it is not clear how the IBA's proposals to continue the production of the USD LIBOR panel past 2021 will interact with transitional arrangements. Given

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8 ICE, Benchmark statement (18 November 2020), available at: https://ir.theice.com/press/news-details/2020/ICE-Benchmark-Administration-to-Consult-On-Its-Intention-to-Cease-the-Publication-of-GBP-EUR-CHF-and-JPY-LIBOR/default.aspx

9 ICE, Benchmark statement (30 November 2020), available at: https://ir.theice.com/press/news-details/2020/ICE-Benchmark-Administration-to-Consult-on-Its-Intention-to-Cease-the-Publication-of-One-Week-and-Two-Month-USD-LIBOR-Settings-at-End-December-2021-and-the-Remaining-USD-LIBOR-Settings-at-End-June-2023/default.aspx and ICE, LIBOR Consultation on Potential Cessation (December 2020), available at: https://www.theice.com/publicdocs/ICE_LIBOR_Consultation_on_Potential_Cessation.pdf

10 FCA, Response to IBA's proposed consultation on intention to cease US$ LIBOR (30 November 2020), available at https://www.fca.org.uk/news/statements/fca-response-iba-proposed-consultation-intention-cease-us-dollar-libor and FCA, Statement on consultation on new benchmarks powers (18 November 2020), available at: https://www.fca.org.uk/news/statements/fca-consults-on-new-benchmark-powers

the robust statements in 2020 about LIBOR discontinuation this may add to the overall sense of confusion and uncertainty mentioned above.[11] Stakeholders have suggested to the FMLC that some market participants are transitioning existing contracts and relationships to USD LIBOR away from other currencies. It is to be doubted this was the intended effect of preserving the USD LIBOR panel.[12] Given all these considerations, the FMLC proposes in paragraph 2.8 below a different approach, involving the adoption of an RFR-based LIBOR as Transition LIBOR.[13]

Issues concerning the use of LIBOR in foreign jurisdictions

2.6. Authorities in the U.K., E.U. and U.S. have all proposed legislation to resolve the problem of legacy contracts, proposing statutory provisions by means of which legacy contracts may be transitioned onto a successor rate—albeit each proposal takes a different approach. In July 2020, the European Commission published a proposal for a regulation to amend the BMR so as to facilitate the exemption of certain Third Country foreign exchange benchmarks and the designation of replacement benchmarks (the "**BMR Amendment Proposal**").[14] The BMR Amendment Proposal gives the European Commission the power to designate a statutory successor for a benchmark whose cessation would result in significant disruption in the functioning of financial markets in the Union. The successor rate will be incorporated, by operation of law, into contracts involving E.U. supervised entities, as Recital 7 and Article 23(a)(2) make clear in combination. The BMR Amendment Proposal is still making its way through the European legislative process.[15] In the U.S., the Alternative Reference Rates Committee

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11 FCA, Impact of the coronavirus on firms' LIBOR transition plans (25 March 2020), available: https://www.fca.org.uk/news/statements/impact-coronavirus-firms-libor-transition-plans; FCA, Further statement from the RFRWG on the impact of Coronavirus on the timeline for firms' LIBOR transition (29 April 2020), available at: planshttps://www.fca.org.uk/news/statements/further-statement-rfrwg-impact-coronavirus-timeline-firms-libor-transition-plans; FCA and Bank of England, Joint Letter How the discontinuation of LIBOR may affect your members and stakeholders (9 March 2020), available at: https://www.fca.org.uk/publication/correspondence/how-libor-discontinuation-may-affect-your-members-stakeholders.pdf; and Rishi Sunak (The Chancellor of the Exchequer), Financial Services Regulation: Written statement - HCWS307, (23 June 2020), available at: https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2020-06-23/HCWS307/

12 The FMLC observes, however, that the Financial Services Bill provides for the selective application of the FCA's powers regarding LIBOR calculation and methodology on a currency-by-currency basis.

13 A full consideration of the detail of the IBA's statement is beyond the scope of this paper.

14 European Commission, Regulation of the European Parliament and of the Council amending Regulation (EU) 2016/1011 as regards the exemption of certain third country foreign exchange benchmarks and the designation of replacement benchmarks for certain benchmarks in cessation (24 July 2020), available at: https://ec.europa.eu/finance/docs/law/200724-benchmarks-review-proposal_en.pdf

15 At the end of 2020, the European Parliament and the Council of the E.U. reached political agreement on the proposed Regulation amending the BMR as regards the designation of replacement benchmarks for certain benchmarks in cessation. European Parliament, Press Release: "Parliament and Council strike a deal on the orderly termination of benchmarks", (30 November 2020), available at: https://www.europarl.europa.eu/news/en/press-room/20201116IPR91723/parliament-and-council-strike-a-deal-on-the-orderly-termination-of-benchmarks.

("**ARRC**") has proposed a different approach: its legislative proposal will incorporate a successor rate by operation of law into contracts, where they are governed by local law.[16] A federal legislation on similar lines has also been proposed.[17]

2.7. The problem of potential conflict and overlap between these varying approaches is a pressing one. For example, as there FMLC has noted in previous publications, "LIBOR" could be theoretically extant under English law as a screen rate but "in cessation" as a methodology and/or as a measure of London interbank unsecured lending rates and therefore replaceable by the statutory replacement rate ("**SRR**") under the proposed E.U. regime. In the case of cross-border contracts, the question of what the terms of the contract mean should be decided according to governing law of the contract, which entails that the SRR will not be automatically incorporated into a contract with an E.U. supervised entity where that contract is governed by English law and that may cause a surprising and possibly chaotic result as far as the entity itself is concerned. Contracts involving E.U. entities with overseas elements could, in theory, be subject to competing interpretations as to which floating price can be strongly supported (Transition LIBOR, as established under the Financial Services Bill, or the SRR), leading to confusion and possible litigation. This concern is exacerbated for market participants by the fact that other jurisdictions, including, for example New York, have proposed a different legislative approach (discussed above). Problems which affect multi-jurisdictional contracts will only be solved through international cooperation.

2.8. In respect of legacy contracts, the prospect of contracts moving to different rates across currencies, products and instruments theoretically introduces a risk of disrupting cash flows and global hedges. In these circumstances, there seem to be two ways forward. Under the first option, the FCA would circumscribe tightly the "tough legacy" contracts that can continue to rely on Transition LIBOR. Should it adopt this position, the FCA would need to work proactively with institutions in the U.K. and cooperate actively with overseas regulators to move firms onto the chosen RFRs. The second option the FCA might consider is taking a more generous approach to the definition of "tough legacy" in combination with exercising its powers under Article 23D to require IBA to

16 See *ARRC Executive Summary of Proposed Legislative Solution to LIBOR Transition*, (NY, 6 March 2020) available at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Proposed-Legislative-Solution.pdf and *ARRC Proposed Legislative Solution Press Release*, (NY, 6 March 2020), available at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Press_Release_Proposed_Legislative_Solution.pdf

17 Smith, R M, "Congress readies surprise 'tough legacy' LIBOR fix", *Risk, net* (9 November 2020), available at: https://www.risk.net/regulation/7708326/congress-readies-surprise-tough-legacy-libor-fix.

adopt a methodology for Transition LIBOR—for example, RFR rates compounded in arrears plus a spread—which it favours for the wider market in the longer term. The IBA's decision to extend the availability of USD LIBOR may weigh in favour of the latter for reasons given above.

3. CONCLUSION

3.1. The FMLC has attempted in this response to draw attention to two large areas of legal uncertainty which it considers should form a key component in the FCA's analysis as to whether and when it might exercise its new powers under the Financial Services Bill. LIBOR, as the Financial Services Bill recognises, is an umbrella term for a variety of different currencies, different tenors, and products and markets with very different maturity and risk profiles. This diversity means that no single response will necessarily mitigate all of the uncertainties arising from its cessation. The FMLC would urge the FCA to centre careful coordination with authorities around the world in exercising its power.

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