UK FINANCE

UK Finance response to Financial Conduct Authority consultation paper CP21/29: Proposed decisions on the use of LIBOR (Articles 23C and 21A BMR)

1. **UK Finance is the collective voice for the banking and finance industry. Representing over 300 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation.**

2. We welcome the opportunity to respond to this consultation, the latest considering how the FCA exercises the powers granted to it under the Financial Services Act 2021 to facilitate an orderly wind-down of critical benchmarks. We summarise our key points on the consultation below and then expand further through the response.

    a. UK Finance members welcome the clarity provided in this consultation paper and the use of the FCA powers on a broad basis to assist with an orderly wind-down of LIBOR.
    b. UK Finance encourages finalisation of the proposed rules as soon as practical in order to give stakeholders as much time as possible for implementation.
    c. There is a risk that the broad approach could impact customer decisions and unintentionally impede active transition. This risk could be mitigated by appropriate FCA customer-facing communications and clear regulatory guidance on the expectations of firms beyond 2022. The industry recognises the official sector's stance that active transition continues to be the preferred route for transition wherever viable.
    d. UK Finance members note that the FCA powers relate to contracts under the UK Benchmarks Regulation ('BMR'), and that material additional products such as commercial loans, do not fall directly in the scope of these powers. We ask the FCA to provide clarity on expectation for products both impacted directly under these powers and in relation to those not impacted by these powers.
    e. It is important that, while a matter for the UK Parliament, the proposed Critical Benchmarks (References and Administrators' Liability) Bill is on the statute book in good time before year-end 2021.
    f. After 2022, there needs to be a clear, timely and orderly approach to any changes in restrictions or discontinuation of tenors.
    g. Noting the proposal to cease mandating production of yen LIBOR after 12 months, a holistic approach should be taken when considering the implications on 'tough legacy' contracts in the UK, Japan and elsewhere.
    h. Some contracts will be on tenors that do not have a proposed synthetic LIBOR equivalent. Guidance on how these should be approached by firms would be welcome.
    i. Firms who have taken action based on information available at the time (noting this consultation was issued after the *Working Group on Sterling Risk-Free Reference Rates*' Q2/Q3 milestone for active transition) and in line with the overarching push to actively transition, must not be judged retrospectively.
    j. International coordination continues to be critical. The implications outside the UK of the FCA's approach to synthetic LIBOR tenors should remain an important consideration.

k. While we support the FCA's proposed prohibition of new USD issuance, we stress the importance of continuing to align to both current and emerging guidance from US authorities on exceptions.

Introductory remarks

3. UK Finance members remain committed to achieving a smooth and orderly transition from LIBOR across all currencies and tenors. The industry has taken significant steps towards achieving this objective. We continue to recognise statements from the official sector that active transition of outstanding LIBOR contracts remains the primary and preferred route to reduce exposures to LIBOR in anticipation of its cessation in its current form.

4. However, as this consultation acknowledges, there are a significant number of contracts across different asset classes which, in the case of LIBOR's permanent cessation, could have led to uncertain or disruptive impacts despite best efforts. We therefore welcome the FCA's proposal to use its powers under the Financial Services Act in a broad way for 2022. This will help ensure contractual continuity and avoid contractual frustration in such instances.

5. The official sector has repeatedly emphasised that the UK legislative solution would serve only as a safety net for contracts that cannot transition. As a result, engagement with customers has been based on routes to active transition and it is important that these steps are not inadvertently undermined by the decision to permit broad legacy use of the 6 LIBOR settings using a synthetic methodology ('synthetic LIBOR').

6. Despite the very extensive efforts to actively transition contracts, we note the FCA estimates that at least 55,000 contracts worth £340bn using sterling LIBOR, and 15,400 contracts worth £165bn using yen LIBOR, could require the relevant synthetic LIBOR rates to avoid disruption after end-2021. It would not be in the interest of contractual parties, or market stability, to see mass contractual uncertainty or frustration.

7. We are therefore supportive of the FCA's proposals in the consultation paper, which will further support an orderly transition away from LIBOR, both with regards to the legacy contract powers noted above, and in the use of powers of prohibition for new issuance of USD LIBOR. We have provided a number of comments where further FCA clarity and consideration could support orderly transition and market consistency.

8. In particular, we would like to emphasise the continued value in clear FCA communications, which are updated to reflect ongoing regulatory and market developments. For example:
    a. Official communications on issues including the emphasis on ongoing active transition (for end users as well as banks and lenders);
    b. Where the FCA has specific expectations with regards to firms' efforts to continue attempts to actively transition contracts after 2021;
    c. How synthetic LIBOR should be explained and described to customers where firms answer understandable client questions around options available to them and at the same time (generally) not provide advice;

d. FCA expectations around its annual process, and the timeline of this, so that the market can plan for future changes in the way the FCA may exercise its powers.

9. Sterling and yen LIBOR have global use. UK Finance members emphasise the continued need for cross-border regulatory coordination when exercising powers provided under legislative solutions enacted by different jurisdictions, to ensure consistency in tough legacy approaches across jurisdictions. We note that the *Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks* is currently consulting on the treatment of tough legacy contracts in Japan.[1] The paper appears to suggest that the synthetic yen LIBOR will be required in some circumstances in the Japanese market.

10. Internationally, authorities should seek alignment between jurisdictions where appropriate and we hope efforts made to consider the implications on international markets continue.

11. We note the FCA's statements that it does not expect to mandate continued production of the continuing yen LIBOR tenors after end-2022. As there may be some contracts in that currency that still retain characteristics of 'tough legacy' contracts after this period, we encourage consideration of any necessary steps or guidance for such circumstances.

12. UK Finance members welcomed the introduction of the Critical Benchmarks Bill as integral to minimising the risk of disruption at the end of 2021. While we appreciate that the timing and passing of the legislation is a matter for the UK Parliament rather than the FCA, members emphasise the need for the Bill to be on the statute books in good time before the end-2021. This will assist in providing continuity of contract in law for those transitioning from panel bank LIBOR to synthetic LIBOR.

13. Overall, UK Finance would like to emphasise our broad support for the manner in which the FCA proposes to exercise its Article 23C and 21A Benchmarks Regulation powers and keenly await the finalisation of the provisions. We urge the publication of the FCA's final decision at the earliest possible opportunity to ensure all impacted parties have sufficient time to consider, and where necessary act on, the implications of the final rules.

14. UK Finance would like to thank TLT LLP for their support in preparing this submission. Please note that this response may not necessarily reflect the views of all UK Finance members but has been written and approved with input from a representative sub-group of the membership.

15. We set out our responses to the specific consultation questions below.

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[1] https://www.boj.or.jp/en/paym/market/jpy_cmte/cmt210928a.pdf

Answers to Chapter 3 Questions (The Article 23C legacy use power):

Q1: Do you agree with the manner in which we propose to exercise our legacy use power?

16. UK Finance members broadly agree with the manner in which the FCA proposes to exercise its legacy use power. It is important that all contracts that have no viable way of being moved away from LIBOR before end-2021 have an appropriate safety net to avoid the disruption, or frustration, of contracts.

17. We welcome recognition (paragraph 3.67 of the consultation) that some uncleared derivatives may require access to synthetic LIBOR. The FCA's identification that in structured financing, where derivatives are linked to other products in a structural or explicit manner, transition must be to the same alternative rate, we believe is a correct and helpful approach.

18. Nevertheless, the proposed broadness of legacy use permitted beyond year-end has resulted in certain areas where additional clarification or support from the official sector would be helpful.

Importance of active transition

19. UK Finance members welcome the exercise of the legacy use power in recognition that some legacy contracts linked to sterling or yen LIBOR may contain contractual provisions for the unavailability of the benchmarks, that could lead to unintended, unfair or disruptive outcomes, or prove inoperable in practice.

20. Many members have, or are, engaging with their customers on routes to active transition. It is important that these are not inadvertently undermined by the decision to permit broad legacy use of synthetic LIBOR.

21. It is particularly important to minimise the risk that this decision adversely impacts levels of customer engagement. UK Finance members believe that there should continue to be clear communications from the official sector emphasising the importance of active transition where possible, to support ongoing engagement with customers. For example, additions to the FCA's page on 'Mortgage interest rates and LIBOR: information for borrowers' may be a useful starting point for that customer cohort.[2] This would help counter the risk that customers could choose to take a 'wait and see' approach now that all legacy contracts have the option of remaining on synthetic LIBOR.

22. Lenders will now be navigating the difficulties of encouraging active transition, whilst also having to identify how and when to explain synthetic LIBOR to customers. UK Finance members therefore see it as important that guidance also continues to be provided for lenders in order to continue to support active transition into 2022. For example, members have suggested that established FCA expectations on transition

[2] https://www.fca.org.uk/consumers/mortgage-interest-rates-libor

efforts in the context of loan amendments (e.g. extensions, changes to repayments, waiver/consent) after the end of 2021, could be useful in helping to identify set engagement points for lenders to promote active transition.

23. It also remains important that further thought is given to the balance between pursuing active transition, whilst maintaining a fair treatment of customers. Guidance on the FCA's expectations as to how firms should continue to seek active transition in contexts such as vulnerable customers and those in financial difficulty after end-2021, would be helpful.

<u>Clarity for customers regarding continued use of synthetic LIBOR</u>

24. Notwithstanding the significant scale of financial contracts already transitioned to a replacement rate, UK Finance members note estimates from the FCA that at least 55,000 contracts worth £340 billion operating on sterling LIBOR may not actively transition before end-2021 and may continue to operate on synthetic LIBOR.[3]

25. Given this, and early communications from the official sector that firms should be prepared for LIBOR to 'cease' at end-2021, UK Finance members believe it is critically important that there is a clear and consistent explanation of what continued permitted legacy use of synthetic LIBOR means.

26. As a result of the FCA's decision and the publication of the Critical Benchmarks Bill, it is likely that many customers will seek further information to understand their position and options. The FCA has identified in the consultation the varying levels of customers' knowledge and understanding of LIBOR transition (paragraph 3.23 – 3.27) which may impact their ability to engage with active transition. UK Finance members believe that, notwithstanding this lower level of financial understanding combined with lenders' inability to provide advice, it is important that these customers are able to understand the implications of synthetic LIBOR on their contracts.

27. UK Finance members believe therefore it would be of great benefit if there was communication from the official sector directly addressed to consumers covering, amongst other things:
    a. the official sector's expectations regarding active transition i.e. why banks are still continuing activity to migrate contracts off synthetic LIBOR and that this is done with official sector guidance in mind;
    b. the role of synthetic LIBOR i.e. its limitations and why it is not a complete solution mitigating any need to engage with transition;
    c. how synthetic LIBOR will operate i.e. including its differences compared to panel bank LIBOR, the role of the credit adjustment spread and why the synthetic LIBOR methodology represents a fair outcome for customers.

28. The effective communication on the role of the credit adjustment spread is particularly critical given the current position of rates. A clear emphasis on the approach's fairness should be fostered to help establish customer confidence in the FCA mandated methodology.

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[3] https://www.fca.org.uk/publication/libor-notices/article-21-3-benchmarks-regulation-first-decision-notice.pdf

29. UK Finance members believe this information could be provided in a similar way to the information provided by the FCA for mortgage borrowers.

Impact of introducing limitations or conditions on use of synthetic LIBOR beyond end-2022

30. The consultation makes it clear that no limitations or conditionality will be applied to the permissions to use synthetic LIBOR *'at least before the end of 2022',* but notes that *'if assumptions about the ability to rely on synthetic LIBOR over a long period mean that market participants continuously postpone effort to remove reliance on the 6 LIBOR settings that is otherwise practicable and beneficial, then we may need to reconsider whether limitations are necessary, e.g. applying a time limit for permitted legacy use for some asset classes.'*

31. Members also note that the decision to continue to compel the publication of synthetic LIBOR is subject to annual review and for a maximum of ten years.

32. We believe that it is important, for the reasons set out in the consultation regarding contractual certainty and risks to consumer protection, that it is clear in what circumstances the FCA might decide not to continue to compel the publication of synthetic LIBOR or seek to introduce restrictions or limitations on use of LIBOR on a synthetic basis beyond end-2022. In particular, the sector would need sufficient notice to prepare. UK Finance members recommend that a minimum of 12 months would be needed for any notice of the cessation of any synthetic LIBOR tenors, and sufficient notice, such as 6 months, where use is to be restricted.

33. Members note that there may, in due course, be a tension between consumer protection and market integrity where small numbers of contracts remain on synthetic LIBOR. A prohibition on use or cessation may cause significant adverse impacts on a small number of customers, or an immaterial value of contracts, but nonetheless, the impact on consumer protection could be significant. Understanding how the FCA would balance its considerations in such circumstances would be helpful in due course.

34. The FCA should also be cognisant of factors that may influence the length of time needed to establish a transition route for a contract, once notice has been given that a synthetic LIBOR setting will cease to be published. For example, members continue to transition to alternative rates in line with the RFR Working Group's 'Use Cases' paper and the FICC Market Standard Board's Standard on use of Term SONIA reference rates. Where contracts do not fall into the use cases for Term SONIA, lenders may need to additionally navigate the added complexities of moving customers to rates that operate differently to synthetic LIBOR, such as compounded RFRs.

35. UK Finance members would therefore welcome any further clarity the FCA can provide on its future supervisory approach to use of synthetic LIBOR, including how it will determine whether and how to introduce any future restrictions/limitations on use, as well as timing of announcements.

The time limited publication of synthetic LIBOR

36. The consultation recognises that there are considerable barriers to removing reliance on the six LIBOR settings in many of the contracts referencing them. Although, in some cases, these barriers may be overcome given additional time to transition, members believe there are contracts where such barriers will not be overcome by the passage

of time (for example, long dated contracts where customer consent cannot be obtained).

37. Acknowledging that the publication of synthetic LIBOR is time-limited (and that many contracts including residential and commercial mortgages and long term export finance clients can extend well beyond 10 years), UK Finance members believe that it is important that consideration is given at an early stage to what should happen to those contracts that may still be unable to actively transition during the life of synthetic LIBOR, however long this may be.

38. Members would welcome any further clarity the FCA can provide in this regard.

<u>Contracts with no corresponding synthetic LIBOR tenors</u>

39. The FCA has made clear that they will only compel ICE Benchmark Administration to continue publishing the most used sterling and yen LIBOR tenors on a synthetic basis, providing an off ramp for those contracts referencing the 1-, 3- and 6-month settings which cannot be transitioned away from LIBOR before end-2021.

40. However, there are likely to be some financial contracts that reference those LIBOR tenors for which there is no corresponding synthetic LIBOR setting. Similarly, a borrower may have a contractual right to draw for a period that is not covered by the synthetic tenors.

41. UK Finance members would like to understand the FCA's expectations in relation to the continued operation of such contracts. With no formal synthetic overnight rate to interpolate, it remains unclear if, and how, banks should cater for interest periods referencing tenors shorter that 1 month, or greater than 6 months.

Q2: Do you have any other views or comments on our proposed exercise of our legacy use power?

<u>Recognition of acting in line with guidance available at the time</u>

42. As stated above, in response to calls from the official sector to actively transition where possible, and not to wait for further guidance or a potential legislative solution, members have, or are, engaging with their customers on routes to active transition.

43. It is of critical importance that the exercising of the legacy use power does not adversely impact banks and lenders that have already actively transitioned customers to a replacement rate. It is important that statements from the official sector mitigate the risk of customers already pro-actively transitioned to a replacement rate expressing a view they should have been left to migrate to synthetic LIBOR. It would be unreasonable for banks and lenders to be retrospectively judged against guidance that was not available at the time where they were following official sector and national working group guidance and timelines.

44. We recognise that the FCA has set out in its 'Conduct risk during LIBOR transition: Questions and answers' the expectation that firms '…*should factor the costs, risks and*

benefits of any options, and the information available to them at the time'.[4] However, as a result of these proposed decisions, this should continue to be made clear to counteract the risk of the broad permissions undermining previous actions undertaken in good faith and in line with guidance. Members would therefore welcome any further public statement the FCA could make in this regard, that would support those firms who acted in line with official sector guidance to not wait for a potential legislative solution, but rather pursue the timely active transition of customers away from LIBOR onto more robust alternatives.

International alignment and extraterritorial impact

45. The FCA has rightly recognised that it will need to consider the impact of its Financial Services Act powers (in particular, the creation of synthetic LIBOR) outside the UK. Market participants (including UK supervised firms) may be subject to uncertainty where they have entered into non-UK law governed contracts that are not covered by the UK's proposed contract continuity measure.

46. Particular uncertainty may arise where it is unclear how local law may treat synthetic LIBOR. For example, it may be unclear if local law would regard contractual references to LIBOR as including synthetic LIBOR and, if not, whether a contract would be frustrated, regarded as void etc. Whilst market participants can seek local legal advice, there is still the risk of uncertainty and potential disputes which may vary depending on governing law and client location.

47. To help minimise these risks to market participants, UK Finance emphasises the importance of: (1) HMT/FCA continuing to liaise with regulatory authorities in other jurisdictions (in particular, around the application of synthetic LIBOR); and (2) encourage the publication of local regulatory guidelines or legislation which provides contract continuity for market participants and provides fair and clear outcomes for clients.

48. Where legislative relief has been published (notably in the European Union and New York) we also stress the importance of international coordination to ensure it is clear how different legislative solutions interact to ensure clear and consistent legislative and commercial outcomes.

Q3: Do you agree that we have identified correctly the main groups of contracts that do not currently contain adequate provisions to deal with a prohibition on use?

49. Yes. Although there is a significant volume of financial contracts not specifically addressed within the consultation (such as commercial loans) that are also unlikely to in some cases include operative fallbacks, we recognise that the FCA's powers (and consequently the consultation) relates to those contracts that fall within the scope of the BMR.

[4] https://www.fca.org.uk/news/statements/conduct-risk-during-libor-transition-questions-and-answers

50. The FCA will no doubt be mindful that some contracts do not come under the scope of the BMR at their inception, but have the potential to become so through the product's lifecycle.

Q4: Do you have any views or comments on the rationale for our proposed legacy use decision?

51. The consultation recognises that there are considerable barriers to removing reliance on the 6 LIBOR settings in many of the contracts referencing them noting that *"many contracts simply need more time to transition"* and that *"if assumptions about the ability to rely on synthetic LIBOR over a long period mean that market participants continuously postpone effort to remove the 6 LIBOR settings that is otherwise practicable and beneficial, then we may need to reconsider whether limitations are necessary …'.*

52. The rationale for the proposed legacy use decision recognises that customers in some markets, in particular for example the mortgage market, are unlikely to have engaged with LIBOR transition and that mortgage lenders may see very limited responses to their attempts to seek consent to contract amendments.

53. As anticipated low levels of customer engagement forms part of the rationale in the consultation for exercise of the legacy use power (particularly for retail customers), UK Finance members would welcome further clarity on what factors the FCA will take into account in determining whether firms are taking reasonable and practicable steps to achieve active transition.

54. We welcome the FCA's recognition in relation to 'evidence that similar contracts have been amended' (paragraph 3.33 – 3.35) that contract documentation, terms and provisions can vary significantly within asset classes and even an individual firm's exposures. Whilst the industry has worked hard to establish appropriate off-ramps from LIBOR, we agree with FCA's view that though some contracts may appear to share a similar nature, they may be subject to complex differing factors.

Answers to Chapter 4 Questions (The Article 21A new use restriction power):

Q5: Do you agree with the manner in which we propose to exercise our new use restriction power?

55. UK Finance members broadly agree with way the FCA proposes to exercise its new use restriction power.

56. We note the importance of clarity on which contracts come under the scope of the BMR and those which do not, as well as the importance of considering any unintended consequences across the two types. Members would also welcome a clear statement of the FCA's expectations for the financial services sector as a whole in the context of new issuance of USD LIBOR, to support transition discussions with customers whose

products fall outside the scope of the BMR. While the assumption is that non-BMR contract new issuance should cease in line with those in scope, some counterparties may wish to understand why restrictions on use are also applied to non-BMR products.

Q6: Do you have any comments on the proposed exceptions to the new use prohibition?

57. UK Finance welcomes the symmetry between the UK (paragraph 4.1 of the consultation) and the US authorities' exceptions to the new use prohibition.[5] It continues to be key that there is coordination between the UK and US authorities regarding the prohibition and exceptions, to the degree this is possible. In particular, we note that whilst there have been clear statements co-ordinating exceptions, the approach to enforcement differs with the US setting out regulatory expectations and the UK's having legal backing. It is important that the prohibition, and associated exceptions, are still enforced to the same extent to maintain alignment.

58. Though we note and appreciate the efforts to synchronise exceptions to date, this must be maintained for any emerging US clarifications as to the scope of prohibitions. As noted above, any finalised FCA policy will be set rules and therefore will lack as much flexibility to respond to any potential changes in US supervisory guidance. The FCA should be cognisant of this and ensure no unintentional divergences emerge in the new use prohibition and adapt to any emerging US changes or clarity.

Q7: Do you have any other views or comments on our proposed decision to exercise our new use restriction power?

59. UK Finance members believe it is important that the FCA addresses some of the key questions that arose in connection with the prohibition on 'new use' of sterling LIBOR in exercise of this power. For example, the FCA should explicitly clarify that where a client has a LIBOR-linked facility commitment entered into before the end of 2021, they can draw down the amounts accessible to them under the product after year-end, and that this would not constitute new issuance. Similarly, the acceptability should be confirmed of a security being priced in 2021 (at which time investor commitments are provided and all material terms are agreed) but closed in 2022.

60. We understand that new issuance of commercial loans and other non-BMR 'use' contracts should also cease after end-2021. However, the specific powers to prohibit use of USD LIBOR do not apply (and therefore we understand the exceptions are less centred on). It is therefore important that the FCA sets out specific expectations. These should be aligned as closely as possible with both existing and potentially forthcoming guidance from the US authorities and national working group. Such specific other clarifications that may be useful to be made include use of deferred switch mechanisms, '+1' extensions, an incremental 'tack-on', permissible amendments to existing contracts and secondary trading.

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[5] https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf

61. Some members, noting the approach taken for the GBP Q1 2021 new issuance milestone, would welcome clarity on the approach for short term issuance of contracts that would mature before June 2023. It is, in general, inferred that this remains within scope of the prohibition and therefore not permissible beyond year-end, but ensuring all parties have this context at the earliest opportunity will help support a smooth transition.

62. The end of new use of USD LIBOR has been known since the US regulators made their position clear in November 2020. However, in preparation for this milestone, acceleration in the adoption of SOFR and other robust alternative replacement rates in the USD market remains critical.

63. The use cases for Term SOFR identified by the US Alternative Reference Rates Committee[6] have a greater scope than those identified by the UK Working Group on Sterling Risk-Free Reference Rates for Term SONIA in sterling contracts.[7] Notwithstanding the March 2021 Dear CEO letter, which stated that UK supervised firms should look to the recommendations of the ARRC for USD transition, some parties expressed uncertainty on the application of different currency term rate use cases.

64. We recommend that the FCA explicitly confirms that it is acceptable for UK supervised entities to follow the ARRC's use cases for Term SOFR, in order to support prompt rollout of alternative rates to USD LIBOR in the UK, in preparation for their prohibition on new issuance at year-end. We note this could be done in the form of publication of RFR Working Group minutes or public statements echoing comments made verbally by the FCA as soon as practical.

Q8: Do you agree that we have identified correctly the potential risks of new use of US dollar LIBOR?

65. Yes, UK Finance members have no additional risks to note.

Q9. Do you have any views or comments on the rationale for our proposed decision to restrict new use?

66. We have no additional comments.

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[6] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/ARRC_Scope_of_Use.pdf

[7] 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?la=en&hash=22BA20A8728D9844E5A036C837874CA3E70FEAE1