ICMSA International Capital Market Services Association

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ICMSA Bulletin – Synthetic LIBOR, Type 1 fallbacks and dealer poll mechanisms

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As the process of transitioning away from LIBOR has continued, the ICMSA has sought to highlight key areas of operational difficulty faced by its members when operating legacy LIBOR-derived interest determination and fallback mechanics in circumstances where one or more LIBOR settings has been discontinued.

One of the core challenges flagged by ICMSA members relates to the operation of Type 1 fallback provisions in the context of capital markets debt instruments and, in particular, the obligation to seek quotations from one or more parties typically referred to as "reference banks" as part of a "dealer poll" mechanism. These concerns are addressed in detail in the annex to the ICMSA's response to the UK Financial Conduct Authority's (the "**FCA**") consultation paper 21/29 regarding its proposed decision on the use of LIBOR (Articles 23C and 21A BMR)[1].

Since submitting this response to the FCA in mid-October 2021, a series of key developments have taken place, which together provide the foundations for a more stable landscape to enable the use of synthetic LIBOR as part of an orderly wind-down of LIBOR and give greater clarity on the use and efficacy of Type 1 fallback mechanisms.

On 15 December 2021, the Critical Benchmarks (References and Administrators' Liability) Act 2021[2] (the "**Critical Benchmarks Act**" or the "**Act**") received Royal Assent. By amending the UK Benchmark Regulation, the Act seeks to provide legal certainty as to how contractual references to LIBOR operate following the FCA's decision to compel the continued publication of certain sterling and Japanese yen tenors on a synthetic basis with effect from 1 January 2022. The Act provides that contractual references to LIBOR, however expressed, will continue to be interpreted as references to LIBOR when published in its synthetic form (except to the extent that this is expressly excluded by contract).

When taken together with the FCA's decision to (i) require the publication of synthetic LIBOR rates for 1-month, 3-month, 6-month sterling and yen LIBOR settings for the duration of 2022[3], and (ii) give wide permission for the use of such rates in all capital markets instruments (other than cleared derivatives)[4], the Critical Benchmarks Act should substantially mitigate the instances where Type 1 fallbacks are engaged and the dealer poll mechanism needs to be operated.

However, the FCA has made it abundantly clear that synthetic LIBOR is temporary. Indeed, synthetic yen LIBOR will be only be published for one year only, ceasing at the end of 2022. In addition, whilst the provisions of the Critical Benchmarks Act are widely construed, it is possible that certain contracts might not be captured and therefore not deemed to refer to synthetic LIBOR. This gives rise to the possibility that Type 1 fallbacks may become relevant, albeit in (what is expected to be) a small number of instances.

[1] https://icmsa.org/app/uploads/2021/10/FCA-CP21_29-ICMSA-response-19-October-2021.pdf
[2] https://bills.parliament.uk/bills/3045
[3] https://www.fca.org.uk/publication/libor-notices/article-21-3-benchmarks-regulation-first-decision-notice.pdf
[4] https://www.fca.org.uk/publication/libor-notices/article-23c-benchmarks-regulation-draft-permitted-legacy-notice.pdf

A number of market participants (including the ICMSA) have highlighted this risk to the FCA and requested further guidance as to how (or whether) dealer polls should be operated in circumstances where the relevant LIBOR settings are no longer published. Whilst the FCA has not published any official guidance, the transcript of a keynote speech by Edwin Schooling Latter (Director of Markets and Wholesale Policy and Wholesale Supervision at the FCA), delivered at Risk.net's LIBOR telethon on 8 December 2021 and published on the FCA's website on 10 December 2021[5], gives some valuable insights.

Mr Schooling Latter's speech covers a broad range of topics related to the discontinuation of LIBOR, but of particular note, it includes the following remarks regarding the appropriateness and suitability of the dealer poll mechanism (and by extension, Type 1 fallbacks):

- the speech reiterates the widely acknowledged view that Type 1 fallback arrangements were designed more for a temporary rather than a permanent interruption to LIBOR publication;
- the FCA considers it to be "*optimistic to think [dealer polls] will work given that a principal reason for the end of LIBOR is banks' unwillingness to continue to provide such quotes for LIBOR itself*";
- the FCA is not currently aware of any firm that has confirmed a willingness to provide rates in response to a dealer poll after the relevant LIBOR setting is no longer published, other than where they have a contractual commitment to do so; and
- the FCA does not think it would be appropriate or reasonable for it to put regulatory pressure on firms to respond to such polls (to do so would create a variety of conduct and other risks).

Whilst not going so far as to prevent banks from participating in dealer polls, the FCA's view on their use and efficacy as a fallback mechanism is clear.

On a practical level, if a Type 1 fallback is required to be operated under the terms of a particular contract, there are likely to be certain operational challenges for the calculation agent which is responsible for making the relevant interest determination. Many of those challenges will depend on the specific drafting of the fallback in question, but the FCA suggests that "*banks that might receive such requests may wish to consider setting up a centralised point to receive and make clear if any response will be provided to such requests. They may wish to consider being clear in their client or other communications where they have policies to decline to respond*".

Conclusion

It is widely agreed amongst the ICMSA's membership that the use of dealer poll mechanisms to obtain quotes for LIBOR-based rates is not appropriate or practicable in circumstances where the relevant LIBOR settings are no longer published. Several have advocated for dealer poll mechanisms to be abandoned completely through legislative action, not least with a view to international consistency with the legislation developed by the ARRC in the US, which automatically disapplies such provisions.

In the absence of a similar legislative solution in the UK, however, the ICMSA strongly supports any initiatives (such as those described in this bulletin) to clarify when reference banks will or will not be in a position to give quotations for these purposes. In turn this will enable the dealer poll mechanism in Type 1 fallback wording to be operated more efficiently and with greater certainty, and critically, is likely to assist with any decision to move to the next level in the fallback waterfall.

[5] https://www.fca.org.uk/news/speeches/so-long-libor-3-weeks-to-go