20 October 2021

ICMA RESPONSE TO FCA CONSULTATION PAPER CP21/29 ON PROPOSED DECISIONS ON THE USE OF LIBOR (ARTICLES 23C AND 21A BMR)[1]

Key points

- The FCA's proposal to grant a broad permission to use synthetic LIBOR is welcome because it will avoid significant legal and practical uncertainty arising in the legacy LIBOR bond market.

- If synthetic LIBOR is published on screen pages but there is no broad permission to use it for legacy LIBOR bonds, significant legal and practical uncertainty would arise. Therefore a broad permission to use synthetic LIBOR for legacy LIBOR bonds will be needed for as long as synthetic LIBOR is published.

- The Critical Benchmarks Bill needs to be passed in good time before the end of 2021 to provide continuity of contract in law between panel bank LIBOR and synthetic LIBOR. In addition, the market is expecting synthetic LIBOR to appear as a single value incorporating both the term RFR and credit adjustment spread elements on the same screens (including commercial providers' screens) and at the same time as panel bank LIBOR.

- While active transition of legacy LIBOR bonds will be feasible for some bonds after the end of 2021, other bonds may be too difficult to convert and may have long maturities.

- The FCA will need to assess the risks to an orderly wind-down of LIBOR before synthetic sterling LIBOR is withdrawn. Clear engagement and communication with market participants in advance of any such withdrawal will be important.

- The FCA's proposed alignment with US supervisory guidance in relation to the restriction on new use of US dollar LIBOR is welcome.

Introduction

1. ICMA welcomes the opportunity to respond to the FCA's consultation on its proposed decisions on permitting use of synthetic sterling and yen LIBOR and restricting new use of US dollar LIBOR. This ICMA response has been prepared from the perspective of the bond markets.

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

2. Yes, we agree with the manner in which the FCA proposes to exercise its legacy use power.

3. For the reasons explained in our response to the FCA's previous consultation on use of critical benchmarks, a broad permission to use synthetic LIBOR for legacy LIBOR bonds is important to avoid significant legal and practical uncertainty that could otherwise arise and pose a threat to market integrity and consumer protection. Briefly, this includes uncertainty as to whether bond

[1] https://www.fca.org.uk/publication/consultation/cp21-29.pdf

fallbacks have been triggered or not, events of default being triggered and mandatory redemption of legacy securitisations at par; all of which may be disputed based on, among other things, the precise wording of bond provisions and different possible interpretations of the scope of "use" under the BMR.

4. These significant legal and practical uncertainties would arise for outstanding legacy LIBOR bonds at any time that synthetic LIBOR is published on relevant screen pages but there is no broad permission to use it. This means that a broad permission to use synthetic LIBOR for legacy LIBOR bonds will be needed for as long as synthetic LIBOR is published.

5. For securitisations, CLOs and other structured financings, permission to use synthetic LIBOR for uncleared derivatives will be particularly helpful given the relationship between the cash products and derivatives in these structures, as acknowledged by the FCA in paragraph 3.67 of the consultation paper.

6. Related to the points above are important considerations on the length of availability of synthetic sterling LIBOR and contract continuity when synthetic LIBOR is introduced. We discuss these points under Q2 below.

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

7. The following points are related to the exercise of the FCA's legacy use power.

Length of availability of synthetic LIBOR

8. Under the UK Benchmarks Regulation, synthetic LIBOR can continue for a maximum period of 10 years, but the FCA must review its decision to compel IBA to continue to publish it each year. The FCA will need to assess the risks to an orderly wind-down of LIBOR before synthetic sterling LIBOR is withdrawn. Central to this assessment will be the volume and maturity profile of the contracts and instruments that reference synthetic sterling LIBOR, the likelihood of successful active transition and the nature of their contractual fallbacks.

9. The FCA has estimated[2] there to be around 480 outstanding transactions in the UK at end-2021 referencing one of the three sterling LIBOR settings for which synthetic sterling LIBOR will be introduced, with a total notional value around £90 billion. The FCA has also stated that there is likely to be a material amount of these outstanding legacy contracts at end-2021, by number and value of contracts, which either have no fallbacks or inappropriate fallbacks to deal with the cessation of LIBOR. It is anticipated that there will be a gradual decline in the number of sterling LIBOR bonds referencing synthetic LIBOR after it is introduced. This decline will result from redemptions (either at maturity or at call dates) and active transition away from sterling LIBOR (via consent solicitation or other forms of liability management). It is very difficult to predict precisely how the volume of sterling LIBOR bonds will decline over time because it will depend on the level of successful active transition and whether or not call options are exercised.

10. ICMA described the challenges associated with active transition of legacy LIBOR bonds in our response[3] to the FCA's previous consultation. It is helpful that the FCA has acknowledged the challenges associated with active transition in the bond market[4]. In some cases, these challenges

[2] See paragraph 3.7 of FCA CP21/19: Proposed decision under Article 23D BMR for 6 sterling and yen LIBOR settings.
[3] See pages 9 – 11 responding to Q2.
[4] See paragraph 3.7 of FCA CP21/19: Proposed decision under Article 23D BMR for 6 sterling and yen LIBOR settings.

are unlikely to be overcome by providing issuers with more time to transition, for example where there is a significant proportion of US investors[5] or an orphan securitisation with insufficient funds or resources to transition actively.

11. Given the challenges of active transition in the bond market, it seems likely that there will be at least some legacy sterling LIBOR bonds outstanding beyond the maximum 10-year period for which the FCA can compel IBA to publish synthetic sterling LIBOR. This issue was raised in the second reading of the Critical Benchmarks (References and Administrators' Liability) Bill in the House of Lords on 13 October 2021.

12. The majority of legacy sterling LIBOR bonds that will reference synthetic sterling LIBOR are likely to contain Type 1 fallbacks[6]. In addition to the likely commercially unpalatable result of fixing the interest rate for the bond at the most recently used rate for the remainder of its term, paying agents have noted that there will be significant practical challenges in operating Type 1 fallbacks because they were designed to deal with temporary unavailability of LIBOR and not permanent cessation. A key concern is that the first step of polling reference banks will not result in any outcome (because reference banks will be unwilling to provide quotes) and the provisions typically do not specify when agents are able to move from polling reference banks to the next step of fixing at the most recently used rate.

13. The practical and commercial drawbacks associated with Type 1 fallbacks in legacy LIBOR bonds will be an important factor for the FCA to consider when it is conducting its annual assessment of whether or not to continue to compel IBA to publish synthetic sterling LIBOR.

14. There are a relatively small number of legacy sterling LIBOR bonds with Type 2 fallbacks. It is anticipated that many of these will reference synthetic LIBOR, although the drafting of Type 2 fallbacks varies and so parties will need to check the precise terms of the particular bond. Type 2 fallbacks are expected to transition the bond to an alternative rate and credit adjustment spread when synthetic LIBOR ceases, meaning the need to transition these bonds actively is less acute than legacy LIBOR bonds with Type 1 fallbacks. The FCA may wish to consider this in its communications regarding the need to transition legacy LIBOR instruments actively.

15. For all legacy sterling LIBOR bonds referencing synthetic LIBOR, it will be important that the FCA engages with the market and gives market participants sufficient notice (at least one year) before synthetic sterling LIBOR ceases to be published.

16. For synthetic yen LIBOR, which will be available for one year only, The Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks has been active in its efforts to support an orderly wind-down, including in its current consultation on the treatment of tough legacy contracts in Japan.

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[5] For example, SEC rules requiring SEC registration of documentation for a deemed new issue of securities arising from a consent solicitation exercise are viewed by non-US issuers as onerous and costly and a significant barrier to involving US investors in consent solicitations. This means that bonds with a high proportion of US investors are very unlikely to be transitioned successfully at any time unless there were to be: (a) significant divestment by US investors; or (b) an SEC no-action letter allowing issuers to involve US investors in their consent solicitation exercise without the need to comply with the relevant SEC requirements.

[6] See paragraph 4 of ICMA's response to the FCA's previous consultation for a brief description of Type 1, Type 2 and Type 3 fallback provisions.

Contract continuity

17. From a practical perspective, market participants are expecting synthetic LIBOR to be published as a single value incorporating both the term RFR and credit adjustment spread elements on the same screens (including commercial providers' screens) and at the same time as LIBOR in order to support contract continuity when synthetic LIBOR is introduced. The importance of publication on the same screens and at the same time as LIBOR is highlighted in ICMA's response to the FCA consultation CP21/19 on its proposed decision under Article 23D for the six sterling and yen LIBOR settings. It is helpful that the FCA stated in its Q&A on LIBOR and the FCA's new powers under the UK BMR published on 15 October 2021: "*While the underlying methodology for the 6 sterling and yen LIBOR settings will change after end-2021, LIBOR's administrator will be required to continue publishing these settings at the scheduled publication time and for all applicable London business days as is currently the case for panel-bank LIBOR. We do not expect the changes in the underlying methodology to affect how LIBOR should continue to be displayed on the relevant screen pages*." If the FCA has not already engaged with the IBA on this issue, it would be helpful if it could do so.

18. From a legal perspective, the large majority of legacy sterling and yen LIBOR bonds are likely to be governed by English or Japanese law.

19. *English law:* For contracts and other arrangements governed by English law, the Critical Benchmarks (References and Administrators' Liability) Bill will, when passed into UK law, be very important in providing legal certainty as to how contractual references to LIBOR should be interpreted following the introduction of synthetic LIBOR. The Bill needs to be passed into law in good time before synthetic LIBOR is introduced.

20. *Japanese law:* We are not aware of similar Japanese legislation for contracts and other arrangements governed by Japanese law. The Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks discusses the introduction of synthetic LIBOR in its current consultation on the treatment of tough legacy contracts in Japan and sets out steps that parties may consider in order to reduce the risk of litigation when synthetic LIBOR is introduced.

Other LIBOR currency settings

21. *US dollar:* There are significant volumes of English law governed contracts referencing US dollar LIBOR. All the concerns outlined above related to permission for use, length of availability and contract continuity will be relevant in the context of any synthetic US dollar LIBOR that may be introduced in due course. Additional questions will arise as a result of the New York legislation providing for an override of US dollar LIBOR references in New York law governed contracts, securities and instruments and the provisions for statutory replacement of a benchmark under the EU Benchmarks Regulation. In both the New York and EU cases, the legislative override would apply to a broad range of legacy US dollar LIBOR bonds, there would be no time limit on it, and the provisions are expressly designed to deal with the issue of contract continuity. Careful thought, collaboration among authorities internationally and communication with market participants will be needed before any introduction of synthetic US dollar LIBOR.

22. *Swiss franc and euro:* We note that the FCA does not intend to exercise its powers to compel IBA to publish synthetic versions of euro and Swiss franc LIBOR. There are understood to be a very small number of legacy Swiss franc and legacy euro LIBOR bonds.

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?

23. We broadly agree that the FCA has identified correctly the main groups of contracts that do not currently contain adequate provisions to deal with a prohibition on use.

24. In relation to bonds, the FCA states in paragraph 3.7 of the consultation paper that "*most (although not all) bonds issued after November 2019 are likely to contain adequate fallback provisions [to deal with a prohibition on use]*". We agree that LIBOR bonds issued after November 2019 are likely to contain fallback provisions with trigger events related to a prohibition on use. We would note, however, that there may be practical challenges associated with operating these fallbacks related to the appointment of independent advisers, agreeing and serving relevant notices, adjustments to systems, and amending contracts in time. We discussed these practical challenges in our response[7] to the FCA's previous consultation.

25. We suspect that the FCA has referenced November 2019 as being the date from which "adequate" fallbacks will have been used because this was the time of Edwin Schooling Latter's speech in which LIBOR's future representativeness was discussed. We note that bond market participants in Europe had started to use fallbacks that included a trigger event based on a prohibition on use earlier than November 2019. However, this would not change the overall analysis that the large majority of legacy LIBOR bonds will not contain such fallback provisions. This is particularly the case because Type 2 and Type 3 fallbacks were not considered to be appropriate for many sections of the securitisation market for ratings and other reasons.

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

26. The FCA's rationale for its proposed legacy use decision seems broadly reasonable.

27. It is helpful that the FCA has acknowledged concerns raised by market participants in response to the previous consultation, for instance in relation to the challenges associated with setting out clear and practicable criteria for the market.

28. In relation to "evidence that similar contracts have been amended" being a factor for determining actual risk to consumer protection and market integrity (per paragraphs 3.33 – 3.35 of the consultation paper), it is helpful that the FCA acknowledges that documentation, terms and provisions, and processes relating to contracts referencing LIBOR vary significantly. This indicates the FCA's understanding that simply because some contracts within an asset class have been amended, it does not necessarily mean that others can also be so amended. In relation to the bond market, another significant differentiating factor in the ability of market participants to transition some legacy LIBOR bonds compared with others is the number and identity of the parties involved. For example, it is much easier to transition a privately-placed bond held by one or a small number of known investors than a publicly distributed bond held by a wide range of unknown investors located in multiple jurisdictions and with different levels of sophistication.

29. In relation to BMR compliance, the FCA states in its Statement of Policy on its powers under Article 23C of the BMR that: "*Contracts that supervised entities entered into after [Article 28(2) of the] BMR came into force (on 1 January 2018) should contain contractual provisions that move the contract to use an alternative benchmark if a benchmark becomes permanently unrepresentative*". Article 28(2) of the BMR requires supervised entities to have "robust" fallbacks but does not specify further what that means. The FCA statement is therefore a

[7] See page 6.

particular interpretation that not all market participants may have taken previously. For example, in the bond market, Type 1 fallbacks[8] were interpreted as meeting the "robust" criteria in Article 28(2) from a legal perspective because they will result in an outcome in the event the benchmark ceases. Because this legally "robust" outcome is unlikely to be commercially palatable for many market participants, alternative fallbacks started to be introduced into new English law governed bonds after Andrew Bailey's speech on the future of LIBOR in July 2017; and the sterling floating rate bond market began referencing SONIA during the course of 2018.

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

30. Yes, we agree with the manner in which the FCA proposes to exercise its new use restriction power.

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

31. It is helpful that the proposed exceptions align with US supervisory guidance (subject to the additional exception for interpolation for contractual fallbacks, which the FCA states is needed because of the way the definition of "use" works under the BMR).

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

32. The statement in Feedback Statement 21/10: FCA use of powers over use of critical benchmarks clarifying that buying and selling existing financial instruments (ie secondary market activity) does not fall within the definition of "new use" in Article 21A(2) of the BMR[9] is helpful. To further confirm this point for market participants and draw attention again to the related Q&A on conduct risk during LIBOR transition, the FCA could include a similar statement in its final decision on the exercise of its new use restriction powers.

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

33. The FCA's analysis seems sensible.

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

34. No.

[8] See paragraph 4 of ICMA's response to the FCA's previous consultation for a brief description of Type 1, Type 2 and Type 3 fallback provisions

[9] See "Our response" underneath paragraph 3.26 on page 23.