Decisions on the use of LIBOR (Articles 23C and 21A BMR)

Feedback Statement

FS21/12

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1 Introduction

Background

1.1 On 5 March 2021 we confirmed that ICE Benchmark Administration (IBA), the administrator of LIBOR, had notified the FCA that it intended to cease providing all LIBOR settings. It will do so at the end of 2021 for all sterling, Japanese yen, euro and Swiss franc settings and the 1-week and 2-month US dollar settings, and at the end of June 2023 for the remaining US dollar settings – subject to the FCA deciding to compel IBA to continue publishing any settings beyond these dates.

1.2 Since then, for the 1-month, 3-month and 6-month sterling and 1-month, 3-month and 6-month Japanese yen LIBOR settings ('the 6 synthetic LIBOR settings'), the FCA has:

- Formally compelled IBA to continue publication after the end of 2021.
- Confirmed that it does not intend to require continued publication of the 3 Japanese yen settings after the end of 2022.
- Designated all 6 settings as Article 23A benchmarks. That is, benchmarks that are permanently unrepresentative of the market they are intended to measure. This designation will take effect on 1 January 2022, and
- Decided to require IBA to use a changed ('synthetic') methodology to calculate these settings from 1 January 2022.

We describe the powers that we have used to make these decisions in more detail here.

Our consultation

1.3 On 29 September 2021, we published a consultation. This sought views on our proposal to use our 'use' powers under Article 23C(2) of the Benchmarks Regulation (BMR) for the 6 synthetic LIBOR settings and Article 21A of the BMR for the 5 US dollar LIBOR settings that will continue to be published after the end of 2021 ('the continuing US dollar LIBOR settings'). These powers relate to the 'use' of critical benchmarks where this use is within scope of the BMR ('use of a benchmark' is defined at Article 3(1)(7)).

1.4 Article 23A designation results in a prohibition on supervised entities using the benchmark, under Article 23B(1) of the BMR. However, Article 23C(2) gives the FCA the power to permit some or all legacy (ie existing) use of the benchmark to continue. We call this the 'legacy use power'.

1.5 Article 21A of the BMR gives us the ability to prohibit some or all new use of a critical benchmark when its administrator has notified us that it will cease to be provided. We call this the 'new use restriction power'.

1.6 On 16 November, following our review and consideration of responses to our consultation, we announced that we have decided:

- to permit all legacy use of the 6 synthetic LIBOR settings by supervised entities other than in cleared derivatives (whether directly or indirectly cleared); and
- to prohibit new use of the continuing US dollar LIBOR settings by supervised entities, with the following exceptions:
  - market making in support of client activity related to US dollar LIBOR transactions executed before 1 January 2022
  - transactions that reduce or hedge the supervised entity's or any client of the supervised entity's US dollar LIBOR exposure on contracts entered into before 1 January 2022
  - novations of US dollar LIBOR transactions executed before 1 January 2022
  - transactions executed for the purposes of participation in a central counterparty auction procedure in the case of a member default, including transactions to hedge the resulting US dollar LIBOR exposure
  - interpolation or other use provided for in contractual fallback arrangements in connection with the US dollar LIBOR settings that will cease at 31 December 2021 (ie the 1-week and 2-month settings)

1.7 On the same day we also published notices explaining our reasons for these decisions as required under the BMR. For Article 23C, we have published the planned text of this notice to provide the market with clarity and certainty. The notice will be formally published, and will take effect, on 1 January 2022. These notices set out how, in reaching these decisions, we took account of our Statements of Policy on our legacy use power and our new use restriction power and of the feedback to our consultation. This Feedback Statement provides more details of the feedback we received and our response. It should be read alongside our notices.

Defining terms

1.8 'Use of a benchmark' is defined at Article 3(1)(7) of the BMR. This use can take place in relation to financial instruments, financial contracts and investment funds. For ease of reference, throughout this feedback statement we refer to use in 'contracts'. By this we mean 'use in financial instruments and financial contracts and by and for investment funds'. Please read 'user' in the same way.

Who this affects

1.9 This Feedback Statement will interest users of the 6 LIBOR settings that will move to a synthetic methodology from 1 January 2022, and users of the continuing US dollar LIBOR settings whether these users are regulated or unregulated. This includes:

- banks and building societies
- investment managers
- life insurance and pension providers
- mortgage lenders and intermediaries
- non-financial corporates of all sizes
- consumers who have mortgages and other consumer loans that use these LIBOR settings

1.10 As we set out in our consultation, these powers will only directly affect contracts within the scope of the BMR. Non-supervised entities such as non-UK firms, non-financial corporations or retail consumers may, however, be party to existing contracts that are affected by the prohibition on use of an Article 23A benchmark. This prohibition, if not overridden by use of our legacy use power, may trigger or otherwise affect contractual terms or fund management measures and/or documents that apply to both parties.

Next steps

1.11 We have now published details of all decisions that will have an impact on LIBOR settings on 31 December 2021 and 1 January 2022. On 1 January 2022 we will publish some formal notices with legal effect. We have published the planned text of these notices in draft form to give the market clarity and certainty.

1.12 We remind market participants that it is important they take all necessary steps to ensure that they understand how their contract terms interact with the winding down of LIBOR. It is up to parties to take their own legal advice on the exact wording of their contracts.

1.13 We encourage users of LIBOR to continue to focus on active transition and move their contracts away from LIBOR wherever possible, rather than relying on synthetic LIBOR, which will not be published indefinitely.

1.14 Similarly, it is also important that market participants understand if and how us exercising our new use restriction power will affect them and take any necessary steps to prepare themselves.

Equality and diversity considerations

1.15 Overall, we do not consider that the proposals materially impact any of the groups with protected characteristics under the Equality Act 2010. To the extent that there is any differential impact, we consider this to be justified, as we do not consider that there is any less impactful way to achieve the objectives we intend to achieve through our use of the powers.

2 Summary of feedback on both powers

2.1 We received 42 responses from banks, asset managers, trade bodies, and law firms, with most respondents from the UK and some from abroad. Overall, respondents agreed with both of our proposals.

2.2 We give details of responses specific to one or other of the two proposed decisions in Chapters 3 and 4. However some issues were raised that were common to both and we address these below.

2.3 A number of respondents asked us to confirm that secondary market activities (which we understand to mean buying or selling cash financial instruments, eg debt or loans) are out of scope of these powers. Many asked the same about non-consumer loans. One went further and asked that we confirm that loans are permitted to use benchmarks in the same way as in-scope contracts and that we will not view this as a conduct issue. Some respondents suggested it would be helpful to have further clarification on our expectations for ceasing new use of US dollar LIBOR in products outside the scope of the BMR.

2.4 Several respondents questioned the impact on the ICE Swap Rate benchmark of reduced volumes of transactions, for both US dollar and sterling. Some were concerned at the prospect of the rates no longer being published.

2.5 Several respondents said we needed to provide continued messaging on active transition. They asked for clear and possibly increased messaging by the FCA/ official sector calling for ongoing active transition efforts. This is partly to help their negotiations with some clients who may be less motivated to engage with transition efforts where we have now confirmed that they can continue to use LIBOR settings. There were also some specific requests on the 6 synthetic LIBOR settings, which we address in Chapter 3.

Our response

2.6 As we set out in our consultation, our powers will directly affect only supervised entities and 'use of a benchmark' as defined in Articles 3(1)(17) and 3(1)(7) of the BMR respectively. Neither secondary market activity in, nor the holding of, cash financial instruments falls within the definition of use at Article 3(1)(7) and so is not in scope. Loans that are covered by the definition of a financial contract in Article 3(1)(18) of the BMR (ie credit agreements and regulated mortgages) are subject to the BMR. Products and activities outside of the scope of the BMR, including loans that are not captured by the definition above, are not directly affected by any prohibition imposed by its provisions.

2.7 However, taking a wider consumer protection and market integrity risk perspective, firms should consider carefully whether it is appropriate to use LIBOR settings for their customers and their contracts. This is both because these settings are ceasing and, in the case of the 6 synthetic LIBOR settings, they will be permanently unrepresentative. Continuing to use LIBOR settings where appropriate and more robust and sustainable alternatives are available is a conduct consideration which firms should take into account. We give more information on this in our LIBOR conduct Q&A. For US dollar LIBOR, firms should already be working towards the deadline for stopping new use by end-2021 across all asset classes, in line with existing FCA and PRA supervisory expectations. These expectations align with US authorities' supervisory guidance, supported globally by the Financial Stability Board and IOSCO.

2.8 Our understanding is that the ICE Swap Rate benchmark will continue to exist after 2021. We understand that US dollar ICE Swap Rate settings will continue to be published in their current form. While sterling settings will cease in their current form, IBA plans to publish a spread-adjusted form of the SONIA ICE Swap Rate. This will support the market in transitioning non-linear derivatives, structured products and cash market instruments that currently reference GBP LIBOR ICE Swap Rate. This rate will be made available alongside the GBP SONIA ICE Swap Rate. However, the availability and publication of the ICE Swap Rate benchmark is a matter for its administrator, IBA, and any specific queries or concerns should be directed to the firm.

2.9 We agree that there should be ongoing messaging on the need for active transition to continue, and we will continue to communicate this and to monitor progress. Market participants and their representative bodies also have a responsibility to undertake such messaging alongside the official sector, including in their engagement with clients.

3 The Article 23C legacy use power

3.1 Our consultation proposed to permit legacy use of the 6 synthetic LIBOR settings in all contracts except cleared derivatives, whether directly or indirectly cleared. None of the 42 respondents to the consultation said they disagreed with this proposed way of exercising the legacy use power, and 35 of them said they agreed or broadly agreed, albeit sometimes with further comments. The remaining 7 respondents either did not respond to the question on whether they agreed or did not express a clear position.

3.2 Following this feedback, we did not consider that any change was required. As a result our final decision is in line with the proposal consulted on.

How we proposed to use the legacy use power

3.3 One respondent, while saying they agreed with the way we proposed to use the power, also said they saw some disadvantages to allowing broad usage. They felt it would require significant effort to implement and clients might be less motivated to proceed with transition negotiations. They suggested that the permission could be more targeted, for example, on issuances (because they are difficult to transition) and on consumer credit (to protect consumers).

3.4 At least 1 respondent mistakenly interpreted our consultation to mean that we had proposed that we would permit interpolation using synthetic rates for fallbacks, intragroup use of synthetic rates, and market making for risk management purposes using synthetic rates. This was not part of our proposals.

3.5 Some respondents asked for clarity on bonds containing 'call options' and/or 'fixed to float' provisions – provisions that will move them to use of one of the 6 synthetic LIBOR settings post-2021.

Our response

3.6 As we set out at 3.4 to 3.9 of our consultation, we think relatively few contracts other than derivatives have provisions to deal adequately with a prohibition of use. The respondent at 3.3 above agreed that we had correctly identified the main groups of contracts that do not have these provisions. There would thus be a significant cost to firms and significant risk of market disruption if we were to permit only limited use, given the current volumes of LIBOR-referencing contracts, the short period of time left before the prohibition would come into force and the practical difficulties of transition in this time period. Several other respondents noted the possible negative impact of our decision on clients' motivation to negotiate amendments, but that their preferred solution was continued and possibly increased messaging on the need for active transition to continue (see 2.9 above and 3.32 below for our response on this point about messaging).

3.7 'Issuance' after the prohibition comes into effect would be new use, not legacy use, and so not allowed using this power (see 3.9 below). Assuming that the respondent's reference to 'issuances' referred to legacy use in bonds, their example of targeting would mean neither investment funds nor any derivatives would be permitted continued legacy use. As we set out in our consultation, we think there are some significant obstacles to some investment funds transitioning away or being amended to cope with prohibition by the end of 2021. There are also some derivatives which, because they are structurally or explicitly linked to other use of the benchmark, need to continue legacy use. Overall, we are not convinced there is a case to depart from our proposed approach in favour of a more 'targeted' one.

3.8 We have the option to review our decision and further restrict continued permission to use synthetic LIBOR in legacy contracts if this would support our consumer protection and market integrity objectives. For example, if work to reduce the stock of outstanding legacy LIBOR contracts does not continue and so undermines progress towards an orderly cessation.

3.9 On the range and scope of the prohibition – **firms need to understand that all new use of synthetic LIBOR settings will be prohibited, and the FCA has no power to override or make exceptions to this. New use is defined at Article 21A(2) of the BMR and results in a wide application of the prohibition. Prohibited use will include:**

- Any intragroup use that falls within this definition.
- Any use for risk management purposes that falls within this definition.
- Use where fallback clauses in existing contracts provide for this, including through interpolation. For example, a benchmark cited in a contract as a fallback is only 'referenced' for the purposes of the BMR from the point at which the fallback clause is triggered. Therefore, if the fallback is triggered at or after the date of the prohibition coming into force, this use falls within the definition of new use at Article 21A(2) and so is prohibited – including where the benchmark is being used as part of an interpolation. This could apply in the event of the cessation of, or material change to, the 'primary' benchmark.

3.10 A contract may provide for conditional use of a benchmark, such as using the benchmark in certain circumstances, or at or from a given date, other than in a 'fallback' provision triggered by the cessation of or material change to the benchmark. In such cases, we consider that it constitutes existing ('legacy') use of the benchmark. Our decision allows all existing use in bonds to continue, and so we think the position on bonds containing 'fixed to float' and 'call option' provisions is clear. However, synthetic LIBOR settings cannot continue indefinitely and so firms should continue to use any practicable means available to them to remove their reliance on LIBOR.

Our rationale

3.11 While supporting our proposed decision, some respondents disagreed with parts of our rationale – notably on non-cleared derivatives. They pointed out that supervised parties to non-cleared derivatives, as with bond issuers, may find that counterparties (or third parties whose consent is required) who are not subject to the prohibition, 'hold out' in negotiations. Therefore, contrary to our rationale, these contracts need to use the 6 synthetic LIBOR settings. Respondents also argued that it is legitimate for parties to seek an exact hedge for a cash product. They also said there may be products for which an appropriate or fair alternative benchmark has yet to develop or be published, although they noted work in some cases to rectify the situation – but they did not elaborate or provide examples.

Our response

3.12 As we said in our consultation, non-cleared derivatives are bilateral arrangements for which there are available standardised contract terms and benchmark-specific amendments and fallback provisions. They are not retail contracts and, as such, parties to them should generally be capable of understanding the issues and able to engage with efforts to agree amendments.

3.13 We recognise that in a relatively small number of cases, there may be an asymmetry between parties which makes negotiating transition challenging. However, as we set out in our consultation, we think that in many of these cases fair and mutually acceptable terms can be achieved. While it is possible that agreement to transition away from LIBOR may not be reached in a small subset of cases, it is not clear from the responses what punitive mechanics would then apply, their frequency in contract terms or whether this outcome can be said to 'punish' all parties (as 1 respondent claimed) as a result of the prohibition taking effect. We therefore remain of the view that it is possible for the vast majority of non-cleared derivatives to transition. Where this is not possible, we have yet to see evidence of where, if use were not permitted, there would be a significant impact and market disruption due to punitive termination mechanisms for those which hadn't transitioned to alternative rates.

3.14 We do not agree that in every situation in which a derivative is being used to hedge a cash product that is permitted to use synthetic LIBOR, the derivative must necessarily be permitted to use synthetic LIBOR as well. Our consultation explained that in many instances we think there could potentially be available mechanisms to provide a satisfactory hedge without directly 'matching' the benchmarks being referenced, eg via an additional basis swap. Respondents did not address the availability of such alternative mechanisms.

3.15 On alternative benchmarks, without examples of the products for which respondents consider these are not available, we still consider that, with appropriate adjustment, there are rates available that provide suitable alternatives to the 6 LIBOR settings. Appropriate adjustments could, for example, include the addition of an appropriate spread.

Adequate contract provisions to deal with a prohibition on use

3.16 Several respondents commented on the types of contracts that we had suggested were unlikely to contain adequate provisions to deal with the prohibition on use coming into effect. One said that contract provisions that allow for early termination if a party is subject to a regulatory obligation should not be considered as having 'good' fallbacks, because early termination can be disruptive. Another said that our assessment for bonds was slightly over-simplistic. This is because some bond market participants in Europe started to use 'Type 3' fallbacks earlier than the November 2019 date we suggested.

3.17 Other feedback noted that in many instances contractual fallbacks and unilateral variation clauses triggered by cessation have been put in place to deal with LIBOR transition. These will not be triggered for the 6 synthetic LIBOR settings because these settings are not now ceasing but will continue to be published on a synthetic basis. We were asked for clarity around how firms should proceed in this situation.

3.18 One respondent suggested that by requiring that fallbacks should make provision for a benchmark becoming permanently unrepresentative we are placing a particular interpretation upon the Article 28(2) requirement for supervised entities to have 'robust' fallbacks. They suggest that a fallback that is triggered solely by cessation should be considered sufficiently robust to meet the Article 28(2) requirement. This is notwithstanding that parties to contracts may well now feel that they want contracts to contain broader fallback provisions, for reasons other than compliance with the BMR.

Our response

3.19 We have assessed whether contract provisions are likely to be adequate to deal with the prohibition on use – not whether they should be regarded as 'good'. The quality and appropriateness of contract provisions is primarily a matter for the parties to the particular contracts. For provisions triggered by prohibition, including those that move to early termination, we think it unlikely that many such clauses will be triggered given the broad legacy use that we have decided to permit.

3.20 On the adoption of 'Type 3' bonds in Europe, we assume that in many cases market participants in Europe will not be UK-supervised entities and so will not be within scope of the prohibition. Overall, we remain of the view (as does the respondent) that the majority of LIBOR bonds entered into before the end of November 2019 are unlikely to include adequate provisions to deal with a prohibition on use.

3.21 It is for market participants to investigate how their contract terms will operate when LIBOR settings move to a synthetic basis. In our Feedback Statement, we recognised that if a contract clause is triggered only by permanent cessation of the benchmark, then the clause is not likely to be triggered while a benchmark continues to be published, even if it is published using a synthetic methodology. However, at some point the benchmark will stop being published and at that point the clause will be triggered, unless the contract has been amended. When Article 23A designation takes effect, with the resulting prohibition on use, we think it likely that contracts – other than directly or indirectly cleared derivatives – that do not contain clauses triggered by permanent unrepresentativeness or prohibition will move onto the 6 synthetic LIBOR settings, and they will be permitted to continue using these rates. However, this will depend upon the terms of the individual contract. As per 1.12 above, market participants must ensure that they understand how their contract terms interact with the winding down of LIBOR. We also continue to stress that synthetic LIBOR rates cannot continue indefinitely and so are not a permanent solution: firms must continue efforts to end their reliance on LIBOR.

3.22 As our consultation and Feedback Statement stated, Article 28(2) requires that contracts within scope of the BMR should contain fallback provisions for both the cessation of the benchmark and a material change to it. We consider that a benchmark becoming permanently unrepresentative is a material change and so the fallback arrangement should provide for this. Where contracts existed before Article 28(2) of the BMR came into force on 1 January 2018, guidance (published in December 2017) makes clear that firms should seek to amend these contracts 'where practicable and on a best-effort basis' to make them compliant with the BMR.

Successful implementation of our proposal

3.23 In many instances respondents suggested factors and strategies to help ensure our decision can be implemented successfully.

3.24 One respondent suggested that bondholders should be protected if banks don't want to provide bids for bonds linked to synthetic LIBOR settings and so the FCA should 'support' the secondary market.

3.25 Some responses stressed the importance of providing synthetic rates on the same screens and at the same time as panel-based LIBOR settings, for contract continuity.

3.26 Several respondents asked for more details on the duration of the synthetic rates and the process and timeline for our annual review of the decision to compel continued publication of the 6 synthetic LIBOR settings. Some suggested a minimum notice period for any changes to or cessation of any of these settings or our legacy use permission. These suggested minimum notice periods included 3, 6 and 12 months.

3.27 Some respondents asked that we provide further messaging to the market, and to consumers in particular, on a variety of areas relating to the 6 synthetic LIBOR settings. These include: why lenders are encouraging transition, why synthetic LIBOR is not a complete solution, how synthetic LIBOR provides a fair rate, other rates to which lenders may already have transitioned potentially being fair replacements, and clear expectations on transition efforts to be made post-2021 and how firms should balance these with fair treatment for customers.

3.28 Some respondents mentioned the Critical Benchmarks Bill that is currently before Parliament, the legislative timetable for it to pass into law, and the importance of this process having been completed by end-2021.

Our response

3.29 We set out in our LIBOR conduct Q&A in 2019 that firms should consider the likely increase in costs of dealing for products linked to LIBOR as the transition to alternative rate products progresses, and liquidity in LIBOR products begins to diminish compared with alternatives. Asset managers have been warned for some time of the need to ensure they assess and manage the risks of declining liquidity in LIBOR-referencing products.

3.30 With regard to the screens on which, and times at which, LIBOR is published, we are requiring LIBOR's administrator 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. We welcome communication from Bloomberg and Refinitiv that all continuing LIBOR settings, including the 6 synthetic LIBOR settings, will continue to be available on the same screens from the start of 2022 as they will at the end of 2021. We also welcome confirmation from IBA that it expects to make all continuing LIBOR settings, including the 6 synthetic LIBOR settings, available to licensees through existing IBA licensee distribution services, as is the case for all current LIBOR settings.

3.31 We understand the market's desire for adequate notice of any changes to our decision about permitted legacy use, and of any change to or cessation of the synthetic rates. We attach importance to the wind-down of LIBOR being orderly, and adequate notice of changes can play an important role in achieving this. So we will seek to provide the market with such notice wherever possible. However, it is not possible for us to give a firm commitment to a minimum notice period, given that we cannot be certain of the circumstances in which we might need to take such decisions in the future.

3.32 As stated at 2.9 above, we will continue our messaging on the need for active transition but market participants and their representative bodies also have a responsibility for this, particularly when engaging with clients. We have published a mortgage-specific Q&A on our website. This includes the topics the respondent raised, such as why mortgage lenders are encouraging transition away from LIBOR and why synthetic LIBOR is not a permanent solution. We give comprehensive information on the synthetic LIBOR methodology, why we have concluded it represents a fair outcome for customers and the role of the credit adjustment spread in Feedback Statement 21/11.

3.33 The Critical Benchmarks Bill has now passed its third reading in both Houses of Parliament, and will shortly formally receive Royal Assent, ahead of the end of the year.

International consistency and coordination

3.34 Some respondents mentioned international consistency and the importance of a coordinated approach between jurisdictions. They asked specific questions about UK supervised entities that may be party to contracts written under non-UK law, and sterling LIBOR contracts written under New York law. They also raised the litigation risk for users of synthetic Japanese yen settings, highlighted in the consultation published by the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks.

Our response

3.35 We agree with respondents that international coordination and consistency is important. The EU, the States of New York and Alabama, and the UK have all legislated to make provision for LIBOR's wind-down. As the home jurisdiction for LIBOR, the UK is in a unique position to provide a solution that potentially works for all LIBOR users by changing LIBOR 'at source', so that synthetic LIBOR rates can flow through to global users. However, EU, US and UK authorities all agree that contractual governing law clauses should prevail and that we should not seek to override solutions written into the relevant contractual governing law. We are aware of the benefits of alignment, ie where legislative solutions point to the same replacement rate, notably in the wholesale market. While it is likely that there will be some differentiation, this will be a conscious choice where there are clear advantages to deviate for a particular product in a particular jurisdiction. We will continue to work closely with other authorities and international bodies on a coordinated approach to LIBOR's wind-down and the transition to risk-free-rates.

3.36 The Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks has now published its report on the results of its consultation. The report acknowledges possible litigation risk for users of synthetic yen LIBOR settings, because the economic value of a contract may change as a result of moving from a panel-based to a synthetic LIBOR rate. As with the consultation (and as noted by respondents to our consultation), the Committee suggests steps that parties may want to consider to reduce this risk.

The temporary nature of synthetic LIBOR settings

3.37 Some respondents were concerned about the temporary nature of synthetic LIBOR rates, as they consider it will be difficult for some contracts to transition within the maximum 10-year duration of synthetic rates.

Our response

3.38 As we have set out in our draft Notice, while many contracts can be transitioned with more time allowed to complete the process, there are some long-dated contracts that face higher, and in a few cases, possibly insurmountable, barriers to transition. We encourage firms to continue actively to transition their contracts away from LIBOR wherever possible notwithstanding the publication of synthetic rates. There may come a time when outstanding contracts that still reference a particular LIBOR setting have reduced so significantly that it is no longer proportionate for the FCA to require continued publication of synthetic LIBOR. We will continue to work closely with the Treasury and the Bank of England (Bank) to support an orderly wind-down of LIBOR and the official sector will continue to monitor progress and risks.

4 The Article 21A new use restriction power

4.1 Our consultation proposed to prohibit new use of the overnight, 1 month, 3 month, 6 month and 12 month US dollar LIBOR settings from end-2021, except:

- where market making in support of client activity related to US dollar LIBOR transactions executed before 1 January 2022
- in transactions that reduce or hedge the supervised entity's, or any client of the supervised entity's, US dollar LIBOR exposure on contracts entered into before 1 January 2022
- novations of US dollar LIBOR transactions executed before 1 January 2022
- transactions executed for purposes of participation in a central counterparty auction procedure in the case of a member default, including transactions to hedge the resulting US dollar LIBOR exposure
- for the purpose of interpolation within contractual fallback arrangements for the ceasing US dollar settings (1 week and 2 month)

4.2 Of the 42 responses we received, 30 of the respondents said that they agreed or broadly agreed with the way we proposed to exercise our new use power. However, some raised concerns and suggested changes to our proposed decision. Many respondents felt that our proposed exceptions were not sufficiently clear in some areas and asked for further clarification. Eight respondents either did not respond to the question or did not express a clear position. Four respondents disagreed with at least some aspects of the proposal.

4.3 Following this feedback, we made one adjustment to our approach on fallbacks. We also added an Annex to our notice setting out our decision to provide further detail on the exceptions to the restriction on new use. We explain these changes in more detail below.

How we proposed to use the new use restriction power

4.4 A key theme several respondents raised was the importance of international alignment, particularly with the US. This is needed to support the efforts of US authorities to achieve an orderly wind-down of US dollar LIBOR, to avoid disadvantaging UK-supervised entities and to avoid disrupting liquidity in the international US dollar market. So respondents welcomed the alignment of our proposals with US authorities' supervisory guidance. However, 4 respondents also noted the difference between the FCA's powers and those of other authorities. They were concerned that our proposed approach would not be flexible enough to align with any potential changes in the approach adopted by other regulators.

4.5 Two respondents suggested that we should rely on a supervisory approach, initially at least, to ensure we have the necessary flexibility to maintain international alignment.

4.6 One respondent suggested that having exceptions to our proposed prohibition could allow subjective interpretation and so an 'all or nothing' approach would be better. We took this to mean either a prohibition of all new use of the continuing US dollar LIBOR settings, or no prohibition at all.

4.7 One respondent suggested that the experience of transition from EONIA to €STR demonstrates that infrastructure and liquidity can build without forcing new business to stop using the 'old' rate that is being replaced.

4.8 Two respondents noted that as our proposed restrictions apply to supervised entities (as defined under the BMR), they are wider than those issued by US regulators, which only apply to banks. They said this could lead to a disconnect, where some market participants are able to use the continuing US dollar LIBOR settings and others are not. One respondent argued that we should amend our exceptions to align better with the US approach. They argued that our proposed restriction would not allow a bank to use the continuing US dollar LIBOR settings in a contract for risk management purposes, to manage down its exposures, if its counterparty would be another supervised entity that would not be risk managing and would be taking on additional exposure. This was unless the relationship was such that the bank was considered a 'client' of the supervised entity.

4.9 One respondent suggested that we should remove the condition that market-making and risk management activities can only be undertaken for transactions or contracts 'executed or entered into before 1 January 2022'. They thought this might be interpreted as preventing ongoing risk management activities that involve or arise from new transactions executed after end-2021 in line with the permitted exceptions.

4.10 Three respondents called for us to amend our proposed decision to allow new use of the continuing US dollar LIBOR settings in short-dated contracts (ie those maturing before the end of June 2023). Another suggested we should permit new use to complete transactions 'commenced in 2021'. There were also some concerns about the adverse impact on liquidity of imposing our proposed restriction.

4.11 One respondent noted that there may be some contracts referencing one of the ceasing US dollar LIBOR settings that provide for moving to use of one of the continuing US dollar LIBOR settings directly upon cessation. Under our proposal, the restriction would prevent these contracts from moving to use the continuing setting. This is because, as explained at 3.9 above, use of a benchmark as the result of a fallback being triggered is considered new use, and the exception we proposed was limited to fallbacks using interpolation only.

Our response

4.12 As we said in our notice setting out our decision, we considered whether relying on a purely supervisory-led approach would meet our objectives. We concluded that, having determined that it is appropriate to restrict new use of the continuing US dollar LIBOR settings, we should use our power to impose a legal restriction. Doing so gives the market clarity and certainty in a way that a purely supervisory-led approach would not. We think this is important to achieve our objectives for the new use restriction. We have included further details in an Annex to help firms implement the restrictions (see 4.26-4.27 below), and we will continue to monitor the market impact of our decision into 2022.

4.13 The policy we consulted on and to which we must have regard when exercising the new use restriction power, sets out factors that can result in risks from new use of a ceasing benchmark. It is therefore reasonable to take these risks into account when considering whether to restrict use of the continuing US dollar LIBOR settings. Our policy also requires that we consider whether permitting some forms of new use might support our objectives, including new use that enables firms to reduce existing exposure to the ceasing benchmark. As we set out in our consultation, we consider that there are both risks that would arise from ongoing new use of the continuing US dollar LIBOR settings, and ways in which some limited forms of new use can nonetheless help reduce existing exposure to these settings. Therefore, constraining ourselves to permit either all or no new use would not be appropriate or in line with our policy in this instance.

4.14 On the transition from EONIA, the working group on euro risk-free rates recommended that no new contracts referencing EONIA should be entered into from early October 2019. In any event, we don't consider the transition from EONIA to €STR to be a direct parallel with US dollar LIBOR and SOFR. The relationship between EONIA and €STR (in terms of the spread adjustment required to produce a fair replacement rate) had already been established with certainty. It was also in operation during the period the respondent describes, as EONIA had already moved to a calculation method directly linked to €STR. This is not the case for the continuing US dollar LIBOR settings, which will continue to be based on submissions by panel banks. We consider that the incentives, and risks, for firms differ as a result. Overall, we remain of the view that permitting new use of the continuing US dollar LIBOR settings for purposes other than those excepted from our restriction could pose risks. So requiring firms to move to appropriate alternatives for this new business is an appropriate response.

4.15 On applying our restriction to all supervised entities, we have considered the relevant factors set out in our policy for the continuing US dollar LIBOR settings and concluded that there is no reason to distinguish between banks and other supervised entities. The likely risks we have identified from continued new use of a ceasing benchmark apply to use by all supervised entities, not just by banks. Supervised entities should be seeking to unwind their LIBOR exposures and not be taking on new exposures other than within the proposed exceptions. We think these exceptions provide adequate channels for banks to transfer risk, for example through the interdealer broker market.

4.16 We understand that risk management is a dynamic process. We consider that the current exceptions facilitate this, provided new transactions relate to the risk management of pre-2022 exposures. Therefore, we have not removed the reference to '1 January 2022' in our exceptions.

4.17 As we said in our notice setting out our decision, we do not consider that it would be appropriate to permit new use of the continuing US dollar LIBOR settings in new contracts that will mature before the end of June 2023. The official sector has made clear for some time the risks of financial markets' continued reliance on LIBOR and the need to transition to alternative rates. The most effective way to avoid LIBOR-related risk is not to write LIBOR-referencing business. Use of SOFR-related rates in new contracts helps the necessary systems and liquidity to develop before the continuing US dollar LIBOR settings cease. US authorities' supervisory guidance restricting new use of the continuing US dollar LIBOR settings after end-2021 does not suggest that use in short-dated contracts maturing before mid-2023 is exempt. We agree with this approach and we note market participants' strong support for international alignment.

4.18 For transactions that 'commenced in 2021', it would be challenging to define 'commencement' of a transaction satisfactorily so that the market had clarity on what new use was included in any exception of this sort. In any event, we do not consider that such an exception is necessary as the market has had considerable notice of the likelihood of a restriction on new use coming into force from the start of 2022.

4.19 Our policy is to balance the risks of continued use of a ceasing benchmark, with the risks of shutting down access to the ceasing benchmark prematurely. As set out in our notice, in the case of the continuing US dollar LIBOR settings, we think there is now adequate confidence and liquidity in alternative benchmarks to avoid material or widely occurring adverse impacts from restricting new use of US dollar LIBOR.

4.20 Finally, as we also set out in our notice, we cannot rule out a risk of some market disruption if we prohibit use of the continuing US dollar LIBOR settings in fallback provisions. This would prevent these fallbacks from operating effectively when the 1-week and 2-month US dollar LIBOR settings cease at end-2021. So we have extended our proposed exception permitting use of the continuing US dollar LIBOR settings to interpolate where this is provided for in fallback provisions, to also include other use of the continuing US dollar LIBOR settings provided for in fallback provisions.

Requests for greater clarity

4.21 Respondents agreed with our proposed exceptions to the prohibition, but a recurring theme of the feedback was that our proposed decision did not give sufficient detail or clarity on these exceptions.

4.22 The most common issues on which clarity was sought were points covered explicitly in the Working Group on Sterling Risk-Free Reference Rates' (RFRWG's) guidance on its milestones to cease initiation of new LIBOR derivatives for sterling, but not in our proposed decision for the continuing US dollar LIBOR settings. Respondents asked about:

- **i.** whether single currency US dollar LIBOR basis swaps can be entered into in order to disperse exposures acquired in the course of permitted risk management activity;
- **ii.** how we expect firms to verify clients' intentions for proposed new trades; and
- **iii.** whether streaming prices (including doing so for the purpose of supporting other benchmarks, ie swap rates) is permitted.

4.23 Other respondents requested further clarity about the definition of 'new use'. This included whether this definition captures scenarios where US dollar LIBOR is used as an 'input' to calculate a reference rate, but is not referenced in a contract. Some respondents noted that alignment of definitions and terminology between international authorities is desirable, and several asked about the treatment of extensions and amendments to contracts entered into before 1 January 2022.

4.24 One respondent asked whether intragroup transactions would be prohibited under our proposed decision. Another sought confirmation that firms can continue to issue securities referencing the continuing US dollar LIBOR settings after the prohibition takes effect in 2022, if the discussions and preparation for the issuance took place before the prohibition takes effect (ie in 2021).

4.25 We were also asked if the continuing US dollar LIBOR settings will continue to be representative through to end-June 2023, and to clarify whether we will compel publication of a synthetic US dollar LIBOR after that date.

Our response

4.26 We agree it is important that the market is clear on which transactions are permitted and which are not. Following the feedback, we added an Annex to our decision to provide further detail. This clarifies that the market making exception applies only where market making is undertaken in response to a request by a client seeking to reduce or hedge their US dollar LIBOR exposure on contracts entered into before 1 January 2022. We recognise that market makers executing such trades for their clients may accumulate US dollar LIBOR risk as a result of this activity.

4.27 The Annex to our decision also clarifies that:

- The prohibition does not prohibit new single currency US dollar LIBOR basis swaps entered into in the interdealer broker market (to the extent they would constitute new use), and
- Where relevant, we expect a market maker to make all reasonable efforts to ensure that the client knows about the prohibition set out in the notice and to engage with them on the extent to which they have taken it into account. We do not expect a market maker executing trades for a client to validate on every occasion the client's intention for the proposed trade.

4.28 We agree that it is desirable that market makers are able to stream prices for US dollar LIBOR swaps to trading venues to facilitate market making and risk management in line with the exceptions. Merely providing prices does not constitute use as defined at Article 3(1)(7) of the BMR. However, the determination of payments by reference to any of the continuing US dollar LIBOR settings is 'use' of a benchmark under the BMR. Therefore, it will only be permitted in new transactions where it falls within the exceptions to the new use restriction. Market participants should note this when considering whether to enter into new swaps. The ongoing streaming of prices should enable the production of swap rates.

4.29 'New use', including new use within an existing contract, is defined in legislation (at Article 21A(2) of the BMR). The FCA has no power to amend this definition. The definition of new use makes clear that all forms of new use in financial instruments and financial contracts involve 'referencing' the benchmark, either directly or in a borrowing rate. An additional form of new use, for investment funds, is set out at Article 21A(2)(e). Where a benchmark is used as a tool to inform judgements about pricing a contract (eg how to price a new bond at issuance), but the benchmark is not itself referenced explicitly in the contract, we do not consider that the benchmark is being 'used' as defined in the BMR.

4.30 The feedback we received does not specify which form of intragroup transactions respondents were envisaging, but for clarity, our decision does not include any specific exemption for intragroup transactions. Use in transactions within scope of the BMR will not be permitted unless they fall within the specified exceptions.

4.31 Issuance of financial instruments is defined as new use at Article 21A(2)(a) and no exemption has been made for this. As a result, no issuance must take place from 1 January 2022 onwards. A 'financial instrument' is defined at Article 3(1)(16) of the BMR.

4.32 As we said in our decision notice, we are confident that the continuing US dollar LIBOR settings will be maintained in a representative manner until end-June 2023. We have said that we will continue considering the case for using our powers to require publication of a synthetic rate for the continuing US dollar LIBOR settings when the US dollar LIBOR panel ends in June 2023. However, market participants should not rely on our doing so.

Successful implementation of our proposal

4.33 In some instances, respondents expressed views and made suggestions on factors and strategies that would be necessary or desirable to help ensure our decision can be implemented successfully. One called for a further coordinated SOFR First initiative for cross-currency swaps for non-LIBOR currencies before the end of 2021, to encourage transition.

4.34 Another suggested that the derivatives trading and clearing obligations should be extended to include SOFR, so as to be consistent with the current regime and increase transparency whilst reducing systemic risk.

Our response

4.35 On 2 December, the CFTC's Market Risk Advisory Committee announced Part II of its "SOFR First" initiative for cross-currency swaps. Part I recommended that newly-executed cross-currency swaps referencing US dollar, Swiss Franc, Japanese Yen, and sterling utilise RFRs in each currency instead of LIBOR as of 21 September 2021. Part II encourages all other cross currency swaps with a US dollar leg to switch trading to SOFR from 13 December 2021, ahead of the end of year restriction on new use of US dollar LIBOR. Our March 2021 Dear CEO letter outlines our expectation for UK regulated firms to meet the milestones and targets of relevant supervisory authorities, as appropriate.

4.36 We recognise that the liquidity profile of the derivatives market will continue to evolve as interest rate benchmark reform unfolds. With this in mind and as stated in our recent policy statement, we will continue to monitor developments in the US dollar interest rate derivatives market and ensure appropriate engagement with relevant authorities to ensure that the derivatives trading obligation (DTO) remains appropriately calibrated. This may require us to propose further changes to the DTO in due course. We also note that the Bank stated in its recent policy statement that it expects to consult on changes to the clearing obligation relating to contract types referencing US dollar LIBOR in 2022. We will work with the Bank and relevant international authorities to ensure, where appropriate, a coordinated and consistent approach.

Annex 1
List of non-confidential respondents

Association for Financial Markets in Europe (AFME)

BlackRock

Fidelity International

Insight Investment

International Capital Market Association (ICMA)

International Capital Market Services Association (ICMSA)

Invesco

Investment Association (IA)

International Swaps and Directives Association (ISDA)

Loan Market Association (LMA)

Nomura

Tradeweb

Unicredit

UK Finance

Annex 2
Abbreviations used in this paper

Abbreviation	Description
BMR	Benchmarks Regulation
Bank	Bank of England
CFTC	Commodity Futures Trading Commission
DTO	Derivatives trading obligation
EONIA	Euro OverNight Index Average
€STR	Euro short-term rate
FCA	Financial Conduct Authority
FS Act	Financial Services Act 2021
FSMA	Financial Services and Markets Act 2000
GBP	British Pound
IBA	ICE Benchmark Administration
IBOR	InterBank Offered Rate
IOSCO	International Organisation of Securities Commission
PRA	Prudential Regulation Authority
RFRWG	Working Group on Sterling Risk-Free Reference Rates
SOFR	Secured Overnight Financing Rate
SONIA	Sterling Overnight Index Average
Q&A	Question and Answer

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