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ARTICLE 23C BENCHMARKS REGULATION – NOTICE OF PERMITTED LEGACY USE BY SUPERVISED ENTITIES

1. ACTION

1.1. On 29 September 2021, the Authority published a Notice under Article 23A(10)(b) of the Benchmarks Regulation (BMR) setting out its decisions to designate the following benchmarks as Article 23A Benchmarks, effective from 00:01 on 1 January 2022:

A. 1-month, 3-month and 6-month sterling LIBOR versions; and

B. 1-month, 3-month and 6-month Japanese yen LIBOR versions,

together the "**Article 23A LIBOR Versions**".

1.2. These designations taking effect result in supervised entities being prohibited from using the Article 23A LIBOR Versions unless permitted to do so by a notice from the Authority under Article 23C of the BMR.

1.3. For the reasons given in this Notice and pursuant to Article 23C(2) of the BMR, the Authority permits all legacy use of the Article 23A LIBOR Versions by supervised entities other than in Cleared Derivatives (whether directly or indirectly cleared) (the "Permitted Use").

1.4. This Notice will take effect on 1 January 2022.

2. SUMMARY OF REASONS

2.1. The Authority considers that it is appropriate to permit the Permitted Use under Article 23C(2) of the Benchmarks Regulation, taking into account the Statement of Policy published on 29 September 2021 under Article 23F(1)(c) of the Benchmarks Regulation.

2.2. The Authority considers that the number and volume of contracts referencing the Article 23A LIBOR Versions that do not contain adequate provisions to deal with the prohibition under Article 23B and that have not been amended, is sufficient that it is desirable to permit the Permitted Use in order to advance both the Authority's integrity and consumer protection objectives.

2.3. The Authority considers that the Permitted Use should be permitted with effect from 1 January 2022 (i.e. the date from which the prohibition would otherwise take effect for these contracts).

3. DEFINITIONS

3.1. The definitions below are used in this Notice:

"the Authority" means the Financial Conduct Authority

"the Benchmarks Regulation" or "BMR" means the UK version of Regulation (EU) No. 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014, which is part of UK law by virtue of the European Union (Withdrawal) Act 2018

"Cleared Derivatives (whether directly or indirectly cleared)" means a derivative which has been cleared through a central counterparty whether or not a direct contractual relationship exists with the central clearing counterparty and whether cleared voluntarily or pursuant to a legal or regulatory obligation

"IBA" means ICE Benchmark Administration Limited

"ISDA" means the International Swaps and Derivatives Association, Inc.

"ISDA 2020 IBOR Fallbacks Protocol" means the ISDA 2020 IBOR Fallbacks Protocol published on October 23, 2020 by ISDA

"ISDA IBOR Fallbacks Supplement" means the Amendments to the 2006 ISDA Definitions to include new IBOR fallbacks, in supplement number 70 to the 2006 ISDA Definitions, published by ISDA, final on October 23, 2020 and effective on January 25, 2021

"ISDA Derivative" means a derivative to which both the ISDA 2020 IBOR Fallbacks Protocol and the ISDA IBOR Fallbacks Supplement apply

"LIBOR" means the ICE LIBOR benchmark provided by IBA

"Statement of Policy" means the Statement of Policy relating to the exercise of the Authority's powers under Article 23C published on 29 September 2021 under Article 23F(1)(c) of the BMR

"version" has the meaning in Article 23G(2) of the BMR and is used to refer to LIBOR as provided for a particular currency and tenor, sometimes known as a LIBOR setting

3.2. Words and expressions used in the Benchmarks Regulation have the same meanings where used in this Notice unless the contrary intention appears.

4. REASONS

Background

4.1. Article 23A of the UK Benchmarks Regulation grants the Authority the ability, in certain circumstances, to designate a critical benchmark as an Article 23A benchmark, i.e. as being permanently unrepresentative of the market it is intended to measure. This designation results in a prohibition on supervised entities using the benchmark, except where the Authority permits use of the benchmark to continue.

4.2. On 29 September 2021 the Authority published a Notice under Article 23A(10(b)) of the Benchmarks Regulation setting out its decisions to designate the Article 23A

LIBOR Versions as Article 23A benchmarks with effect from 1 January 2022, following the departure of the panel banks that contribute to them currently.

4.3. Between 20 May and 17 June 2021 the Authority consulted on a Statement of Policy on the exercise of the Article 23C power. The final Statement of Policy was published on 29 September. Between 29 September and 20 October 2021, the Authority consulted on its proposed decision to use its power under Article 23C of the BMR in respect of the Article 23A LIBOR Versions, setting out how it had regard to the Statement of Policy. The Authority has considered the responses received and has decided to permit the Permitted Use as set out above.

Reasons for permitting legacy use by supervised entities

Potential risk to consumer protection and market integrity

4.4. Our Statement of Policy states that our first consideration is the scale and nature of legacy contracts that do not have adequate provisions to deal with a prohibition on use that follows an Article 23A designation. This group of contracts is comprised of contracts within scope of the BMR that do not contain workable fallbacks or other provisions that are triggered by either permanent unrepresentativeness of the benchmark, material change to the benchmark (where this is either not defined or is defined in a manner that includes permanent unrepresentativeness), or a party to the contract being prohibited from using the benchmark. We think this group is likely to include most exposures within scope of the BMR other than:

- most (although not all) bonds issued after November 2019;
- cleared derivatives; and
- non-cleared ISDA Derivatives.

4.5. We have considered the scale and nature of legacy contracts across asset classes, using the data available to us, and have sought to gauge the extent to which they are likely to contain adequate provisions to cope with prohibition, based on information provided to us by market participants and their representatives and advisors. We have concluded that, in relation to all of the Article 23A LIBOR Versions, there is sufficient number and volume of contracts that are likely not to contain these provisions that it is desirable for us to use our power to permit legacy use in order to advance both consumer protection and market integrity.

Actual risk to consumer protection and market integrity

4.6. The potential risk can be avoided if the contracts described above have been amended to remove reliance on the Article 23A LIBOR Versions before or when the prohibition comes into effect. In line with our Statement of Policy we have considered whether and to what degree it is feasible for parties to amend these contracts in a way that delivers fair outcomes, by reference to a range of factors:

Are there alternative benchmarks which would be appropriate and fair replacements?

4.7. International authorities have expressed the view consistently over several years that near-risk-free rates (RFRs) provide a robust and appropriate alternative foundation rate for most forms of contract that reference LIBOR. These rates are now sufficiently used to ensure liquidity and market confidence. Some authorities and / or national working groups have identified limited cases in which there is a case for use of a forward-looking rate. In these cases, forward-looking term rates based on the relevant RFR are available. Other rates, such as central bank policy rates, can also be referred

to in contracts. Some market participants have suggested that there may be products for which an appropriate or fair alternative benchmark has yet to develop or be published, but they have provided no data. In our view, with appropriate adjustment (e.g. through the addition of an appropriate spread) these rates provide suitable alternatives to the six LIBOR settings.

How easy is it to amend these contracts?

4.8. The ease of amending these contracts varies from one asset class and contract type to another. It depends upon the number of parties to the contract and how many of them must consent to change it, the ease of identifying the relevant parties, and the type of legal, regulatory and operational procedure(s) required for the relevant parties to consent. We have found that for asset classes other than derivatives, amendment is often likely to be challenging, time-consuming, or both.

Are mechanisms available for changing large volumes of contracts without making bespoke amendments?

4.9. Contracts and documentations for bonds, mortgages and investments funds are rarely standardised and, in many instances, individual approval for amendments is also needed. For cleared derivatives, the relevant clearing houses set their terms and can amend them in bulk with relative ease. Uncleared derivatives' documentation is very often (though not always) standardised using industry-agreed standard templates, which can be relatively easily updated in bulk via a 'Protocol' mechanism.

What is the nature of the parties to the contracts?

4.10. Contractual parties' awareness, knowledge and understanding of Article 23A designation, and of the process for amending the contract, will likely have affected their willingness to engage with efforts to amend the contract and agree to any amendments. For instance, retail consumers, or SMEs, may not have been familiar with the need to transition away from the Article 23A LIBOR Versions, or may not be aware of the consequences of a prohibition on their use. For mid-size and large non-financial corporates, awareness of LIBOR transition may also be limited, although these firms should often be able to acquaint themselves relatively quickly with the relevant issues.

What is the effect of the prohibition on parties who must consent to, or be involved in, amending the contract?

4.11. If the prohibition on use affects parties differently then it can create misaligned incentives to amend the contract on fair terms. For example, only some of the parties may be subject to the prohibition (e.g. one might be a non-UK firm), and the contract terms may penalise these parties if the prohibition means they are unable to fulfil their obligations under the contract.

4.12. In the case of contracts referencing the Article 23A LIBOR Versions, there are a number of examples of asymmetries resulting from the prohibition impacting one or more, but not all, parties to contracts. It is not always clear how the contract terms require the parties to proceed where this is the case.

Is there evidence that similar contracts have been amended?

4.13. Similar contracts having been amended successfully to deliver fair outcomes could indicate that amendments to a contract are feasible. However, in respect of LIBOR, even within asset classes and sometimes even across a single firm's products within

an asset class, contract documentation, terms and provisions and resulting processes can vary significantly. As a result, even where contracts referencing LIBOR within the same asset class or product have been amended, these can rarely if ever be regarded as 'similar' contracts to the degree that it is certain that other contracts can also be amended successfully.

How much notice have the parties had of the prohibition?

4.14. Where parties have had a long period of notice of a prohibition coming into effect, or of the likelihood of a prohibition, then they will have had considerably more time to plan for and implement amendments to the contract. The Authority flagged to the market the strong possibility that LIBOR would cease to be published at the end of 2021 or soon after as early as mid-2017. As some firms have pointed out in the feedback to us, in some cases this led to contracts being amended to include fallback clauses triggered by cessation; or to firms checking that their existing provisions – such as unilateral variation clauses in mortgages – would be triggered in such circumstances. The Government announced its intention to grant us the necessary power to require publication of a 'synthetic' rate in June 2020. The legislation that set out full details of this power, and the prohibition that would take effect at the point the power became available, was published in September 2020 and came into force in July 2021. Therefore, market participants have had a year's notice of the possibility of some LIBOR settings continuing on a synthetic basis, and a prohibition on use coming into effect.

Is the contract structurally and/or explicitly linked to other use of the benchmark, and if so, does this create a barrier to amending the contract and achieving a fair outcome?

4.15. In some circumstances, even though it might be practicable to make amendments to a contract, links between it and another use of the Article 23A LIBOR Versions – e.g. in another linked contract – can present an obstacle to risk-free transition, if the linked use has not yet moved to another benchmark. In some circumstances, it will be important to ensure that the same benchmark is used in the linked uses, e.g. to maintain precise cashflow where a derivative is embedded within a structured transaction.

4.16. Market participants have provided several examples of linked contracts that they consider justify our permitting continued legacy use because the linkage is a barrier to transition to a fair alternative arrangement. We do not agree that all of these are structural or explicit linkages (we set out our thinking on this in our Feedback Statement FS21/10). However, we know that LIBOR is sometimes used in complex transactions involving interconnected products such as securitisations or collateralised loan obligations, where the links between the products are clearly structural and/or explicit.

Summary – actual risk to consumer protection and market integrity

4.17. While appropriate alternative rates to the Article 23A LIBOR Versions exist, with sufficient use to ensure liquidity and market confidence, there are considerable barriers to many contracts transitioning to these rates or otherwise removing reliance on the Article 23A LIBOR Versions. While many of these barriers – such as gaining consent from bondholders or borrowers – could likely be overcome given enough time, this has not been achieved in many instances. Given the extent of LIBOR use, and notwithstanding notice to users of the prospective end of LIBOR, evidence provided to us shows that a significant number of users have not completed all necessary changes to remove reliance on it in all contracts.

4.18. Overall – we consider that most of the contracts described at 4.4 above (i.e. all exposures within scope of the BMR other than cleared derivatives, non-cleared ISDA Derivatives, and most bonds issued after November 2019) have faced barriers to removing their reliance on LIBOR settings, and progress on overcoming those barriers will not be sufficient to avoid risks to market integrity and consumer protection if use of synthetic rates is not permitted. As a result, we consider that it is desirable to exercise our legacy use power to advance both our market integrity and our consumer protection objectives.

4.19. We conclude that the risks to market integrity and consumer protection are real, if we do not, at least in the first year after the end of panel bank LIBOR, allow a relatively wide legacy use of the synthetic rates. As a result, we consider that there are grounds to exercise our legacy use power at least for the duration of 2022. This is to advance both our market integrity and our consumer protection objectives.

Further considerations

4.20. We have considered a number of other factors in reaching our decision on the use of this power.

The effect of permitted legacy use on the robustness and/or the sustainability of any benchmark used as an input to the Article 23A benchmark

4.21. Overall, we estimate that around 97% of the sterling LIBOR derivatives market is now comprised of either ISDA Derivatives or contracts covered by clearing house conversion mechanisms and therefore should have already transitioned to compounded SONIA. A large proportion of yen LIBOR derivatives is also covered by either the ISDA protocol or clearing house conversion mechanisms. This significantly reduces the risk of any 'inverted pyramid' effect (i.e. high use (including indirect use) of a benchmark combined with low levels of activity in the markets underpinning it) for the RFR-based term rates, and any resulting financial stability risk.

International consistency

4.22. There is consensus across international authorities that use of LIBOR must cease and firms should transition their legacy contracts to appropriate alternative rates wherever practicable. While the tools to achieve this may differ across jurisdictions, authorities are seeking consistent outcomes in ensuring an orderly wind down of LIBOR by minimising market disruption and consumer harm.

Whether contracts are required by law or regulation to contain suitable fallback provisions such that they should not be adversely impacted by the prohibition

4.23. Contracts within scope of the BMR should contain fallback clauses that operate in the event of either the cessation of the benchmark or a material change to it. This provision of the BMR came into force on 1 January 2018. Many LIBOR-referencing legacy contracts were originated before this date. Guidance (published in December 2017) states that firms should seek to amend these contracts 'where practicable and on a best-effort basis' to make them compliant with the BMR.

4.24. We recognise that firms faced obstacles and uncertainty in trying to comply with these requirements with respect to LIBOR in 2018. For much of 2018 there was not consensus in the market on the design and content of appropriate fallback language – but there was clear value in achieving consistency of approach rather than fragmentation.

4.25. We have concluded that there is a sufficient number and volume of contracts that do not contain 'material change' provisions (in line with BMR requirements), that there is a potential risk of market disruption and a threat to consumer protection if we do not permit these contracts to continue using the Article 23A LIBOR Versions.

The degree to which we can set out clear and practicable criteria for the market

4.26. With the exception of cleared derivatives, the Authority does not consider that it can at this point in time distinguish with clarity and certainty the classes and characteristics of contracts for which permitting legacy use of the Article 23A LIBOR Versions is necessary or desirable, from those for which it is not necessary, in a manner that users would be able to apply to their contracts and determine with confidence and certainty whether they are permitted to use these versions.

4.27. For derivatives, all Cleared Derivatives (whether directly or indirectly cleared) should already have moved away from use of the Article 23A LIBOR Versions. So Cleared Derivatives (whether directly or indirectly cleared) are an identifiable subset of contracts for which permission for legacy use is not necessary.

4.28. A small proportion of derivatives are linked to other contracts or uses of LIBOR in a structural or explicit manner such that risks of transition are lower if they transition to the same alternative rate, at the same time, in order to maintain the economic terms of the transaction. Of the estimated circa 3% of the derivatives market that is not covered by the ISDA Protocol or clearing house conversion mechanisms, we consider that only uncleared legacy derivatives that are structurally or explicitly linked to other uses of the Article 23A LIBOR Versions need to be permitted to continue to use them following prohibition. However, we think it would be disproportionate for us at this point to undertake the complex task of attempting to delineate this group of contracts from the remainder in a manner that provides sufficient clarity and confidence for derivatives users. This would be complex and we have assessed that it would take a considerable amount of time, expertise and research for such a delineation to be both accurate and clear. To undertake such an exercise at the present time, given current circumstances and the current position with regard to other priorities, including in relation to LIBOR transition, would not be an appropriate use of the resource that would be required. Therefore, we think that permitting continued legacy use by all uncleared derivatives is the best way to provide clarity and certainty for the market in a timely manner.

Time limited permission and/or conditionality

4.29. The Authority has considered whether it would be appropriate to apply limitations or conditionality to the permission of legacy use.

4.30. Many contracts can be transitioned but more time will be needed to complete this transition. However, there are some long-dated contracts that face higher (possibly in a few cases, insurmountable) barriers to transition. It would be challenging (though not necessarily impossible) to delineate this latter group clearly from contracts which are more easily transitioned, and for which it might be reasonable to set an earlier time limit after which the permission to use synthetic LIBOR could cease without damage to our objectives. The Article 23A LIBOR Versions will continue to be published as a result of the exercise of our power under Article 21(3) of the BMR to compel continued publication until the end of 2022. This power is subject to annual review and the Authority has concluded that there is no need at the present time to apply a time limitation to legacy use permission for a subset of legacy contracts. However, it may become appropriate to put limits or conditions on permitted use in some contracts if the publication of synthetic sterling LIBOR is extended.

4.31. Given the mitigating factors identified as to why there may be non-compliance with the BMR, we do not consider it proportionate at present to apply conditionality that requires firms to take steps to make these contracts compliant. Instead, for the moment we have used our Statement of Policy to set out very clearly the requirements of Article 28(2), and we expect firms to address any non-compliance promptly and appropriately.

Effects of the permitted legacy use by supervised entities

4.32. Supervised entities are permitted to continue to use the Article 23A LIBOR Versions other than in Cleared Derivatives (whether directly or indirectly cleared) unless and until a further Notice is published in accordance with Article 23C(2) altering or withdrawing this permission.

4.33. Supervised entities who are permitted to continue to use the Article 23A LIBOR Versions should note that any exercise of the Authority's powers under Article 23D of the Benchmarks Regulation would also be relevant to such continued use.

5. PROCEDURAL MATTERS

5.1. This Notice is given under Article 23C(2) of the Benchmarks Regulation. It is published in accordance with Article 23C(8) of the Benchmarks Regulation.

5.2. A copy of this Notice has been given to the Treasury pursuant to Article 23C(9)(a) of the Benchmarks Regulation.

FCA contacts

5.3. For more information concerning this matter generally, contact benchmarkspolicy@fca.org.uk.

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