LMA Loan Market Association

15 January 2021

BY EMAIL

Financial Conduct Authority
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Dear Sirs,

Consultation on proposed policy with respect to the exercise of the FCA's powers under new Article 23D

The LMA welcomes the opportunity to respond to the consultation document entitled "*Consultation on proposed policy with respect to the exercise of the FCA's powers under new Article 23D*", published on 18 November 2020 (the "**Article 23D Consultation**").

We have also submitted a response to the consultation published the same day on the proposed policy with respect to the designation of benchmarks under new Article 23A (the "**Article 23A Consultation**").

The LMA is the trade body for the syndicated loan market in Europe, the Middle East and Africa. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 750 organisations across 69 jurisdictions and consists of banks, non-bank investors, law firms, rating agencies, borrowers, service providers, regulators and legislators, including the FCA.

The LMA welcomes the Financial Services Bill (the "**Bill**") and the proposed provisions which would allow an orderly cessation of a critical benchmark. We also welcome the FCA consultations on the proposed policies for exercising the FCA's powers under proposed Article 23A and Article 23D. We have not sought to respond to each element in the consultation, but have set out our thoughts on the key relevant areas for the syndicated loan market below.

Our member institutions are likely to have other thoughts on the Article 23D Consultation and we have encouraged them to submit their own feedback.

How best to consult on prospective decisions to exercise the Article 23D(2) power in respect of LIBOR

It is noted that the FCA will be seeking to give all those who are parties to "tough legacy" contracts or instruments, including those outside the United Kingdom, an opportunity to engage.

In order to do this, the FCA will need to be clear what the scope of "tough legacy" contracts are, and the scope of any exemptions for use of an Article 23A benchmark, so that the right parties can be targeted. A market-wide consultation will be needed so as to ensure that all parties are given a chance to respond, as well as further global roundtable events like the helpful roundtable conducted on 25 November 2020.

It will also be important for the FCA and regulators in other jurisdictions to consider the make-up and scale of tough legacy contracts which exist in their jurisdictions. One element of this will be to ask supervised entities to categorise and quantify their "tough legacy" exposures. However, it will also be important to engage the corporate community as there are many non-financial contracts which reference LIBOR and which do not have a supervised entity as a counterparty.

It will also be key for the FCA, before consulting, to engage with other regulators and legislators to consider how the exercise of the Article 23D(2) power interacts with proposals for "tough legacy" legislation in other jurisdictions. For example, there are proposals for legislative solutions to the cessation of benchmarks in both the US and the EU. The importance of this is considered further in "International impact" below.

Evaluation of the practicality of transition and scale of "tough legacy"

The Article 23D Consultation notes that "tough legacy" constitutes contracts and/or instruments that cannot practicably be transitioned away from the benchmark rate by actions or agreements by or between the contract counterparties themselves. This definition, by itself is very wide so it is helpful that the FCA is seeking feedback on how to assess the practicality of transition by the counterparties and how many "tough legacy" contracts or instruments are likely to exist.

We note that the Article 23D Consultation also refers to "tough legacy" as being "contracts or instruments for which such transition is not a realistic prospect". It would be helpful to use the same terminology throughout when describing "tough legacy" to avoid any confusion.

Whilst the FCA is not consulting on the relevance of "tough legacy" contracts and instruments to the question of orderly wind-down, it is important to recognise the need to be clear on what "tough legacy" means (particularly in the context of allowing continuing use of any Article 23A benchmark). This is within the FCA's powers to determine rather than the legislative regime. In this respect, please see our comments on the Article 23A Consultation.

In terms of assessing practicality of transition, we would reiterate the points made in the "*Paper on the identification of Tough Legacy issues*" published by the Working Group on Sterling Risk-Free Reference Rates (the "**£RFR WG**") in May 2020 which notes considerations impacting practicality of amendments. For example, in the context of the loan market, the very large number of bilateral and syndicated loan contracts, the diverse nature of the borrowers, questions of cost, resource availability and other challenges to transition (e.g.

creditor standstills, financial restructurings or insolvency proceedings) means that the renegotiation of all these contracts on an individual basis ahead of end-2021 creates practical difficulties for market participants.

Significance of scale of "tough legacy"

We agree that the level of "tough legacy" contracts or instruments should be significant in order to justify intervention. We also agree with the considerations for "significance" outlined in paragraph 2.12 of the Article 23D Consultation. When considering whether parties could achieve a fair outcome in the absence of FCA intervention, the FCA may also need to have regard to its consumer protection and integrity objectives. The other point for the FCA to consider is that, in addition to the tough legacy contract or instrument itself, there may be related contracts which also need to be amended (for example, a derivative related to a loan or export credit agency cover documents for export finance transactions).

Circumstances in which orderly transition is possible without exercise of Article 23D powers

In addition to the likely timescales for "cessation" of the benchmark, the FCA should consider the scale of "tough legacy" in the context of that timescale and the extent to which contracts already contain workable fallback or transition provisions. The FCA should also consider in this context the relevant market environment, for example, the ongoing impact of the Covid-19 pandemic on resources of parties (particularly end users).

International impact

We agree that the FCA should have regard to the impact of a disorderly wind-down outside the UK when considering the Article 23D(3) criteria and welcome the proposal to extend the FCA's engagement and consultation processes outside the United Kingdom.

Given the international use of LIBOR and international aspects of many financial products, it is important that the FCA have regard to the impact of its Article 23D powers beyond English law contracts or UK counterparties. In particular, as noted above, the impact on and interaction with legislative solutions in other countries needs to be considered. For example, under the amendments agreed to the EU Benchmarks Regulation, the European Commission's powers to designate a replacement rate for contracts between EU counterparties are stated to have extra-territorial effect. It is not clear how the European Commission's powers would interact with the FCA's powers. Given that the proposals for legislation are designed to deal with "tough legacy" contracts, by definition it is important that the implications of, and interaction with other legislation, are clear so as not to cause confusion or result in litigation at a time where certainty is required.

Least disturbance or disadvantage to affected parties

We note that potential methodology change would be the FCA's focus and that the FCA will seek to exercise its powers in a way which causes least disturbance or disadvantage to affected parties. It is helpful that the FCA will consider taking into account how best to maintain the ability to hedge affected contracts and how best to align with the approach taken by those who are transitioning away from the benchmark.

In the context of the loan market, it is important to ensure that the benefit to legacy contracts with no fallback mechanisms is not outweighed by the potential detriment to counterparties with fallback or amendment mechanisms that are triggered upon material change to the methodology of a benchmark. This potential detriment could arise where the agreed fallback or amendment mechanism either is not triggered or where there is uncertainty around whether or not the fallback or amendment mechanism has been triggered (because references to LIBOR are construed as references to LIBOR as amended, so the fallback or amendment mechanism is never triggered). This may lead to counterparties being left with contracts that reference amended LIBOR when their agreed fallback, or rate agreed as part of an amendment mechanism, would have been another rate more suitable to their contract (e.g., Bank Rate), or may also lead to litigation where the position is simply uncertain. Under LMA style agreements, the parties may have included a replacement of screen rate clause which allows, upon the occurrence of certain triggers (including a material change of the benchmark), for changes to be made to a benchmark rate with a lower consent level than would otherwise be required. The exercise of the FCA's powers should not cut across the ability of parties to move to an alternative rate using a lower consent level if they agree to do so under the replacement of screen rate mechanism. In addition, contracts containing workable fallback or transition provisions (for example, rate switch provisions or ARRC-style hardwired fallback language) should not be disrupted from switching to an alternative rate by the availability of a designated benchmark with a changed methodology.

The impact on related contracts will also be important for loans which are hedged or are part of a wider structure. It will be important to ensure that "tough legacy" contracts and any related contracts are allowed to reference the same rate, otherwise there will be a mismatch. Given the FCA's powers are focused on "tough legacy" contracts and instruments, by definition it will not be practicable for parties themselves to agree on ways to deal with any mismatches caused by the operation of the powers.

Availability to the benchmark administrator of robust and transparent inputs

We note that the Article 23D Consultation states that there may be multiple potential providers of the inputs the FCA would want to use as part of a changed methodology. In this case, the FCA will assess them relative to each other and have regard to certain factors such as the robustness of the inputs.

We note that there are currently multiple proposed administrators for a forward-looking term SONIA reference rate. One factor that the FCA may wish to consider when assessing multiple potential providers is whether a change to the administrator from the current administrator could create contractual continuity issues in existing contracts which refer to a particular administrator, not just a screen rate, without provision for that administrator to change from time to time.

The FCA will also need to consider how to appropriately reference the screen chosen for the changed methodology. The LIBOR screen references have changed over the many years of publication (for example, given the change in screen providers). Whilst contracts may contain wording allowing for a replacement screen to be referenced, it will be important not to inadvertently cause issues in contracts which refer to a specific screen or screen provider only.

Likely effect outside the United Kingdom of exercising the power

We note here our comments above on "International impact".

Further issues to consider in the FCA's approach to using its powers

We note that the FCA's provisional position is to use a forward-looking term rate based on the overnight RFR already chosen by relevant national working groups (plus a credit adjustment spread). We welcome this approach as this will assist "tough legacy" transactions given the similarity of a forward-looking term rate to LIBOR.

However, it is important to note that relevant national working groups may have limited the use cases for forward-looking term rates. For example, the policy recommended by the £RFR WG is that there is no use case for forward-looking term rates for the majority of the corporate loan market. These use cases should be factored into the consideration of the use of the FCA's powers.

It would, for example, be odd if large parts of the corporate loan market ended up defaulting to a synthetic, forward-looking term LIBOR simply because they were caught by the wide definition of "tough legacy" when the £RFR WG has made it clear that in most cases there is no such use case after December 2021. "Tough legacy" contracts are meant to be a small part of the corporate loan market and that small part of the market should not direct the imposition of synthetic LIBOR on the larger part of the market which is not really "tough legacy". In this regard, the statement in the FCA's announcement relating to its proposed new powers under the legislation that "*If we adopt and apply our proposed policy to the LIBOR settings, there would be, however, a case for using the proposed new powers to require a change to the LIBOR methodology where:*

- *LIBOR currency-tenor settings are widely used in outstanding contracts and/or instruments that cannot practicably be transitioned away from the benchmark rate by actions or agreements by or between contract counterparties themselves (often known as 'tough legacy' contracts) and*

- *using the powers would contribute to protecting consumers or preserving market integrity*"

seems helpful as it indicates that the FCA will be careful to ensure that the provisions do not apply to contracts (like most syndicated and bilateral corporate loans) which are capable of being amended. The question of how this policy is implemented (and how "tough legacy" comes to be defined) may be key and it will be important to emphasise that market participants should not rely on the legislation.

We hope that you will find our feedback constructive. We would be pleased to discuss any aspect of the above with you in more detail. If we can be of any further assistance please do not hesitate to contact me by email at clare.dawson@lma.eu.com or on 020 7006 6007).

Yours faithfully,

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