Benchmarks Regulation: how we propose to use our powers over use of critical benchmarks

The response

This online form provides the format for your response to the CP.

Introduction

The Financial Services Act 2021 (FS Act) introduced a package of amendments to the Benchmarks Regulation (BMR). This package was aimed at ensuring the FCA has the appropriate regulatory powers to help reduce risk in the wind-down period before LIBOR ceases permanently. The FCA is consulting on how it proposes to consider using two new powers relating to the use of critical benchmarks that are being wound down.

Responding to the consultation

You are asked to respond to the consultation by completing this online response process that lists the questions as set out in the consultation paper.

The following is a link back to the consultation paper if you need to refer back to it.

[CP 21/15 Benchmarks Regulation: how we propose to use our powers over use of critical benchmarks]

Note, this online form provides a short summary of the CP. For full details please refer to the CP.

Why we are consulting

We are seeking views on how we propose using two new FCA powers, which are described below. The 'legacy use' power could be used in relation to any critical benchmark designated as an Article 23A benchmark, and the 'new use restriction power' could be applied to any critical benchmark that is ending. LIBOR is a critical benchmark to which these powers could be relevant (and the only UK critical benchmark currently), but the consultation sets out factors that could also apply to other critical benchmarks.

The 'legacy use' power: If a critical benchmark becomes permanently unrepresentative of the market it is intended to measure, it may be designated as an 'Article 23A benchmark'. This results in an automatic prohibition on use of the benchmark by UK supervised entities. However, this ‘legacy use’ power allows us to permit some or all ‘legacy’ (i.e. existing) use of the benchmark to continue. The consultation sets out which factors we think are relevant in determining what kind of legacy use we might permit.

The ‘new use restriction’ power: This power gives us the ability to prohibit some or all new use of a critical benchmark when we have been notified that its administrator intends to stop providing it at a future date. The consultation sets out which factors we think are relevant in determining if and how we might restrict new use of a critical benchmark we know is ending.

Instructions

You can use this form to upload your completed document. Please complete the 'about you' section first.

FCA privacy notice on how we will use the data you provide in this survey:
https://www.fca.org.uk/privacy/personal-data-and-surveys-consultations-and-market-research

Consultation Questions

Question 1

What kinds of provisions do you consider would lead to unintended, unfair or disruptive outcomes, or prove inoperable in practice, if a critical benchmark could no longer be used?

LMA response

We consider that the following provisions would potentially lead to a threat to either or both of the FCA's consumer protection and integrity objectives.

Cost of funds

As noted in the Sterling Risk-Free Reference Rates Working Group Paper on the identification of Tough Legacy Issues, in the syndicated loan market the ultimate fallback (if the agreement cannot be amended) is to an individual lender's cost of funds. This may be problematic for a number of reasons, including the difficulty of calculating the relevant cost and could be inoperable in practice. Whilst such provisions may potentially be workable in the context of bilateral or club loans, they could not work on any scale or for larger syndicates.

Whilst facility agreements may have a 'replacement of screen rate' clause, which contemplates replacement of the screen rate upon various triggers, including a discontinuation of that rate (with majority lender (i.e. $66_{2/3}$%) and borrower consent), some older legacy loan documentation does not contemplate replacement of the screen rate and requires all lender and borrower consent to amend the facility agreement to transition to an alternative rate. Such consent may be difficult to achieve in practice.

Illegality provisions

Syndicated loans typically include provisions that apply if it becomes unlawful for a lender to perform any of its obligations under the agreement or fund or maintain its participation in any loan. The lender is given an option to exit the facilities (subject to an obligation to mitigate the effects of any illegality) and the borrower is required to prepay the relevant lender on request and the lender's commitment is cancelled.

In addition, a facility agent has the right to resign, which it may choose to do if unable to carry out its duties for some reason (although it should be noted that this is not a simple process in practice). Syndicated loans typically contain language clarifying that the agent would not be required to take any action that would breach law or regulation.

Additionally, in relation to obligors/borrowers, syndicated loans typically include an event of default if it becomes unlawful for an obligor to perform any of its obligations under the finance documents.

In syndicated loans with parties from different jurisdictions, this could result in unlawfulness applying to some, but not all parties (for example, it might result in interest being calculated on the basis of different reference rates across the syndicate of banks).

Replacement of screen rate provisions

Replacement of screen rate provisions provide a trigger for negotiation to move to alternative benchmarks, but they do not automatically trigger a move to an alternative benchmark. Pending the outcome of such negotiations, cost of funds would apply. As noted above, this would be inoperable on any scale and could result in market disruption.

Unintended outcomes

In addition to the specific provisions under loan agreements noted above, the practical impact of a prohibition on use of a critical benchmark needs to be considered. In particular, the prohibition on use would only apply to UK supervised entities, whilst the loan market involves a range of counterparties located in different jurisdictions who will not be subject to the same prohibition. This would create an unlevel playing field for UK supervised entities, along with complexity and confusion in the context of syndicated loans, if similar prohibitions are not introduced in other jurisdictions. International coordination on this issue is key, particularly for maintaining the competitiveness of UK supervised entities and ensuring liquidity remains available for borrowers.

As noted above, replacement of screen rate provisions will allow for transition but this is not automatic and is a trigger for negotiation. If a critical benchmark could no longer be used by UK supervised entities, but could be used by other counterparties to the contract, this could create disincentives to /disparities in any negotiations to transition away from LIBOR (as noted in paragraph 2.11 of the Consultation Paper).

Question 2

a. Do you think the factors below are relevant to determining whether or not it is feasible to amend contracts?

	Yes	No	No view
Whether appropriate alternatives are available	●	○	○
Ease of amending the contract (eg number of parties; legal, regulatory or operational procedures)	●	○	○
Whether large volumes of contracts can be amended without making bespoke amendments	●	○	○
The nature of the parties to the contract	●	○	○
The effect of prohibition on parties who must consent to, or be involved in, amending the contract	●	○	○
Evidence of similar contracts having been amended	○	●	○
How much notice parties have had of the prohibition	○	●	○

b. Where you do not think a factor is relevant, please explain why.

LMA response

<u>Evidence of similar contracts having been amended</u>

It is not clear what "similar" contracts means here. In any case, loan agreements are bespoke in nature. Simply because some loans may have been amended it does not mean that other loans can easily be amended. There are various factors which could impact transition of a particular loan which are specific to that loan.

<u>How much notice parties have had of the prohibition</u>

Whilst advance notice of a prohibition is helpful to plan amendments to contracts, this might not necessarily make it easier for loan agreements to be amended and there may be legitimate reasons why a loan agreement has not been amended (for example, borrowers not being engaged given the impact of Covid or market factors impacting transition, for example, creditor standstills and restructurings).

c. Are there any other factors not listed that are relevant?

LMA response

<u>Whether contracts require bespoke amendments despite protocol methods being available to amend large volumes</u>

Within the factor of whether large volumes of contracts can be amended without making bespoke amendments, it should be considered that there will be derivatives relating to underlying loans. Loans require individual amendment and a protocol method of amendment is not possible given the bespoke nature of loans. Some loans may be hedged, and the hedging would have been tailored to the loan. Given differences between loan and derivative conventions, hedging related to a loan would require bespoke amendment to maintain consistency between products and mitigate any basis risk. Whilst parties could sign up to the ISDA protocol, end users understandably have concerns about basis risk and their negotiating power to subsequently agree bespoke amendments. Whilst the production of the latest ISDA rate options for loan conventions should assist with this for loans based on compounded in arrear, there may be loans which move to a forward-looking term rate (which is not accounted for in ISDA rate options). Whilst basis swaps could be used for this difference, this would come at a cost to the end user, which would not be aligned with consumer protection objectives. This should be taken into account when considering this factor given the impact on end users.

Whilst it is understood that the FCA has concerns around the impact of permitted legacy use on the robustness and sustainability of the Article 23A benchmark itself, and on any benchmark that is used as part of its input data, the size of the market which genuinely hedges a cash 'tough legacy' product can be expected to be small (particularly relative to the wider derivatives market).

<u>Transactions forming part of a bigger structure</u>

We would expect this to be factored into the consideration on ease of amending the contract, as a syndicated loan may be part of a more complex structure. For example, in project financing LIBOR is also often embedded within related concession and operation agreements. Because these financings are structured on a limited recourse basis, they depend on the back-to-back nature of all parts of the structure, which will also need to be amended accordingly.

<u>Multicurrency and cross-jurisdictional impacts</u>

In addition to the factors noted in the Consultation Paper on the nature of the parties to the contract and effect of the prohibition on parties who must consent to, or to be involved in, amending the contract, international consistency should be considered as a core factor (rather than just a "further consideration").

The syndicated loan market is an international market in the context of both the prevalence of multicurrency facilities, but also the international nature of loan syndicates (which often contain lenders from across the globe). Given the different speeds of transition in different markets, the engagement and timelines of different counterparties to the same transaction could create challenges in transition which should be factored in.

Question 3

a. Do you think there may be situations where we could or should only permit a limited form of continued use of the benchmark?

- (•) Yes
- ( ) No
- ( ) No view

b. Please explain your answer.

LMA response

We do not consider that it would be appropriate for the FCA to permit a limited form of continued use of the benchmark, as a general rule.

In particular, we consider that where the FCA permits only a limited form of continued use, there is an increased risk of unintended consequences as inevitably it will be extremely challenging to identify all the potential ramifications of prohibiting certain market participants from using the benchmark, or prohibiting market participants from using the benchmark in only certain products, and for the FCA to be certain that its actions will not lead to more market instability than if it had allowed broad continued use.
However, there may be situations where the FCA could or should only permit continued use of the benchmark for a limited period of time. If the FCA takes this approach, it should consult as widely as possible to confirm what would be an appropriate period of time.

In the context of LMA-based loans, whilst bilateral and club loans may technically be easier to amend since there are fewer counterparties, given the number of loans which require amendment before end-2021, it may not practically be possible to amend them all within the time available. In addition, necessary resources (such as agency and legal expertise) may not be readily available as this year progresses. Therefore allowing further time for run-off or amendment of legacy contracts would be beneficial to market integrity and consumer protection.

In addition, allowing continued use for a limited period of time would help preserve consistency, at least for a period of time, in international transactions involving non-supervised firms. This helps create a level playing field in order for parties to transition.

Question 4

a. Do you think the considerations below are relevant to determining whether it would be desirable to exercise our legacy use power?

	Yes	No	No view
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.	◉	○	○
International consistency.	◉	○	○
Whether contracts are required by law or regulation to contain suitable fallbacks but there has been non-compliance with the requirement.	○	◉	○
The degree to which we can set out clear and practicable criteria for the market.	◉	○	○

b. Where you do not think a consideration is relevant, please explain why.

LMA response

<u>Whether contracts are required by law or regulation to contain suitable fallbacks but there has been non-compliance with the requirement</u>

We do not think that this consideration is relevant. It is not clear what is meant in this context by "suitable fallbacks". Fallback provisions, and the perceived robustness of them has changed over time. For example, whilst the Article 28(2) EU BMR requirements have been in place for some years, it has been determined by the Working group on euro risk-free reference rates that more robust fallbacks need to be included in respect of EURIBOR. As a result that Working group has recently issued recommendations in respect of robust fallbacks and triggers. Contracts prior to those recommendations would not have contained provisions as robust as those recommendations.

The suitability of fallbacks has therefore been an iterative process, which has also been evident in the loan market. Whilst replacement of screen rate provisions provide a contract to be moved, upon negotiation, to use an alternative benchmark rate, these provisions have evolved over time. There has been a move over time to more robust rate switch mechanisms which only became possible once there was clarity as to what a replacement rate for loans would look like. Fallbacks have been a product of the transition and have become more robust over time. Parties should not be penalised for the fact that replacement rates were not clear at the time that they entered into a contract.

c. Are there any other considerations not listed that are relevant?

LMA response

Within the consideration of international consistency, as well as the potential for confusion and uncertainty and ensuring there is consistency with action taken in other jurisdictions, there is the risk of creating an unlevel playing field. As the prohibition on use would only apply to UK supervised entities, there would be many counterparties to syndicated loans who will not be subject to the prohibition. This will create an unlevel playing field for UK supervised entities, if similar prohibitions are not introduced in other jurisdictions. International coordination on this issue is key, particularly for maintaining the competitiveness of UK supervised entities and ensuring liquidity remains available for borrowers of legacy loans.

International consistency will also be relevant to the degree to which the FCA can set out clear and practicable criteria for the market. It will be challenging to distinguish with clarity and certainty the classes and characteristics of contracts for which use would be allowed, and those for which a prohibition would remain in place. This will particularly be challenging to apply for facility agents in multicurrency, international, syndicated loans and it must be noted that their role is administrative in nature. There is a very real risk of uncertainty and confusion.

Question 5

Are there other relevant factors or considerations we have not reflected in our proposed policy approach to the use of our legacy use power?

LMA response

We do not consider there to be other relevant factors or considerations in addition to the comments we have made above.

Question 6

a. Do you think the factors below are relevant to determining whether new use of a ceasing critical benchmark could be a risk to consumer protection and / or market integrity?

	Yes	No	No view
System-wide operational risk of a cliff-edge when the benchmark ceases.	◉	○	○
The nature and/or degree of activity in the market(s) underpinning the ceasing critical benchmark.	◉	○	○
Whether the benchmark is expected to remain representative for the entirety of the wind-down period.	○	◉	○
The risk that consumers or the market face unexpected changes (eg volatility or liquidity impacts) in the ceasing benchmark or market(s) using it.	◉	○	○
Whether there is adequate confidence and liquidity in alternative benchmarks and market preparedness to use them.	◉	○	○

b. Where you do not think a factor is relevant, please explain why.

LMA response

<u>Whether the benchmark is expected to remain representative for the entirety of the wind-down period</u>

We assume that an assessment would have been made on the representativeness of the critical benchmark at the point at which the cessation announcement was made. A statement would have been made giving clarity to the market on timing for the wind-down period in order to provide an orderly transition from the ceasing critical benchmark. A more relevant factor would be, as already identified by the FCA, the risk of volatility or liquidity impacts to consumers.

c. Are there any other factors not listed that are relevant?

LMA response

Whether there is adequate confidence and liquidity in alternative benchmarks and market preparedness to use them

We agree that this is a relevant factor, however, this will need to be judged based on the product rather than a general assessment. For example, whilst there may be appropriate alternatives available for corporate syndicated loans, there may not be adequate alternatives for trade finance, export finance or developing markets loans. These areas will need to be considered separately to the loan market generally.

International consistency

Whilst the FCA lists international consistency in the Consultation Paper as an additional factor that it proposes to take into account, we note that this is not listed as a factor above. We would consider this to be a very important factor in the context of the FCA's market integrity and consumer protection objectives for the following reasons:

International coordination on approach and timing: it will be important to align any restrictions on using a ceasing benchmark with the approach being taken in other currency jurisdictions and the timing of such approaches. The FCA has the power to prohibit new use, but a less strict approach may be adopted in other jurisdictions because regulators do not have similar powers (e.g. new use may be discouraged but not prohibited). It is important that the same approach is adopted to avoid disadvantaging UK supervised entities. It would also be important for any announcements in respect of restricting new use to be coordinated internationally.

Creation of an unlevel playing field: we have already noted in our response the international nature of loan syndicates. The prohibition on the use of a ceasing benchmark would apply only to UK supervised entities. This means that there will be many counterparties to syndicated loans who will not be subject to the same prohibition. This will create an unlevel playing field for UK supervised entities, along with complexity and confusion in the context of syndicated loans, if similar prohibitions are not introduced in other jurisdictions. International coordination on this issue is key, particularly for maintaining the competitiveness of UK supervised entities and ensuring liquidity remains available for borrowers.

International coordination on the availability of adequate alternatives: there have been differences in messaging on alternative benchmarks and whether they are an adequate alternative or not. In particular in the syndicated lending market, there is a real risk of bifurcation given the international nature of syndicates where some entities consider an alternative to be adequate but others may not given different regulatory messages in their base jurisdictions.

Question 7

a. Do you think there may be situations where we could or should impose a limited form of restriction (eg for certain contract maturities; certain types of product or user, or after a defined time period)?

- (•) Yes
- ( ) No
- ( ) No view

b. Please explain your answer.

LMA response

We agree there may be situations where a limited form of restriction would be helpful instead of applying a blanket ban on new use.

Whilst we understand the logic behind suggesting restricting new use for certain contract maturities, such as those that mature after the benchmark will cease, there are caveats to this. For example, export finance loan agreements in developing markets are longer in tenor than corporate loans and could be disproportionately impacted by the restriction on new use, particularly if adequate alternatives are not available. Therefore, this situation would need to be considered in conjunction with the types of product or user that should not be restricted from using the ceasing critical benchmark.

Restricting new use after a certain defined period could assist with giving parties a set date to work towards rather than bringing in any restriction immediately. However, this would need to be considered in the international context to ensure that parties within the same contract are not subjected to different rules.

Question 8

a. Do you think the considerations below are relevant to determining whether us <u>not</u> intervening in respect of certain new use of the ceasing critical benchmark might support consumer protection or market integrity?

	Yes	No	No view
Whether new use reduces exposure to the ceasing benchmark	◉	○	○
Whether users have access to suitable replacement benchmarks	◉	○	○

b. Where you do not think a consideration is relevant, please explain why.

LMA response

Not applicable.

c. Are there any other considerations not listed that are relevant?

LMA response

Whilst the FCA lists international consistency in the Consultation Paper as an additional factor that it proposes to take into account, we note that this is not listed as a factor above. We would consider this to be a very important factor for the FCA to consider in deciding whether not to intervene for some new use.

Question 9

a. Do you think the other factors below are relevant in determining whether and how exercising our new use restriction power would advance consumer protection and / or market integrity?

	Yes	No	No view
International consistency	◉	○	○
The degree to which we can set out clear and practicable criteria for the market.	◉	○	○

b. Where you do not think a factor is relevant, please explain why.

LMA response

Not applicable.

c. Are there any other factors not listed that are relevant?

LMA response

In relation to international consistency, it is important that the following factors are also considered:

International coordination on approach and timing: it will be important to align any restrictions on using a ceasing benchmark with the approach being taken in other currency jurisdictions and the timing of such approaches. The FCA has the power to prohibit new use, but a less strict approach may be adopted in other jurisdictions because regulators do not have similar powers (e.g. new use may be discouraged but not prohibited). It is important that the same approach is adopted to avoid disadvantaging UK supervised entities and also disrupting liquidity in the international dollar market. It would also be important for any announcements in respect of restricting new use to be coordinated internationally.

Creation of an unlevel playing field: we have already noted in our response the international nature of loan syndicates. The prohibition on the use of a ceasing benchmark would apply only to UK supervised entities. This means that there will be many counterparties to syndicated loans who will not be subject to the same prohibition. This will create an unlevel playing field for

UK supervised entities, along with complexity and confusion in the context of syndicated loans, if similar prohibitions are not introduced in other jurisdictions. International coordination on this issue is key, particularly for maintaining the competitiveness of UK supervised entities and ensuring liquidity remains available for borrowers.

The above factors will also be relevant to the ability of the FCA to set clear and practicable criteria for the market, particularly in the context of multicurrency international syndicated facilities. This will particularly be challenging to apply for facility agents to apply given the administrative nature of their role. There is a very real risk of uncertainty and confusion.

Question 10

Are there other relevant factors or considerations we have not reflected in our proposed policy approach to use of our new use restriction power?

LMA response

No, other than the ones listed in response to question 9 above.

Question 11

Please provide any other comments you may have on this consultation.

LMA response

We appreciate the recognition in the consultation paper of points previously made by the LMA in respect of international consistency and availability of suitable alternatives. We would stress again the importance of international consistency, not creating an unlevel playing field which could pose a threat to market integrity. Differences within a syndicate on restrictions on use would cause confusion at a time when certainty is key given the focus is on tough legacy transition.

We are asking for comments on this Consultation Paper (CP) by 17 June 2021.

You can submit this Word document using the online form here:
[Benchmarks Regulation: how we propose to use our powers over use of critical benchmarks]

If you have any questions when completing the survey, please contact cp21-15@fca.org.uk.