

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

November 2020

1 Introduction

- 1.1 The [overview document](#) sets out the background to the Benchmarks Regulation (BMR) and the amendments proposed by the Government under the [Financial Services Bill 2020](#) ("FS Bill") to give us enhanced powers, in particular in relation to managing the orderly wind-down of critical benchmarks which are no longer representative. As is widely known, these powers have been introduced at the present time in order to allow us properly to address the issues relating to LIBOR transition.
- 1.2 The FS Bill proposes the insertion of a new Article 23D into the BMR. Its provisions would grant us the ability, in certain circumstances, to impose requirements on the administrator of a critical benchmark designated under new Article 23A.
- 1.3 A critical benchmark can be designated under new Article 23A where we have found that it is no longer representative of the market it is intended to measure, or its representativeness is at risk, and its representativeness will not be restored and maintained. Our consultation about our proposed policy in respect of the designation of benchmarks under Article 23A is [here](#).
- 1.4 Following such a designation, the requirements we could impose on the benchmark administrator are set out in the proposed new Article 23D(2). These relate to the way in which the benchmark is determined, the rules of the benchmark or, where the benchmark is based on submissions from contributors, the benchmark's code of conduct.
- 1.5 New Article 23F(1)(d) of the BMR requires us to prepare and publish a Statement of Policy on how we exercise our powers under new Article 23D, to which we must have regard when exercising the powers¹. Further, when we exercise the power, we are obliged to explain how we have taken account of the relevant policy statement².
- 1.6 The purpose of this document is to consult on our proposed policy approach.

Relationship between the Statement of Policy and our prospective future decisions in respect of LIBOR

- 1.7 The legislative framework clearly anticipates that we prepare and publish a Statement of Policy before deciding to exercise our powers. In our view, it is an important fact that LIBOR is currently the only critical benchmark, and therefore the only benchmark in respect of which the new Article 23D powers could presently be exercised. In line with previous statements, both from Government and from us, there is an urgent need to transition away from LIBOR and also a need to address the position of so called "tough legacy" contracts or instruments for which such transition is not a realistic prospect. In that context, it is in our view appropriate that we reduce the risk of market disturbance by indicating the likely implications of the policy on which we are consulting for our potential future actions in respect of LIBOR.
- 1.8 Accordingly, this consultation document is drafted with a particular focus on LIBOR. It is to be anticipated that the resulting Statement of Policy will do likewise. In due course,

¹ New Article 23F(5)

² New Article 23D(7)(d)

should other benchmarks become critical, our intention is to revisit our Statements of Policy to ensure that they are adequately addressed, and to revise the Statements of Policy as necessary.

Who this affects

1.9 We expect that this consultation will be of interest to:

- administrators of critical benchmarks
- contributors to critical benchmarks; and
- users of critical benchmarks, both regulated and unregulated.

What we will do next

- 1.10 We are asking for responses to this consultation by 18 January 2021. Please send your feedback using our online response form or by email to: benchmark-article23D@fca.org.uk
- 1.11 We will finalise our proposals taking account of responses to the consultation and publish these as a Statement of Policy on our website.
- 1.12 **We will conduct a further consultation in relation to specific future decisions to exercise the Article 23D power in respect of LIBOR.** In paragraph 4.2 below we invite the views of consultees on how best to engage with affected parties at that point. In line with the above, we set out below a summary of the potential implications if we do adopt a statement of policy which reflects our proposals set out in this document.

Potential implications of proposed policy applied to LIBOR

LIBOR is [defined](#) by its administrator as “a wholesale funding rate anchored in LIBOR panel banks’ unsecured wholesale transactions to the greatest extent possible, with a waterfall to enable a rate to be published in all market circumstances”.

LIBOR is, in economic terms, composed of:

- a. a measure of the general movement of risk-free rates plus;
- b. a premium above risk free rates reflecting in large part term bank credit risk.

One way to measure the first of these component parts on an ongoing basis is by using a forward-looking term-RFR based on the overnight RFR already chosen by relevant national working groups for the relevant currency (for example, SONIA for sterling, SOFR for US dollar and TONA for Japanese yen). Our provisional position is to adopt this course.

Greater challenges exist in measuring the second component part. To illustrate, for a LIBOR rate, the current methodology measures the rates at which large internationally active banks with access to the wholesale, unsecured funding market consider they could fund themselves in such market in particular currencies for certain tenors. The lack of a dynamic, forward-looking basis to measure the term bank credit risk component in a robust way is the primary reason why it does not appear practicable in

the medium term to maintain representative LIBOR rates on the basis of panel bank contributions.

In our view, the fairest and most robust way to approximate this component is to take an average of historical values over a period that reflects a range of economic conditions.

For LIBOR, wide support on how best to do this has already been established through a series of consultations by the International Swaps and Derivatives Association (ISDA), launched at the request of international authorities, and inviting and receiving feedback from market participants in all major jurisdictions, across a range of major currencies including but not limited to the five LIBOR currencies. Cross-market working groups in the [UK](#), the [US](#) and [Switzerland](#) have also endorsed this approach as the best way to approximate this second component in fallback arrangements in “cash” contracts such as bonds and loans. The equivalent Japanese working group is reviewing the responses to a consultation which is proposing the same approach.

To approximate the value of an IBOR in contractual fallbacks, ISDA uses a 5-year historical median of the spread between the relevant IBOR and relevant RFRs, which is then added to the RFR. Our provisional view is that this is a fair and robust way of approximating the outcome delivered by LIBOR.

Subject to the outcome of this consultation and the content of the ensuing Statement of Policy – it is this approach which we are likely to consult upon in due course.

- 1.13 Further, we invite views on **how best to consult (Q1)** in respect of our prospective decisions to exercise our Article 23D(2) power in respect of LIBOR. In particular, we 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.

Q1: Do you have any view on how best to consult in respect of our prospective decisions to exercise our Article 23D(2) power in respect of LIBOR?

2 Decision on whether to use the powers

- 2.1 Article 23D(2) (together with Article 23D(5)) set out the powers that would be at our disposal.
- 2.2 Article 23D(3) provides that the FCA may only exercise its powers if "*(a) it considers it appropriate to do so having regard to the desirability of securing that the cessation of the benchmark takes place in an orderly fashion, and (b) it considers it desirable to do so in order to advance either or both of the following – (i) its consumer protection objective³ and (ii) its integrity objective³.*"
- 2.3 Our approach to Article 23D(3) is that it governs both whether we are able to exercise the powers (i.e. as a threshold which must be satisfied) and also how we should exercise the powers (i.e. what we should be seeking to achieve when exercising the powers).
- 2.4 There are, of course, other considerations which we may take into account when deciding how to exercise the powers; these are set out in the following section of this document. But the overarching considerations for us, throughout the decision-making process, will be "*does this assist in securing the orderly wind-down of the benchmark? And is it desirable in order to advance either or both of the consumer protection objective and the integrity objective?*"⁴.
- 2.5 In considering our approach we look in turn at each limb of Article 23D.

"The FCA ... considers it appropriate to do so having regard to the desirability of securing that the cessation of the benchmark takes place in an orderly fashion..."⁵

- 2.6 We consider a disorderly cessation to include situations where a critical benchmark ceases in a way which leaves significant numbers of market participants unlikely to be able to agree how obligations determined by reference to the benchmark can be fulfilled, or means that market participants' ability to manage risks is seriously impaired. The risks of a disorderly transition are therefore likely to be more acute where there are significant numbers of contracts that cannot reasonably be converted to reference alternative benchmarks through sufficiently timely action or agreement by parties to those contracts.

"Tough Legacy" Contracts or Instruments

- 2.7 Therefore, when assessing the risk of cessation occurring in a disorderly fashion, our key considerations will be the extent of "tough legacy" contracts or instruments. By this we mean:

³ Section 1C FSMA

⁴ Section 1D FSMA

⁵ Article 23D(3)(a)

- 2.6.1 whether the critical benchmark is referenced in 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; and
- 2.6.2 how many such contracts and/or instruments are likely to exist.
- 2.8 It is our view that these are fundamental considerations given that the intention of the legislation is to allow us the powers to address the so-called “tough legacy” contracts in the LIBOR context. On that basis, we will be including these in our finalised policy approach and are therefore not seeking feedback on this point.
- 2.9 However, there are two related questions on which **we would welcome views (Q2 and Q3)**.
- 2.10 First, evidentially, how should we assess the practicality of transition by the counterparties, and how many “tough legacy” contracts or instruments are likely to exist? We propose to look at public and non-public data which could help to identify the amount of outstanding legacy contracts and their duration, the nature of the contracts and the practicability of amending them in a fair way by mutual agreement or other contractual mechanism, and other relevant information which could evidence the effect in relevant jurisdictions of any intervention. In particular, we propose:
- 2.9.1 To pay particular regard to the views of working groups established in affected jurisdictions with the express intent of addressing LIBOR transition issues, as well as other affected market participants and stakeholders.
- 2.9.2 To take into account views from authorities responsible for financial stability, market integrity and consumer protection issues in the jurisdictions in which there is significant use of LIBOR.
- 2.9.3 Where needed, to elicit further views by a process of consultation as part of our decision-making. This could happen, for example, when we have contradictory information or data are not sufficient.
- 2.11 Second, what is the level of “tough legacy” contracts or instruments which should justify intervention under the Article 23D powers? While this may be inexact, our minded-to position is that the problem must be significant in order to justify intervention.
- 2.12 In assessing the significance of the problem we would consider the amount of use in tough legacy contracts of the benchmark as a whole or some specific currency-tenor settings, the duration of the contracts linked to the relevant setting and the likelihood that parties to contracts referencing the benchmark would achieve a fair outcome in the absence of our intervention.

Where orderly cessation is possible without exercise of Article 23D powers

- 2.13 When we come to assessing the risk of disorderly transition, we need to consider what that transition would look like if we did not exercise the proposed Article 23D powers.
- 2.14 Our overall aim is to facilitate orderly cessation. It is possible that orderly cessation could be achieved without the use of the proposed Article 23D powers. One of the factors we might take into account in reaching this conclusion is the likely timescales for “cessation” of the benchmark. Another is the circumstances which have given rise to the

unrepresentativeness of the benchmark and how that affects parties to different types of contract. **We invite consultees to comment on this (Q4).**

Feasibility of producing the benchmark through a changed methodology

- 2.15 We would not use the powers where appropriate inputs, as described further below, which are necessary for the benchmark administrator to produce the benchmark through a changed methodology, are not available.

International Impact

- 2.16 We consider that, when considering cessation in an orderly fashion of a benchmark that is used outside the UK, we may have regard to the situation outside the UK.
- 2.17 The legislative scheme refers expressly to this consideration only “when exercising” the power (and, in that context, only to the likely effect outside the United Kingdom of the exercise of the power, rather than the likely effect if the power is not exercised). However, in our view it is sensible and appropriate, and permitted by the legislation, for us to have regard to the impact of a disorderly wind-down outside the UK when considering the Article 23D(3) criteria. We propose to do so by extending our engagement and consultation processes outside the United Kingdom. We will welcome views from authorities and market participants in relevant overseas jurisdictions.

“...and (b) it considers it desirable to do so in order to advance either or both of the following – (i) its consumer protection objective⁶ and (ii) its integrity objective⁷”

- 2.18 Under the legislative regime, it is not enough for us to consider that intervention is appropriate having regard to the desirability of securing cessation in an orderly fashion. We must also be satisfied that the intervention is desirable in order to meet one or both of our consumer protection objective and integrity objective (as defined in the Financial Services and Markets Act 2000, sections 1D and 1E, respectively).
- 2.19 In respect of consumer protection, we will consider whether and how consumers are affected, with regard in particular to:
- their level of exposure to the critical benchmark in terms of the number, materiality and duration of consumer contracts referencing the benchmark
 - the likely and possible financial effect on consumers, especially any expected change in the cost or risk borne by consumers.

⁶ See section 1C of FSMA

⁷ See section 1D of FSMA

- the likelihood that consumers would achieve fair outcomes should we not intervene, or decide to do so, the ability of consumers to understand and manage as necessary the consequences should we not intervene, or decide to do so.

2.20 In respect of market integrity, we will, in particular, consider the impact of any intervention in terms of:

- Orderliness: including whether market transactions can continue more or less as expected.
- Resilience: the ability of firms and market infrastructure to continue functioning, serve their customers, and meet obligations to counterparties.
- Transparency: including sufficient clarity about the rights and obligations defined in contracts and how they will be determined in future.
- Cleanliness: including the impact on the likelihood of market abuse or fraud.

2.21 **We welcome the views of consultees on how we intend to consider whether intervention is desirable (Q5).**

Q2: How should we evaluate the practicality of transition and the scale of “tough legacy”?

Q3: Do you agree that the scale of “tough legacy” must be significant in order to justify intervention?

Q4: Under what circumstances might orderly transition be achieved without the use of Article 23D powers?

Q5: Do you have any views on how we intend to consider whether intervention is desirable?

3 How we would use the powers

- 3.1 As we set out in paragraph 2.3 above, our view is that the legislative conditions set out in Article 23D(3) should inform and govern our exercise of the powers. Accordingly, we will consider whether our proposed exercise of those powers meets those conditions throughout our decision-making process. It may be the case, for example, that intervention is desirable in the abstract but is not desirable in practice.
- 3.2 Against that background, it is our intention to apply the following policy when deciding the way in which we will exercise our powers.
- 3.3 **We welcome the views of consultees on each of the proposed elements of our policy set out below (Q6). We also welcome suggestions as to any further considerations (Q7).**

Fair approximation of the value the benchmark would have had

- 3.4 New Article 23D(6) states that the new powers, including the power to impose requirements on the way in which the benchmark is determined, would not be limited by the underlying market or economic reality that the benchmark intended to measure before it was designated as an Article 23A benchmark. It also states, however, that we could have regard to that underlying market or economic reality when exercising those powers.
- 3.5 It is our intention generally to have regard to the underlying market or economic reality that was intended to be measured by the benchmark immediately before it became an Article 23A benchmark. In particular, we would seek to achieve a reasonable and fair approximation of the value that the benchmark would be expected to have, if it were practicable to continue to publish it on a representative basis. Where robust ways of replicating precisely the previous approach are not feasible, we would look for other ways of approximating the value, for example based on historical observations.
- 3.6 Our reason for adopting this “fair approximation” approach is that we believe it is likely to be the truest to the contractual counterparties’ intentions with deciding to use the benchmark, and therefore to constitute the least interference with their rights.

Least disturbance or disadvantage to affected parties

- 3.7 We will seek to exercise the power in a way which causes least disturbance or disadvantage to affected parties. By way of example, we may take into account:
- 3.7.1 How best to maintain the ability to value and hedge affected contacts;
- 3.7.2 How best to align with the approach taken by those who are transitioning away from the benchmark;
- 3.7.3 How best to make sure that any change resulting from the use of our powers is clear and transparent; and
- 3.7.4 How best to minimise disruption, for example by considering whether the modified approach could be extended following the end of the modified benchmark (which

may be possible if the component parts are visible and available to market participants).

Market support

- 3.8 We would take into account whether market support has already been established, through public or private sector-led working groups, and/or open consultation, on a fair way of establishing a replacement value for the designated benchmark.

Availability to the benchmark administrator of robust and transparent inputs

- 3.9 As set out in paragraph 1.7 above, our focus at present is on the policy constraints which should apply to a decision in respect of LIBOR. As to this:
- 3.9.1 In relation to LIBOR specifically, it is unlikely that we would seek to exercise our powers to require a change in the rules of the benchmark or to the code of conduct, under proposed new Articles 23D(2)(b) and (c). We think that the limited underlying market that LIBOR seeks to represent means that it is unlikely that a change to its rules would be effective in making the rate sustainable for an orderly wind down. Changing the benchmark's code of conduct would only be effective if the changed methodology continued to rely on submissions.
- 3.9.2 It is likely that a need for us to intervene would exist because there are insufficient input data to calculate a representative benchmark through the current methodology. Therefore, the most effective route to achieve an orderly wind down would be to use our powers in relation to a change in the methodology. Accordingly potential methodology change would be our focus.
- 3.10 Where we consider requiring a changed methodology, any such change would need to produce a rate robust enough to support an orderly wind down. In assessing the robustness of the rate we would take into account the quality, reliability and transparency of the inputs necessary to produce the benchmark through the changed methodology. We would also consider the rate's vulnerability to manipulation.
- 3.11 We would consider the properties of any component input, for example whether that input met the [IOSCO principles for financial benchmarks](#), or the requirements of the BMR or any legislation or supervisory arrangements the Treasury found to be equivalent.
- 3.12 The proposed power under Article 23D(2)(a) would allow us to direct the administrator as to the input data that should be used in any changed methodology. However, in some circumstances, we might judge that the administrator would be better placed to choose or calculate some elements of the input data that would best deliver an outcome that we considered to be desirable to protect consumers and/or enhance market integrity, given their specialist knowledge and experience. In other circumstances, it might be inappropriate to grant the administrator discretion (if, for instance, this resulted in conflicts of interest that could not be adequately mitigated, or we considered that this would entail unreasonable risks to the administrator). Or we might conclude that there was only a single set of input data that would achieve the outcome we were seeking, so there was no opportunity to exercise discretion.
- 3.13 In some cases, there may be only a single provider of one or more of the inputs which we would want to use as part of a changed methodology. In other cases, there may be

multiple potential providers. We would identify and assess them relative to each other on an objective, fair, reasonable, non-discriminatory, proportionate and transparent basis. In assessing the providers, we would have particular regard to the robustness and transparency of the inputs and, where appropriate, whether they are subject to the BMR or equivalent requirements. We would also have regard to whether they are available to the benchmark administrator on acceptable terms (which we address further in paragraph 3.20 below).

Likely effect outside the United Kingdom of exercising the power

- 3.14 As noted in paragraph 2.16 above, where the benchmark is used outside the United Kingdom, the legislation allows us to take account of the likely effect outside the United Kingdom of the exercise of the Article 23D power. Our intention is to take account of that effect. We will do so by extending our engagement and consultation processes to market participants outside the United Kingdom. We will welcome views from authorities and market participants in relevant overseas jurisdictions.

Length of publication on a changed basis

- 3.15 Under the provisions of the BMR as amended by the FS Bill, we would be empowered to require an administrator to continue publication of the benchmark for up to 10 years⁸, but would have to re-assess each year whether continuing this requirement remains necessary.
- 3.16 Any use of the power to require a change to the benchmark's methodology, rules or code of conduct is also subject to a separate 2-yearly review of whether the intervention has advanced our consumer protection or market integrity objectives. A changed methodology could apply for the entire period of publication until the benchmark's cessation, subject to this review.
- 3.17 Our proposed policy is to intervene for as short a time as is appropriate to assure an orderly wind down of the critical benchmark in line with our statutory objectives.

Impact on the benchmark administrator

- 3.18 We propose to take account of the impact that a change in the methodology may have on the benchmark administrator. This involves two issues in particular:
- 3.18.1 Is the administrator operationally able to produce the benchmark under the new methodology?
- 3.18.2 The financial or commercial impact on the benchmark administrator.
- 3.19 As to the first of these, changing the methodology may require the administrator to change its systems or processes.
- 3.20 As to the second of these, the benchmark would have been designated as an Article 23A benchmark (i.e. it would no longer be a representative benchmark) prior to it being determined and published through a changed methodology. As a result, its use in new regulated financial contracts and instruments (and possibly in some existing instruments

⁸ Article 21.

and contracts) would be prohibited in the UK. Other authorities, market infrastructures and market participants might also reasonably be expected to limit future use of the benchmark from the point that it is no longer representative. The benchmark would, therefore, have limited remaining commercial value to the administrator. If the inputs necessary to make that change were only available to the administrator on terms that would clearly cause the administrator to suffer a material financial loss that could not reasonably be recouped, or a liability to the supplier of those inputs that we considered commercially unreasonable, it is unlikely we would be minded to use our powers to require use of those inputs. Alternatively, we could explore the ability of the administrator to produce similar inputs from its own resources or consider an alternative methodology.

Q6: Do you think we have identified all the relevant factors?

Q7: Are there any further issues which we need to consider in our approach to using our powers?

4 How to respond to this consultation

- 4.1 We welcome the views of consultees on our proposed policy approach, set out above. As we indicate, although we are not consulting on the relevance of “tough legacy” contracts and instruments to the question of orderly wind-down (since our view is that consideration of this issue is required by the legislative regime), we otherwise welcome all views on our proposed policy approach set out above. This includes whether there are factors, considerations or objectives which we have omitted but which, in the views of the consultees, we should include in our statement of policy.
- 4.2 We welcome responses to this consultation from any interested party. Please send your responses to benchmark-article23D@fca.org.uk by 18 January 2021.

Summary of questions in this paper

- Q1: Do you have any view in how best to consult in respect of our prospective decisions to exercise our Article 23D(2) power in respect of LIBOR?**
- Q2: How should we evaluate the practicality of transition and the scale of “tough legacy”?**
- Q3: Do you agree that the scale of “tough legacy” must be significant in order to justify intervention?**
- Q4: Under what circumstances might orderly transition be achieved without the use of Article 23D powers?**
- Q5: Do you have any views on how we intend to consider whether intervention is desirable?**
- Q6: Do you think we have identified all the relevant factors?**
- Q7: Are there any further issues which we need to consider in our approach to using our powers?**