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LIBOR Update: FCA Issues Notices and Consultation on Tough Legacy and Synthetic LIBOR

[33797]

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TO: Derivatives Markets Advisory Committee
Global Regulated Funds Committee
LIBOR Transition Working Group
SEC Rules Committee RE: LIBOR Update: FCA Issues Notices and Consultation on Tough Legacy and Synthetic LIBOR

On September 29, the UK Financial Conduct Authority (FCA) issued a series of publications on its proposed approaches to the definition of tough legacy contract, the permitted use of synthetic UK sterling and Japanese yen LIBOR, and the prohibited new use of USD LIBOR, with limited exceptions, after December 31, 2021.[1]

As a reminder, "tough legacy" generally refers to those contracts and instruments that continue to reference LIBOR when those rates are discontinued or deemed unrepresentative. The FCA has previously announced that UK sterling and Japanese yen LIBOR, among other rates, will be unrepresentative under their current methodology on December 31.[2] "Synthetic LIBOR" refers to an alternative methodology for calculating LIBOR rates, which are currently calculated from the contributions of panel banks.

The FCA issued the following publications:

- A feedback statement and two statements of policy, in response to feedback solicited in a consultation earlier this year, on how the FCA intends to use its powers under the UK Benchmarks Regulation (BMR) to allow legacy contracts to continue to use critical benchmarks that are permanently unrepresentative and to prohibit all or some new uses of those benchmarks.[3]
- Notices designating sterling and yen LIBOR as critical benchmarks and compelling the ICE Benchmark Administrator (IBA) to continue publishing those rates using a synthetic methodology for a period of 12 months after those rates become unrepresentative under the current methodology on December 31.[4]
- A draft notice to the IBA specifying the methodology for calculating synthetic sterling

and yen LIBOR. As the FCA has previously signaled, the synthetic versions of those rates will be based on the forward-looking term versions of the risk-free rate applicable to that currency (i.e., SONIA for sterling LIBOR and TORF for yen LIBOR) plus a fixed spread adjustment between LIBOR and the risk-free rate. The FCA will use the spread adjustment set by ISDA in its fallback rates for derivatives transitioning from LIBOR.[5]

- A consultation to determine which tough legacy contracts and instruments the FCA will allow to use synthetic sterling and yen LIBOR and whether to prohibit new uses of USD LIBOR as of December 31.[6]

ICI is considering responding to this consultation, which we discuss in further detail below. Responses to the consultation are due October 20. We encourage you to reach out with any feedback.

Consultation on Tough Legacy Contracts and New Use of USD LIBOR

Legacy Use of Synthetic Sterling and Yen LIBOR

The FCA proposes to permit legacy use of synthetic sterling and Japanese yen LIBOR in all contracts referencing LIBOR except cleared derivatives (whether directly or indirectly cleared), through 2022. Among other contracts and instruments, the FCA expects bonds issued before November 2019 to constitute a portion of legacy contracts. The FCA also notes that performance benchmarks for investment funds may be among these legacy contracts.

In excepting only cleared derivatives from the ability to use synthetic rates, the FCA notes that those instruments are likely to be subject to adequate fallback rates through clearing house rules. While most uncleared derivatives also are expected to have adequate fallbacks through counterparty adherence to the ISDA Protocol, the FCA states that it would be "unwise" to undertake the complex task of delineating this group of contracts from the remainder that do not.

The FCA provides details on how it expects contracts may be within the set of legacy contracts permitted to use synthetic LIBOR - or without - depending on the drafting of fallback language in those contracts. In particular:

- Contracts that include fallbacks that would move the contract away from LIBOR when the relevant LIBOR setting ceases permanently are likely to transition to synthetic LIBOR and not to their contractual fallback rate, at least while synthetic LIBOR is being published through 2022. The FCA's reasoning is that, for these contracts, LIBOR will continue to be published, even if it is unrepresentative and computed through an alternate methodology.

- Contracts that include fallbacks that would move the contract away from LIBOR when the relevant LIBOR setting becomes permanently unrepresentative, however, are likely to transition to their fallback rate and not use synthetic LIBOR after December 31, 2021 as the rate will become unrepresentative then, even as it continues in synthetic form.

- Similarly, contracts that include language that would move to a fallback rate upon a material change to the contract or upon a party to the contract being prohibited from using a particular benchmark may also move to their fallback rate and not use synthetic LIBOR, depending on specific contractual wording.

Prohibitions on Use of USD LIBOR

The FCA consultation also includes a proposal to prohibit UK entities and contracts within the scope of the BMR from using USD LIBOR as of December 31, although most USD LIBOR rates will not cease until June 30, 2023. The FCA proposes limited exceptions to this prohibition on use, including:

- Market making in support of client activity related to transactions executed before January 1, 2022;
- Transactions that reduce or hedge a supervised entity's or any client of the supervised entity's USD LIBOR exposure;
- Novations of USD LIBOR transactions;
- Transactions executed for purposes of participation in a central counterparty auction procedure in the case of a member default, including transactions to hedge the resulting USD LIBOR exposure; and
- "Interpolation" within contractual fallback arrangements to allow for the transition of 1 week and 2-month USD LIBOR settings (that will cease on December 31, 2021) to other USD LIBORs (that will not cease until 2023). Specifically, the FCA has in mind contracts that have fallbacks that enable linear interpolation where a benchmark is ceasing, but other 'bookend' versions of that same benchmark are still available.

The FCA notes that its prohibition and limited exceptions are designed to be consistent with the prohibitions on the use of USD LIBOR that US prudential regulators advised last year,[7] except that the FCA would add a limited exception for interpolation.

The FCA also notes that it expects "changes in liquidity in US dollar LIBOR markets and [that] users may face increased costs in dealing products linked to the continuing US dollar LIBOR settings as the transition progresses (particularly the closer we get to mid-2023)." However, it does not expect "a risk that the continuing US dollar LIBOR settings themselves face unexpected volatility purely due to the fact they are ceasing. We expect the panel banks will continue to submit until mid-2023 and do not expect the quality of their input data materially to change in this relatively short period."

Bridget Farrell
Assistant General Counsel

endnotes

[1] Further arrangements for the orderly wind-down of LIBOR at end-2021(September 29, 2021), *available at* https://www.fca.org.uk/news/press-releases/further-arrangements-orderly-wind-down-libor-end-2021.

[2] The FCA has announced that USD LIBOR will continue as a representative rate through June 30, 2023. The FCA stated that "The decisions to require publication of some sterling and Japanese yen LIBOR settings on a synthetic basis are not determinative of any future decisions in respect of US dollar LIBOR from end-June 2023."

[3] Feedback Statement: FCA use of powers over use of critical benchmarks, *available at* https://www.fca.org.uk/publication/feedback/fs21-10.pdf; Statement of Policy on the FCA's power under Article 23C BMR: https://www.fca.org.uk/publication/policy/statement-policy-23c-critical-benchmarks.pdf; Statement of Policy on the FCA's power under Article 21A BMR: https://www.fca.org.uk/publication/policy/statement-policy-21a-critical-benchmarks.pdf; For background on the FCA's earlier consultation, *see* ICI Memorandum No. 33553, *available at* https://www.ici.org/memo33553. ICI's response to the consultation is *available at* https://www.ici.org/memo33588.

[4] Article 23A Benchmarks Regulation - Notice of Designation, available at https://www.fca.org.uk/publication/libor-notices/article-23a-benchmarks-regulation-designation-notice.pdf; Article 21(3) Benchmarks Regulation - Notice of First Decision, *available at* https://www.fca.org.uk/publication/libor-notices/article-21-3-benchmarks-regulation-first-decision-notice.pdf.

[5] ICI Memorandum No. 33640, *available at* https://www.ici.org/memo33640. Regarding the ISDA spread adjustment, *see* ICI Memorandum No. 33161, *available at* https://www.ici.org/memo33161#_ftnref3; ISDA, LIBOR Cessation and the Impact on Fallbacks (March 5, 2021), *available at* https://www.isda.org/2021/03/05/libor-cessation-and-the-impact-on-fallbacks/.

[6] Proposed decisions on the use of LIBOR (Articles 23C and 21A BMR), *available at* https://www.fca.org.uk/publications/consultation-papers/cp21-29-proposed-decisions-libor-articles-23c-21a-bmr.

[7] *See* ICI Memorandum No. 32950, *available at* https://www.ici.org/memo32950.