Review of the use of our Article 23D power for 3-month synthetic sterling LIBOR

February 2024

Purpose of this report

1. Article 23E of the Benchmarks Regulation (BMR) requires us to review every 2 years whether any use of our powers under Article 23D(2) of the BMR has advanced either or both of our consumer protection and integrity objectives, having regard to the policy statement on the exercise of our powers under Article 23D. We are also required to publish a report setting out the outcome of the review.[1]

2. This report sets out the outcome of our review of the use of our power under Article 23D(2) of the BMR to require ICE Benchmark Administration (IBA) to publish 3-month sterling LIBOR ('the LIBOR Version') under a changed, 'synthetic' methodology for the period between 1 January 2022 and 1 January 2024 (the review period).[2]

3. The report concludes that the way in which we have exercised our power under Article 23D(2) of the BMR for the LIBOR Version has advanced both our consumer protection and integrity objectives.

Background

4. The panel-bank submissions for all sterling LIBOR settings ended on 31 December 2021. Using our power under Article 21(3) of the BMR, we compelled IBA to continue to publish the LIBOR Version initially for 12 months starting immediately after the final publication of the LIBOR Version on 31 December 2021 and, further to 2 subsequent compulsion decisions (which were subject to annual reviews under the BMR), until the end of March 2024.[3] In making the decision to compel continued publication, we noted that IBA would not be able to continue to publish the LIBOR Version on the basis of its panel-bank contributions-based methodology. We intended, in line with our Article 23D Decision Consultation, to require IBA to continue to publish the LIBOR Version under a changed, 'synthetic' methodology, which would no longer be representative.[4]

5. We designated the LIBOR Version under Article 23A, in order to access the Article 23D power to sustain the publication of the LIBOR Version to secure its orderly wind down. The designation took effect on 1 January 2022. Given that the Article 23A designation would result in supervised entities being prohibited from using the LIBOR Version, we permitted, under Article 23C(2) of the BMR, its use in certain legacy contracts.

6. On 1 January 2022, we imposed requirements on IBA to change the way in which the LIBOR Version is determined under Article 23D(2) of the BMR.[5] These requirements

1 Article 23E(1)(b) of the BMR.

2 Under Article 23E(2) of the BMR, the review period is the period of two years beginning with the day on which the first notice under Article 23D(2) relating to the benchmark is published, that is between 1 January 2022 and 1 January 2024.

3 In November 2023, we compelled IBA to continue publishing the LIBOR Version until the end of March 2024 under Article 21(3) of the BMR to ensure an orderly cessation of the setting. This followed our previous Article 21(3) decision to require continued publication from the end of December 2022 until the end of December 2023.

4 This was subject, in particular, to us taking account of all responses provided to the consultation and also any representations IBA would make in respect of the Article 23D notice and/or the notice to designate the LIBOR Version under Article 23A of the BMR.

5 The Article 23D Notice given to IBA on 1 January 2022 imposed requirements for the 1-month, 3-month and 6-month sterling LIBOR settings. The 1-month and 6-month sterling LIBOR settings, however, ceased permanently at the end of March 2023, thus these settings are not subject to the scope of this review.

took effect immediately after our Article 21(3) compulsion decision and the designation of the LIBOR Version as an Article 23A benchmark.

7. Using our Article 23D(2) power, we required IBA to calculate the figure for the LIBOR Version as the sum of the ICE 3-month Term SONIA Reference Rate and the ISDA Spread Adjustment for 3-month sterling LIBOR. We decided to impose these requirements on IBA, having considered our Article 23D Statement of Policy published under Article 23F(1)(d) of the BMR and the responses we received to our June 2021 consultation, as we considered it:

1. appropriate to do so having regard to the desirability of securing that the cessation of the benchmark takes place in an orderly fashion; and
2. desirable to do so to advance both our consumer protection and integrity objectives

8. The changed, 'synthetic' methodology has been used to produce the LIBOR Version since 1 January 2022 and will remain until the end of March 2024. Our requirements on IBA for the LIBOR Version under Article 23D(2) have been in place for over 2 years. Therefore, we are required to perform an Article 23E review.[6]

Overview

9. Given the scale of the estimated outstanding legacy contracts referencing the LIBOR Version at the end of 2021 and the potential disruption they would have likely caused to consumers and the wider market if those contracts were not able to continue to function[7], the use of our power under Article 23D of the BMR, together with our Article 21(3) compulsion power, has ensured continuity of these contracts by sustaining the LIBOR Version and advanced both our consumer protection and market integrity objectives.

10. In line with our Article 23D Statement of Policy, we considered several factors in exercising our power which have contributed to the advancement of both of our statutory objectives, as we discuss below. In our view, we have exercised our power in a way that has delivered a fair approximation of the value the LIBOR Version would have had and the least disturbance or disadvantage to affected parties. We have selected components which have been robust, transparent and available to the administrator having considered the impact the changed methodology would have on the administrator. We give more detail in the 'consumer protection' and 'market integrity' sections below.

11. We also considered whether market support had been established on the method for calculating a replacement value for the LIBOR Version. The vast majority of respondents to our June 2021 consultation supported our approach for the selection of the 2 components for the 'synthetic' methodology. We have not received any adverse feedback on the selection of the components for the 'synthetic' methodology since we exercised our Article 23D power.

6 Article 23E(2) of the BMR.
7 For an estimate of the outstanding contracts please refer to our June 2021 consultation.

12. On the length of the publication of the LIBOR Version under a changed methodology, our policy intention has been to intervene for as short a time as is appropriate to assure an orderly wind down of the LIBOR Version in line with our statutory objectives. Our compulsion power on continued publication under Article 21(3) of the BMR has been subject to our annual review on whether continuing this requirement remains necessary. As mentioned above, we have compelled IBA to continue publication of the LIBOR Version until the end of March 2024 to ensure that market participants have the time to complete their transition plans for the outstanding contracts, to ensure an orderly cessation of the LIBOR Version.

13. Throughout the compulsion period, we have exercised our Article 23D power in the same way, ie to maintain the changed methodology. The lack of any need to change our approach suggests that the use of our power has achieved its policy objective to advance consumer protection and market integrity. Additionally, one of the reasons given by market participants to our November 2022 consultation on 'synthetic' USD LIBOR for supporting publication of 'synthetic' versions of the remaining US dollar LIBOR settings has been the success of 'synthetic' sterling LIBOR.[8]

14. In the paragraphs below, we discuss in more detail whether the way in which we have used our power has advanced our statutory objectives; considering, but not limited to, the factors mentioned above.[9]

Consumer protection

15. In advance of the end of the panel-bank LIBOR at the end of 2021, we had estimated there were a large number of outstanding LIBOR-referencing contracts with potential consumer impact (eg retail mortgages, or, through consumers' pensions or other investments, bonds and securitisations). By sustaining the LIBOR Version using our Article 23D(2) power, the outstanding legacy contracts have been able to function as intended during the course of the review period. This has mitigated the risk of potential financial loss that consumers may have suffered, or unexpected change in the cost of their contracts, ensuring an appropriate degree of consumer protection.

16. For instance, in the mortgage market, we had estimated that there were significant mortgage exposures referencing the LIBOR Version that could not practicably be transitioned by the end of 2021.[10] Many of these contracts did not contain fallbacks or other variation mechanisms or, where they did, market participants may have not been able to rely on them. In the absence of the LIBOR Version based on the 'synthetic' methodology, these mortgages would have faced uncertainty as to what rate to use, which would have caused consumer harm. The use of our Article 23D power, together with our Article 21(3) power, to require IBA to continue the publication of the LIBOR Version under a changed, 'synthetic' methodology, allowed transition efforts to

8 FS23/2: Decisions on US dollar LIBOR: Feedback to CP22/21 (fca.org.uk)

9 The Article 23D Statement of Policy includes an additional factor which is the likely effect outside the United Kingdom of exercising the power. We considered this factor when exercising our power in relation to the 6 Versions of sterling and yen LIBOR settings given the impact outside the UK. For the purpose of this review in relation to 3-month 'synthetic' sterling LIBOR only, we consider this as less relevant and have not discussed this factor in this report given that the LIBOR Version has been predominantly used in the UK.

10 We had estimated there were at least 200,000 outstanding regulated and unregulated mortgages in the UK referencing the LIBOR version, with a total mortgage value of around £37 billion. https://www.fca.org.uk/publication/libor-notices/article-23d-benchmarks-regulation.pdf

continue. This was necessary for market participants, especially parties to mortgage contracts, to complete transition away from the LIBOR Version in an orderly way.[11] Based on feedback and information available to us, during the time we have exercised our power, mortgage exposures have continued to decline and have been significantly reduced. Additionally, and as we discuss below in paragraph 29, the provision and use of the changed methodology since January 2022 has provided lenders with an established alternative rate formula which they could potentially replicate to support transition, ensuring continuation of economic outcome, if they wish.[12]

17. We have exercised our Article 23D(2) power in a way that has helped consumers achieve fair outcomes, where they were unlikely to have been able to manage the consequences of the cessation of LIBOR without our intervention. Having considered the likely financial effect on consumers, the selected components of the changed methodology (forward-looking term RFR and the ISDA spread adjustment) have aimed to achieve a fair approximation of the LIBOR Version's expected value if panel-bank LIBOR had continued, as described below. This ensured a continuation of economic outcome for the outstanding LIBOR-referencing contracts, so advancing consumer protection.

18. We selected the ICE 3-month Term SONIA Reference Rate and the ISDA Spread Adjustment for 3-month sterling LIBOR as the most appropriate components of the changed methodology having considered our Article 23D Statement of Policy and based on feedback received to our June 2021 consultation.

19. Having considered the underlying market that LIBOR intended to measure before it was designated as an Article 23A benchmark[13], we viewed LIBOR as the sum of (a) a measure of the expectation of RFRs over a fixed period; plus (b) an adjustment reflecting bank credit risk and liquidity conditions in funding markets over the corresponding fixed period.

20. The ICE Term SONIA Reference Rate (TSRR) – the first component – provided by IBA, has been an appropriate component to measure the market expectation of interest rates over a fixed term that was reflected in LIBOR itself. It is a forward-looking term rate based on the relevant RFR chosen by the industry to facilitate transition away from LIBOR (ie SONIA).[14] A forward-looking term rate has been more suitable to support many legacy contracts which require a payment amount to be identified or made at the beginning of, or well in advance of, the end of the relevant interest period, compared to 2 alternative options we had considered and discounted at that time (RFRs calculated 'in arrears' at the end of the relevant interest period and backward-looking measures of the relevant RFRs calculated at the beginning of the relevant interest period (ie RFRs 'in advance')). Further details are in our June 2021 consultation, paragraphs 3.34 and 3.35.

11 Article 21(3) Benchmarks Regulation – Notice of First Decision – 3 month sterling LIBOR (fca.org.uk)

12 Decision Notice 2022: ICE Benchmark Administration Limited (fca.org.uk)

13 The panel-bank LIBOR methodology was 'designed to produce an average rate that is representative of the rates at which large, leading internationally active banks with access to the wholesale, unsecured funding market could fund themselves in such market in particular currencies for certain tenors.'

14 It is based on the fixed rates offered in SONIA-referencing derivatives markets, e.g. overnight indexed swaps (OIS), which provide information on market expectations of the varying overnight SONIA rates over a forward-looking 3-month period.

21. The ISDA spread adjustment – the second component – which is calculated based on a 5-year historical median spread between LIBOR and the corresponding RFR 'in-arrears', takes into account the credit risk and funding market liquidity conditions that panel-bank LIBOR intended to measure, and which are not reflected in the forward-looking term RFR. We considered that the fairest way to calculate the credit risk and funding market liquidity component was to take the median of historical values over a lookback period that reflects a range of economic and market conditions. In particular, a 5-year lookback period is better at capturing a range of economic and market conditions that could occur in the future than a shorter lookback period.

22. The ISDA spread adjustment was established by market consensus in the derivatives markets in major jurisdictions – including but not limited to the LIBOR currency jurisdictions – through a series of ISDA consultations. It was also endorsed by the Financial Stability Board's Official Sector Steering Group, as well as national working groups in the UK, the US, EU, Switzerland and Japan to be incorporated in fallback arrangements for cash contracts.

23. An additional factor we considered, as part of our consumer protection objective, has been the operational, financial and commercial impact our methodology would have on IBA, taking into account any potential knock-on financial effect on consumers to ensure that consumers do not bear any reasonably avoidable additional costs. As we discuss in more detail below, the components of our methodology have been available to IBA.

Market integrity

24. The use of our Article 23D power has mitigated the risk of market disruption and so advanced the integrity of the UK financial system in terms of orderliness, resilience, transparency and cleanliness of the market as follows.

25. **Orderliness:** The exercise of our power has minimised market disruption by allowing relevant contracts to continue to function in an orderly manner, maintaining the 'orderliness' of the financial system. For instance, in the bond market we were aware that a material amount of outstanding legacy bonds, by number and value of contracts, were written before it was commonly envisaged that LIBOR would cease. We understood that the fallbacks contained in these bonds, if they had any, were written primarily to deal with temporary problems and may have included fallbacks using the last available LIBOR rate. This would mean that these floating rate bonds would become fixed rate products on the permanent cessation of LIBOR, which was not what was envisaged for these products and could have led to disruption.[15]

26. The changed methodology has facilitated continued hedging of relevant products causing the least disturbance or disadvantage to the affected parties, mitigating market disruption. Using a forward-looking term RFR means that outstanding

15 Article 21(3) Benchmarks Regulation – Notice of First Decision (fca.org.uk)

legacy contracts that reference LIBOR under the changed methodology would have the same expected value of interest payments as those that have been amended to use RFRs 'in-arrears' over the same calendar period plus those same ISDA spread adjustments from the point that panel-bank LIBOR ended. While realised overnight RFRs, compounded in arrears at the end of a period, are likely to differ from expectations at the beginning of that same period, the basis between the two can be hedged.

27. **Resilience:** Sustaining the LIBOR Version has maintained resilience in the market, as outstanding LIBOR-referencing contracts have continued to operate following the end of the panel-bank submissions. This has helped parties to these contracts to continue serving their customers and meeting their obligations to counterparties, minimising the risk of disputes and litigation.

28. **Transparency:** Sustaining the LIBOR Version has maintained transparency in the market. It has allowed legacy contracts to continue to function in line with the already defined rights and obligations in the contracts following the end of the panel-bank LIBOR. The changed methodology has ensured that outstanding legacy contracts continue to operate very similarly to the way these legacy contracts would have operated under panel-bank LIBOR[16], causing the least disturbance or disadvantage to the affected parties.

29. The component parts for the changed methodology have been visible and available to market participants. This has helped minimise disruption allowing market participants to replicate potentially the relevant components, if they wish, to support transition of the outstanding contacts as discussed in paragraph 16 above. For instance, based on information available to us, several firms in the mortgage market have replicated the components of our 'synthetic' methodology to create their own replacement rate for use in their outstanding legacy LIBOR-referencing contracts.

30. **Cleanliness:** Both components of the changed methodology have been robust and transparent. This has helped the LIBOR Version to not be vulnerable to market abuse, maintaining the 'cleanliness' of the financial system. TSSR has been a reliable and robust component given that the markets that underly term SONIA have been sufficiently liquid to support use of the relevant forward-looking term RFR as a component for the 'synthetic' methodology. The ISDA spread adjustment – as a historical median – has been robust against market manipulation, given that it is based on a historical median reflecting a range of economic and market conditions. A historical median is also better in calculating a representative spread to minimise value transfer, as a median is less affected by data outliers under unusual market conditions.

31. The components have also been available to the benchmark administrator. We selected ICE TSRR provided by the IBA as a component for the purpose of producing the LIBOR Version under the changed methodology. The ISDA spread adjustment, published for the purpose of the ISDA IBOR fallbacks for the relevant Version, has been available to IBA to produce the benchmark.

16 The changed methodology has provided parties to outstanding legacy contracts with certainty on the interest payment due to be made or received very similar to the way the legacy contract would have operated under panel-bank LIBOR.

Outcome of the review

32. Based on the analysis above, we consider that the way in which we have exercised our Article 23D power for the LIBOR Version has advanced both of our objectives of securing an appropriate degree of protection for consumers and protecting and enhancing the integrity of the UK financial system.

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