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ARTICLE 21A BENCHMARKS REGULATION – NOTICE OF PROHIBITION ON NEW USE OF A CRITICAL BENCHMARK

1. ACTION

1.1. For the reasons given in this Notice and pursuant to Article 21A(1) of the Benchmarks Regulation, the Authority prohibits new use of the following LIBOR Versions by supervised entities, subject to the exceptions set out in paragraph 1.2 below (the "**Prohibition**"):

(1) Overnight US dollar LIBOR

(2) 1-month US dollar LIBOR

(3) 3-month US dollar LIBOR

(4) 6-month US dollar LIBOR

(5) 12-month US dollar LIBOR

(the "**Prohibited USD LIBOR Versions**")

1.2. The above prohibition shall not apply to the following, to the extent that they constitute new use (the "**Exceptions**"):

(1) Market making in support of client activity related to US dollar LIBOR transactions executed before 1 January 2022

(2) Transactions that reduce or hedge the supervised entity's or any client of the supervised entity's US dollar LIBOR exposure on contracts entered into before 1 January 2022

(3) Novations of US dollar LIBOR transactions executed before 1 January 2022

(4) Transactions executed for the purposes of participation in a central counterparty auction procedure in the case of a member default, including transactions to hedge the resulting US dollar LIBOR exposure

(5) Interpolation or other use provided for in contractual fallback arrangements in connection with the US dollar LIBOR Versions that will cease at 31 December 2021 (the 1-week and 2-month USD LIBOR Versions)

1.3. Such prohibition shall take effect from 1 January 2022 at 00:01.

1.4. Annex 1 makes further provision and includes information in relation to the Prohibition and the Exceptions.

2. SUMMARY OF REASONS

2.1. Our Statement of Policy sets out factors that we consider may be relevant when we make decisions to exercise our new use restriction power. Having applied these to the Prohibited USD LIBOR Versions and consulted on our proposed exercise of our Article 21A power, the Authority considers that it is desirable to take this action in order to advance our consumer protection and integrity objectives.

2.2. Market participants have been made aware since July 2017 of the need to transition away from the LIBOR benchmarks, and that their availability could not be guaranteed beyond end-2021.

2.3. The Authority considers market participants have had sufficient notice of the need to stop using the Prohibited USD LIBOR Versions in new contracts and should already be working towards an end-2021 deadline (in line with our supervisory expectations). Our action means that there will now be legal consequences for supervised entities breaching the Prohibition if the new use does not fall within one of the Exceptions.

2.4. Consistent with previous messaging on LIBOR transition (see 2.2 above) and a globally coordinated approach (see 4.36-4.41 below), the prohibition of the Prohibited USD LIBOR Versions shall take effect on 1 January 2022 at 00.01.

3. DEFINITIONS

3.1. The definitions below are used in this Notice:

"The Authority" means the Financial Conduct Authority "the Benchmarks Regulation" or "BMR" means the UK version of Regulation (EU) No. 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014, which is part of UK law by virtue of the European Union (Withdrawal) Act 2018

"IBA" means ICE Benchmark Administration Limited

"LIBOR" means the ICE LIBOR benchmark provided by IBA

"Statement of Policy" means the statement of policy with respect to the Authority's exercise of its power under Article 21A, published under Article 23F(1)(a) of the Benchmarks Regulation

"Version" has the meaning in Article 23G(2) of the BMR and is used to refer to LIBOR as provided for a particular currency and tenor, sometimes known as a LIBOR setting

3.2. Words and expressions used in the Benchmarks Regulation have the same meanings where used in this Notice unless the contrary intention appears.

4. REASONS

Background

4.1. IBA formally notified the Authority of its intention to cease providing the following LIBOR versions immediately after the publication of LIBOR on 31 December 2021:

1. all 7 Sterling versions;
2. all 7 Yen versions;
3. the 1-week and 2-month US dollar versions
4. all 7 Swiss franc versions; and
5. all 7 Euro versions.

4.2. IBA also formally notified the Authority on 4 March 2021 under Article 21(1) of the BMR of its intention to cease providing the Prohibited USD LIBOR Versions immediately following publication on 30 June 2023.

4.3. Article 21A provides that the Authority may only use Article 21A powers if it considers it desirable to do so in order to advance either or both of its consumer protection and integrity objectives, and only after it has completed an assessment of the Prohibited

USD LIBOR Versions under Article 21(2) of the BMR. The Authority has assessed how the Prohibited USD LIBOR Versions are to cease to be provided.

4.4. The Authority consulted on and subsequently published a Statement of Policy with respect to the exercise of Article 21A powers in September 2021. In September 2021, the Authority published a consultation seeking views on its proposed decision to exercise the Article 21A power in respect of each of the Prohibited USD LIBOR Versions and setting out how it had regard to the Article 21A Statement of Policy ("**Decision Consultation**"). The consultation closed on 20 October 2021.

There were 42 responses to the Decision Consultation. Most respondents were supportive of the approach on "new use" and welcomed alignment with the US. However, a key theme raised in the feedback were concerns that the Authority's approach would not be flexible enough to adapt to future changes by other regulators. In addition, some respondents identified a number of issues where they felt that our proposed exceptions are not sufficiently clear and requested that the Authority provide further clarity. We also received feedback that there may be some contracts referencing one of the ceasing USD settings that provide for moving to use of one of the Prohibited USD LIBOR Versions directly upon cessation. The Authority has reviewed all responses received to the Decision Consultation. As a result, the Authority has decided to make changes in relation to the exception it had proposed for fallback arrangements and to provide more detail in Annex 1 on the scope of exceptions.

Reasons for Prohibition

4.5. The FCA has taken into account the factors in the Article 21A Statement of Policy as set out below.

<u>a) Resilience – system wide operational risk</u>

4.6. New market ecosystems take time to develop and rely on concerted actions from a range of market participants, as we have seen in both sterling and dollar markets in the transition from forward-looking LIBOR rates to backward-looking risk free rates (RFRs). We have observed through LIBOR transition that markets can face significant amounts of inertia in the face of change. This is in part driven by the attractiveness of using products that are familiar and have more liquidity.

4.7. In the absence of restrictions to stop new use of the Prohibited USD LIBOR Versions, we think there is a risk that some market participants delay shifting their new business activity to SOFR in earnest.

4.8. If firms encounter delays or backlogs in their transition programmes, this creates the potential for operational risks to crystallise on a greater scale around a single deadline, especially as such risks may be faced in respect of a firm's front and back-book, rather than just the latter. This risk may be heightened where firms rely on third party suppliers who may have their own resource constraints. If this occurs across many firms at the same time, it creates potential systemic risk.

4.9. Undertaking a phased transition, whereby new business moves to alternative rates first, helps market participants gain experience in operating with these alternative rates. It also establishes a path to switch legacy contracts.

4.10. Our experience in sterling markets is that having clear dates for stopping new LIBOR business has helped firms manage their LIBOR transition programmes in two main ways:

- From an internal standpoint, it has supported their project management process including approval for resources.
- From an external standpoint, it has proved helpful for firms to have specific dates to reference when dealing with clients.

4.11. Continuing to create new exposure referencing the Prohibited USD LIBOR Versions increases the volume of legacy contracts that need to be remediated by mid-2023. Even where firms have implemented clear, robust fallbacks (which supervised entities are required to have under the Benchmarks Regulation), there will still be steps needed to operationalise the fallbacks. Increasing the volume of legacy contracts referencing the Prohibited USD LIBOR Versions therefore increases the pressure on firms' systems and processes and in turn increases operational risk.

<u>b) Financial stability - the nature and/or degree of activity in the market(s) underpinning the benchmark</u>

4.12. As set out in the FSB's report 'Reforming Major Interest Rate Benchmarks', high volume of use of a benchmark may create financial stability risks, and these risks are particularly acute when combined with low levels of activity in the underlying market.

We refer to this as the 'inverted pyramid' issue. This inverted pyramid is the fundamental reason for concern about the sustainability of LIBOR.

4.13. Ongoing use of the Prohibited USD LIBOR Versions in new contracts increases the impact to financial stability if a dislocation occurs. While we are confident that the Prohibited USD LIBOR Versions will be maintained in a representative manner until end-June 2023, risks attached to LIBOR are higher if the number of contracts using the Prohibited USD LIBOR Versions continues to grow.

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

4.14. When applied to the Prohibited USD LIBOR versions, this factor does not pose market integrity or consumer protection risks as we do not expect any of these LIBOR Versions to become unrepresentative before mid-2023.

<u>d) Risk that consumers or the market face unexpected changes such as volatility or liquidity impacts in either the ceasing benchmark itself, or the market(s) using it</u>

4.15. There are likely to be changes in liquidity in US dollar LIBOR markets and therefore users may face increased costs in dealing products linked to the Prohibited USD LIBOR Versions as the transition progresses (particularly leading up to mid-2023).

4.16. In addition, there is a risk that any consumers using the Prohibited USD LIBOR Versions would not fully understand the impacts of these LIBOR Versions ending. While the inclusion of robust fallback provisions may help reduce this risk, it does not always eliminate it. From a conduct perspective, we have been clear that the best way to avoid the complications of calculating and explaining fallbacks from LIBOR to fair replacement rates is to avoid new LIBOR contracts.

4.17. We do not think there is a risk that the Prohibited USD LIBOR Versions themselves face unexpected volatility purely due to the fact they are ceasing. We expect the panel banks will continue to submit in relation to the Prohibited USD LIBOR Versions until the end of June 2023 and do not expect the quality of their input data materially to change in this relatively short period.

<u>e) Adequate confidence and liquidity in alternative benchmarks and market preparedness to use them</u>

4.18. In the case of the Prohibited USD LIBOR Versions, we think there is now adequate confidence and liquidity in alternative benchmarks to avoid material or widely occurring adverse impacts from restricting new use of US dollar LIBOR

4.19. In July 2021 the US Commodity Futures Trading Commission (CFTC) supported a 'SOFR first' initiative to encourage liquidity in SOFR derivative markets. Since this initiative began, in the interdealer market we have consistently seen at least 85% of notional in new US dollar linear swaps reference SOFR.

4.20. We have accordingly concluded that there is a potential risk of market disruption and risks to financial stability if we do not intervene to restrict new use of the Prohibited USD LIBOR Versions and that it would be desirable to do so to advance our consumer protection and integrity objectives.

Further considerations

Our Statement of Policy sets out other factors that we consider could be relevant to a decision whether and how to exercise our new use restriction power.

<u>Whether not restricting some or all use of the ceasing benchmark might support our objectives</u>

Reducing exposure to the ceasing benchmark

4.21. We received some feedback to our Decision Consultation calling for us to allow short-dated contracts (i.e. those maturing before the end of June 2023) to use the Prohibited USD LIBOR Versions. However, we do not consider that this would be appropriate.

4.22. The official sector has made clear for some time the risks of financial markets' continued reliance on LIBOR and the need to transition to alternative rates. The most effective way to avoid LIBOR-related risk is not to write LIBOR-referencing business. Use of SOFR-related rates in new contracts helps the necessary ecosystem and liquidity to develop in advance of the Prohibited USD LIBOR Versions ceasing.

4.23. In addition, US authorities have issued supervisory guidance restricting new use of US dollar LIBOR settings after end-2021 and this guidance does not suggest that use in short-dated contracts maturing before mid-2023 is exempt. We agree with this approach.

4.24. To achieve an orderly wind down of US dollar LIBOR, existing contracts using US dollar LIBOR must transition to alternative benchmarks such as SOFR – whether that be through amending the contract to reference an alternative benchmark such as SOFR before mid-2023, or through a fallback that takes effect when US dollar LIBOR ceases or becomes unrepresentative.

4.25. A particular feature of derivatives is that new transactions referencing the ceasing benchmark can be used in some cases to reduce legacy exposure. For example, derivative positions can be "unwound" by entering an equal and opposite trade and typically "compressing" those trades down to zero. This would require new use of US dollar LIBOR.

4.26. Equally, parties may enter into other risk reducing trades that are not compressed, and therefore don't reduce the overall notional amount, but nevertheless reduce the economic exposure of the parties, either to zero or at least partially.

4.27. If this type of activity is prevented, then market participants may not be able to unwind or reduce their existing derivatives portfolios via these mechanisms. That would not be in line with our overall transition objectives.

4.28. In addition, where firms or their clients have existing exposures linked to US dollar LIBOR, new derivative transactions may also be needed to ensure this exposure can be risk managed appropriately (i.e. through adequate hedging arrangements). Removing market participants' ability to manage risk associated with existing US dollar LIBOR exposure would undermine the effective and orderly functioning of markets, and potentially increase trading costs.

4.29. Where trades are cleared, there may be procedural requirements that arise, such as participating in CCP auction procedures in case of member default. To ensure the effective and safe functioning of CCPs, new transactions for this purpose would need to be permitted, along with new transactions that may be required to hedge the resulting exposure.

4.30. We therefore consider that these sorts of limited exceptions from the prohibition on new use of the Prohibited USD LIBOR Versions would support our integrity objective, by reducing overall exposures to the Prohibited USD LIBOR Versions and the resulting financial stability risks posed by these. The proposed decision on which we consulted included these exceptions.

4.31. A number of respondents to our Decision Consultation expressed concern that our proposed decision provided insufficient detail or clarity on these exceptions. As a result we have added an Annex (Annex 1) to this Notice setting out further details on two of the issues highlighted: (i) whether single currency USD LIBOR basis swaps can be entered into in order to disperse exposures acquired in the course of the activity described at 4.28 above, and (ii) our expectations in relation to verifying client intentions.

4.32. Finally, we understand that some contracts have fallbacks that enable linear interpolation where a benchmark is ceasing, but other 'bookend' versions of that same benchmark are still available. For example under ISDA's IBOR Fallbacks, when the 1-week and 2-month US dollar LIBOR versions cease at the end of 2021, contracts referencing these versions will interpolate between the overnight / 1 month, and 1-month / 3-month US dollar LIBOR versions respectively, until mid-2023. To enable these contracts to be wound down in an orderly way, it is important that market participants can activate these fallbacks (which require new use of the relevant Prohibited USD LIBOR Versions under the terms of the Benchmarks Regulation). We therefore proposed an exception for this form of use, in our Decision Consultation.

4.33. We received feedback to our Decision Consultation that there may be some contracts referencing one of the ceasing USD versions (the 1-week and 2-month USD LIBOR versions) that provide for moving to use of one of the Prohibited USD LIBOR versions directly upon cessation. In the form proposed in the consultation, our restriction would prevent these contracts from moving to the Prohibited USD LIBOR versions, as this would constitute new use of the Prohibited USD LIBOR versions. Enabling these fallback provisions to operate effectively reduces market disruption and is therefore desirable. We have therefore extended the exception referred to at 4.32 to include other use provided for in contractual fallback arrangements.

Ensuring users have access to suitable replacement benchmarks

4.34. Where adequate alternatives are not available, or are not widely used, the risks to consumer protection and integrity from shutting down access to the relevant markets by restricting new use of the ceasing benchmark might outweigh the risks set out previously. However, we consider that there are suitable replacement benchmarks available for the Prohibited USD LIBOR Versions.

4.35. Since SOFR's publication began in 2018, approximately $1trn notional in floating rate instruments tied to SOFR have been issued, of which about half is still outstanding. There has been similar progress in other asset classes, indicating that SOFR is now a viable alternative for these products.

International consistency

4.36. There is already consensus across international authorities that new use of the Prohibited USD LIBOR Versions must cease as soon as practicable, and by end-2021 at the latest.

4.37. In November 2020, US authorities issued supervisory guidance restricting new use of these US dollar LIBOR settings after end 2021. The guidance notes that new use of US dollar LIBOR after year-end and the associated consumer protection, litigation and reputational risks would create safety and soundness risks.

4.38. This guidance also sets out 4 specific circumstances when it would be appropriate for firms to enter into new contracts referencing the Prohibited USD LIBOR Versions after year-end (broadly speaking for 'risk management purposes').

4.39. The Financial Stability Board and IOSCO support this approach. Given the significant exposure of PRA / FCA regulated firms to US dollar LIBOR, we also set clear expectations for firms to cease new use of the Prohibited USD LIBOR Versions as soon as practicable and no later than the end of 2021, in line with the US supervisory guidance. This was communicated through a Dear CEO letter published in March 2021.

4.40. As a result, there is already a concerted and globally consistent supervisory expectation regarding stopping new use of the Prohibited USD LIBOR Versions.

4.41. Therefore, we think it is appropriate – and important – to align the prohibition on new use of the Prohibited USD LIBOR Versions and any exceptions with those in existing US supervisory guidance, where appropriate in the UK context. This would minimise the risk of confusion and possible regulatory arbitrage, which could occur if one jurisdiction's exceptions are considered different from another's.

4.42. As set out above, we consulted on including an extra exception compared with US supervisory guidance – for interpolation within contractual fallbacks – because of the way the definitions of 'use' work under the Benchmarks Regulation. Following feedback from the consultation, as per 4.33 above we are extending the exception to also include other use of the Prohibited USD LIBOR versions within fallbacks, where provided for in contractual fallback arrangements.

4.43. We also received feedback noting the difference between the Authority's powers and those of other authorities. Respondents noted the importance of alignment with other authorities, to avoid disadvantaging UK supervised entities and also disrupting liquidity in the international US dollar market.

4.44. We have made clear to firms our position in relation to LIBOR transition and conduct risks associated with the use of LIBOR, in terms of our supervisory approach and expectations. We have considered whether relying on a purely supervisory-led approach would meet our objectives in respect of the restriction of new use of the Prohibited USD LIBOR Versions. Having determined that it is appropriate to restrict new use of the Prohibited USD LIBOR Versions, we think we should use our new power under Article 21A of the Benchmarks Regulation to impose a legal restriction. Doing so provides clarity and certainty for the market in a way that a purely supervisory-led approach would not, and we think this is important in order to achieve our objectives in relation to restricting the new use of the Prohibited USD LIBOR Versions.

<u>The degree to which we can set out clear and practicable criteria for the market</u>

4.45. We received feedback from market participants on the importance of ensuring that any exceptions to a restriction on new use of US dollar LIBOR (for example, for 'risk management purposes') are clearly defined.

4.46. US authorities have already set out criteria describing where they consider new use of the Prohibited USD LIBOR versions after year-end would be appropriate.

4.47. Following feedback requesting more clarity, as described in paragraph 4.31 we are providing further detail in Annex 1.

5. EFFECTS OF THE PROHIBITION

5.1. Under Article 26A of the Benchmarks Regulation, supervised entities and supervised third country entities must comply with prohibitions and other requirements imposed on them by the Authority under the Benchmarks Regulation. If a supervised entity contravenes the Prohibition, it may be subject to enforcement action by the Authority.

6. PROCEDURAL MATTERS

6.1. This Notice is given under Article 21A(1) of the Benchmarks Regulation. It is published in accordance with Article 21A(7) of the Benchmarks Regulation.

6.2. This Notice is given to the Treasury pursuant to Article 21A(8)(a) of the Benchmarks Regulation.

FCA contacts

6.3. For more information concerning this matter generally, contact benchmarkspolicy@fca.org.uk.

Edwin Schooling-Latter
Director of Markets and Wholesale Policy and Wholesale Supervision, for and on behalf of the FCA

Clare Cole
Director of Market Oversight, for and on behalf of the FCA

Annex 1

Further Provision and Information in relation to the Prohibition and the Exceptions

1. The Exception in paragraph 1.2(1) of this Notice applies only where the market making referred to in that paragraph is undertaken in response to a request by a client seeking to reduce or hedge their US dollar LIBOR exposure on contracts entered into before 1 January 2022. The Authority recognises that market makers executing such trades for their clients may accumulate USD LIBOR risk as a result of this activity.

2. For the purposes of the Exception in paragraph 1.2(1) of this Notice, the Authority expects a market maker, where relevant, to make all reasonable efforts to ensure that the client is aware of the prohibition set out in this Notice and to engage with them on the extent to which they have taken the prohibition into account. The Authority does not expect a market maker executing trades for a client to validate on every occasion the intention of the client in relation to the proposed trade.

3. The Prohibition set out in paragraph 1.1 of this Notice does not prohibit new single currency USD LIBOR basis swaps entered into in the interdealer broker market (to the extent they would constitute new use).