ICMSA RESPONSE TO FCA CONSULTATION PAPER CP21/29
PROPOSED DECISIONS ON THE USE OF LIBOR (ARTICLES 23C AND 21A BMR)

Introduction to ICMSA response

1. The International Capital Market Services Association (ICMSA) is a London-based self-regulating organisation representing international financial and non-financial institutions active in the provision of services to the International Capital Market. Our membership includes universal banks, registrars, stock exchanges, law firms, the International Central Securities Depositories (ICSDs) and other service providers specialised in specific product segments. The primary purpose of the association is to foster the highest standards in the practice and management of international capital market services, thereby facilitating the efficient functioning of the market.

2. We welcome the opportunity to provide the views of the IBOR Transition Working Group of the ICMSA on the FCA's consultation paper 21/29 regarding the Proposed decision on the use of LIBOR (Articles 23C and 21A BMR) (the "**Consultation**").

3. We have responded to those aspects of the Consultation which most directly affect and impact our membership and give our views primarily from the standpoint of the international bond market, and in particular, with respect to legacy floating rate notes which reference LIBOR.

Q1: Do you agree with the manner in which we propose to exercise our legacy use power?

4. Yes, we agree with the manner in which the FCA proposes to exercise its legacy use power.

Q2: Do you have any other views or comments on our proposed exercise of our legacy use power?

Length of availability of synthetic LIBOR

5. Given the widespread use of LIBOR in the international capital markets throughout a range of bespoke contracts, it is likely to be challenging for the market to be in position to transition all legacy contracts before the end of 2022, being the point at which the FCA may consider introducing limitations or conditionality on the use of synthetic LIBOR. Indeed, given the well-known practical issues associated with transitioning bond contracts and the likelihood of successful consent solicitation exercises, it is possible that at least some legacy LIBOR bonds (notably those denominated in sterling) will be outstanding beyond the maximum 10-year period for which the FCA can compel IBA to publish synthetic LIBOR.

6. A particular issue of concern for the bond market is that a large number of legacy LIBOR bonds that will reference synthetic LIBOR are likely to contain Type 1 fallbacks. As noted in our response to the FCA's consultation CP21/15, the paying agents amongst our membership have flagged that there will be significant practical challenges in operating Type 1 fallbacks which were not designed to deal with a permanent cessation of LIBOR. The primary issue is that the reference bank polling mechanism which is central to such Type 1 fallbacks is no longer fit for purpose in an environment where reference banks are unwilling (and potentially unable) to provide the quotations on which the fallback provisions are based. See further Annex 1 to this response, which attaches a paper prepared by the ICMSA, highlighting the issues and concerns associated with the reference bank polling mechanism.

7. Therefore, whilst the FCA's proposed decision to permit unrestricted use of all six synthetic LIBOR settings in all contracts (other than cleared derivatives) for an initial one year period is welcomed, we urge the FCA to consider fully the practical and commercial challenges associated with

transitioning legacy bond contracts and operating Type 1 fallbacks when it is conducting its annual assessment of whether or not to continue to compel IBA to publish synthetic LIBOR.

Contractual continuity

8. Whilst the Critical Benchmarks Bill is drafted to capture references to LIBOR in as broad a manner as possible, a typical bond contract will require the agent which is responsible for calculating interest to take a LIBOR reading from a designated screen page at a specific time. It would therefore create significant practical difficulties for the Eurobond market if, for example, references to LIBOR were deemed to be changed to synthetic LIBOR, yet the publication of synthetic LIBOR was made in a manner different and at a different time to current and historic practice. In a similar manner, for the vast majority of floating rate debt contracts, agents are not generally afforded a discretion to choose between one or more rates displayed on a particular page, so it is important that only a single figure or value (which represents synthetic LIBOR) is published in line with current practice for LIBOR.

9. It is therefore critical that synthetic LIBOR is published on the same screens (including commercial providers' screens), in the same manner and at the same time as LIBOR in order to realise fully the benefits of the contractual continuity provisions introduced through the Critical Benchmarks Bill.

Q3: Do you agree that we have identified correctly the main groups of contracts that do not currently contain adequate provisions to deal with a prohibition on use?

10. We agree that the FCA has identified correctly the main groups of contracts that do not currently contain adequate provisions to deal with a prohibition on use. We read the phrase "bonds" to be construed as broadly as possible and therefore to include all types of capital markets debt obligations (excluding derivatives, which the FCA specifies separately), including but not limited to securitisations.

Q4: Do you have any views or comments on the rationale for our proposed legacy use decision?

11. We broadly agree with the FCA's rationale for its proposed legacy use decision.

12. The FCA has set out a number of criteria to support its rationale for its proposed legacy use decision. Our views and comments on certain of those criteria are as follows:

    a. "Available mechanisms for changing large volumes of contracts without making bespoke amendments" – we agree entirely with the FCA's observation in paragraph 3.20 of the response and note further that as a result of the consent solicitation mechanism, it may not be possible for all legacy bonds to be transitioned by the end of 2022, which may necessitate an extension to the FCA's permitted use of synthetic LIBOR beyond that point. See also our response to Question 2 above.

    b. "The nature of the parties to the contract" - given the wide distribution of a large proportion of bonds to investors in a number of different jurisdictions, it may not always be possible to engage investors across such a broad stage, in particular where legal restrictions may impact an issuer's ability to seek investor's consent (either at all or in a time/cost efficient manner). Therefore, it may be relatively simple to transition a privately placed bond held by limited numbers of known investors, but significantly more challenging in respect of publicly distributed bonds held across multiple jurisdictions.

We note in particular that in some cases (e.g., where there is a significant proportion of US investors[1] or an orphan securitisation with insufficient funds or resources to transition actively) the challenges faced by issuers to transition their capital markets debt on a voluntary basis are unlikely to be overcome by providing for more time to effect that transition.

c. "Evidence that similar contracts have been amended" – it is helpful that the FCA acknowledges that documentation, terms and provisions, and processes relating to contracts referencing LIBOR vary significantly. In relation to the bond market in particular, a wide variety of different fallback provisions have developed in an organic fashion, meaning that contracts which ostensibly achieve the same overall aim may be treated very differently depending upon the precise legal drafting. We also refer to the points made in the immediately preceding paragraph.

Q5: Do you agree with the manner in which we propose to exercise our new use restriction power?

13. Yes.

Q6: Do you have any comments on the proposed exceptions to the new use prohibition?

14. No.

Q7: Do you have any other views or comments on our proposed decision to exercise our new use restriction power?

15. No.

Q8: Do you agree that we have identified correctly the potential risks of new use of US dollar LIBOR?

16. Yes.

Q9: Do you have any views or comments on the rationale for our proposed decision to restrict new use?

17. No.

[1] This is because SEC rules requiring SEC registration of documentation for a deemed new issue of securities arising from a consent solicitation exercise are viewed by non-US issuers as onerous and costly and a significant barrier to involving US investors in consent solicitations. This means that bonds with a high proportion of US investors are very unlikely to be transitioned successfully at any time unless there were to be: (a) significant divestment by US investors; or (b) an SEC no-action letter allowing issuers to involve US investors in their consent solicitation exercise without the need to comply with the relevant SEC requirements

Annex 1

Type 1 Fallbacks with a Reference Bank mechanism

Introduction

In the RFR Working Group Bond Market Sub-Group meeting of 8 June 2021, an open question was asked as to what else could be done to assist with an orderly LIBOR transition. The ICMSA IBOR Working Group would like to flag concerns expressed by its members with the operation of Type 1 fallback provisions and, in particular, the obligation to seek quotations from one or more parties typically referred to as “reference banks”.

These mechanisms are most commonly seen in bond documents but are also present in other products and may be relevant in complex structures even where Type 2 or Type 3 fallbacks apply at the note level. The fallbacks and concerns outlined below are primarily relevant in the absence of a widespread and clear ability to use synthetic LIBOR such that the screen rate can continue to be used and reference bank fallback provisions are not activated.

Background

Type 1 fallbacks were designed to deal with temporary unavailability of LIBOR rather than an ongoing or permanent cessation. They were created on the theory that if there was a problem with provision of the centrally calculated LIBOR rate, then calculation agents could determine a simpler variant by approaching a number of reference banks directly in order to obtain directly their quotations (which would presumably be the same as were submitted for LIBOR).

There are many variations between the following aspects of Type 1 fallback wording:

- the number of reference banks to approach;
- the identity of those reference banks (in particular many contracts will refer to “leading banks” or “major banks” without giving further clarity);
- which party should approach the reference banks for quotations (there are many where the obligation falls on the issuer);
- the time and date at/on which the reference banks should be called;
- whether or not the highest and lowest quotations should be discounted; and
- what alternative rate to request a quotation on (i.e., if the bank will not quote the rate at which it would lend to another bank, then will it quote as to the rate that it would expect to borrow at).

Calculation agents have, for a number of years, flagged to issuers and legal counsel that there are real practical problems with the fallbacks in the context of the international bond market. In particular, following the LIBOR setting scandals which precipitated the present changes, reference banks have been extremely reticent to provide any quotations. Trading desks at banks are aware that the calculation agents who are contacting them to request quotations do not have actual funds to lend or borrow and that the rationale for the request is to set a rate on a third-party instrument – therefore there is no commercial impetus for a reference bank to provide such a quotation. For this reason, there are many more recent variants of the Type 1 fallback in which it is the obligation of the issuer, who may have better connections with reference banks, to obtain quotations. Very few versions of Type 1 fallbacks set out clear provisions on timing for when to move to the next fallback, which is typically the use of the last published or previously determined rate and which will result in the “fixed rate” scenario long discussed in the bond market.

The contractual provisions of the Type 1 fallbacks: (i) need to be individually reviewed in order to determine the exact obligations; (ii) are clear in terms of requiring actions; and (iii) are arguably unclear on when it is possible to move to the final fallback. Commercially, however, it has long been accepted by all market counterparties (and, it seems, regulators) that Type 1 fallbacks will result in a fallback to a previous rate so that the relevant instrument becomes, in effect, fixed rate.

Issues which may disrupt an orderly wind-down of LIBOR

ICMSA members are concerned as to the steps which are required in order to comply with the contractual obligations in seeking quotations in circumstances where reference banks are unwilling to provide quotations. There is litigation risk for issuers and calculation agents if a counterparty or noteholder were to argue that quotations were, or should have been, available and that it was not appropriate or correct to move to the final fallback step and determine a "fixed" rate.

To mitigate the litigation risk, issuers/calculation agents will need to demonstrate that they have taken actual, documented efforts to contact the trading desks at reference banks to seek quotations. Even where the obligation to obtain quotations is incumbent upon the issuer, calculation agents may require confirmations from issuers that they have not been able to obtain any such quotations as a prerequisite for moving to the next fallback. This same process will need to occur every day on an ongoing basis in respect of all floating rate securities which a calculation agent has in its books. Matters are further complicated if, by performing this reference bank polling process, calculation agents are deemed to create a benchmark and/or act as benchmark administrators under the BMR (i.e., activities for which they do not have the relevant regulatory permissions).

As it is anticipated that reference banks will systemically ignore requests from calculation agents or issuers, who will nonetheless be obliged to continue to make requests under the terms of a typical Type 1 fallback, there will be a significant amount of time and resource spent attempting to obtain quotations and documenting that it has not been possible to obtain them. Far from assisting with an orderly wind-down of LIBOR, the lack of clarity around Type 1 fallbacks has the potential to distract key market participants from this very objective. Indeed, the reference bank polling process seems to exacerbate the very issue which the transition from LIBOR is designed to remediate, so it is a counter-intuitive position that Type 1 fallbacks should continue to prevail in a post-LIBOR environment.

It is further noted that with less than six months until the demise of LIBOR, calculation agents with large books of tough legacy instruments need to act now in order to put in place a robust infrastructure to service their obligations to consult reference banks if a Type 1 fallback were to be triggered. Without clarity as to (i) the manner and scope with which synthetic LIBOR will be applied from 1 January 2022 and (ii) the need for an ongoing reference bank polling mechanism, calculation agents will need to divert significant resource to putting in place their contingency plans to ensure continued compliance with their contractual obligations under tough legacy instruments.

Potential solutions

Set out below are some suggested solutions and mitigants to the issues and risks identified above. The ICMSA would welcome the opportunity to discuss these matters further with the FCA and HMT (together, the "**Authorities**") with a view to achieving a workable solution to a problem which has the potential to affect significantly the orderly wind-down of LIBOR.

1 **Legislation** – legislation could be enacted which clearly and unequivocally addresses the following key issues:

- that references to LIBOR in all existing legacy contracts for all capital markets instruments (however drafted or described) should be interpreted as references to synthetic LIBOR;
- that reference banks are no longer permitted to provide LIBOR quotations in the context of rate-setting requests received by them for capital markets instruments; and

- that any related provision regarding quotations (whether related to the primary rate or a fallback) are to be considered without any force and effect. In this respect, and with a view to international consistency, we note that the legislation developed by the ARRC in the US has adopted the position automatically to disapply any reference bank polling provisions.

It is noted in particular that if any such legislation properly achieves the purpose set out in sub-paragraph (a) above, this is likely to significantly mitigate the risk that Type 1 fallbacks are activated and thus the need for reference banks to be engaged. As noted above, in the absence of clear guidance to this effect being provided in the near term, however, calculation agents with large books of tough legacy instruments need to make plans to satisfy their contractual obligations with effect from 1 January 2022 when LIBOR will no longer be available.

2 **Regulatory guidance** – in the absence of a legislative solution, the Authorities could consider publishing guidance or other official statements. Two suggestions are:

(a) The Authorities proactively contact all banks which might be considered as reference banks to ask for confirmations as to whether or not they would provide any rate-setting quotations. A subsequent statement clarifying that all banks have confirmed to the Authorities that they will not provide such quotations could be published.

(b) Similar to paragraph 1(b) above, the Authorities publish official guidance that reference banks are no longer permitted to provide LIBOR quotations in the context of rate-setting requests received by them for capital markets instruments.

Reference banks would be able to refer to any such publications/guidance in declining to provide quotations on an ongoing basis. Similarly, with the support of appropriate legal advice, calculation agents can refer to these statements as ongoing evidence as to unavailability of reference bank quotations in the context of their contractual obligations to source such quotations under a Type 1 fallback provision.

3 **Formal reference bank quotation mechanism** – if the Authorities consider that a reference bank polling mechanism is still required/necessary (e.g., after having undertaken the exercise referred to in paragraph 2(a) above), the FCA provides a mechanism for the names and contact details of those banks which are willing and able to provide quotations, to be provided to calculation agents and others in the market which require a similar service. This has the advantage of creating a centrally controlled mechanism for rate-setting purposes and avoids the concerns expressed above that calculation agents are seen to be creating a benchmark and/or acting as benchmark administrators under the BMR.