

Statement of Policy on the FCA's power under Article 21A BMR

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1 Introduction

Summary

- 1.1** Our overview document sets out the background to the Benchmarks Regulation ('BMR') and the amendments to it made by the Financial Services Act 2021 ('FS Act'). These amendments give us enhanced powers for managing the orderly wind down of critical benchmarks.
- 1.2** Article 21A of the BMR gives us the ability to prohibit some or all new use of a critical benchmark when we have been notified by its administrator that it will cease to be provided. We call this the 'new use restriction power'.
- 1.3** Restricting new use of a critical benchmark which is ceasing could help reduce the risk of it being misused, or of unnecessary risk to market integrity from creating new exposures, during a wind-down period. We can only exercise our new use restriction power where we consider that doing so would advance either or both of our consumer protection and integrity objectives.
- 1.4** Under Article 23F(1)(a) of the BMR, we must publish a Statement of Policy before we exercise our Article 21A new use restriction power. We must have regard to this Statement of Policy when exercising the power and are obliged to explain how we have done so.
- 1.5** We published a consultation on our proposed policy on 20 May 2021. Having considered and taken account of the feedback received, the following Statement of Policy sets out factors we consider may be relevant when we make decisions to exercise our new use restriction power. Not every factor will always be relevant. They might not all be considered or applied in every instance. The list of factors is not exhaustive. The prevailing circumstances at the time of the decision may make it desirable or appropriate to only take account of some of these factors, or to take account of additional or alternative factors or both.
- 1.6** We will issue a revised Statement of Policy in future if our policy changes.
- 1.7** Both the Financial Stability Board (FSB) and the UK's Financial Policy Committee have been monitoring interest rate benchmark reform for several years. The financial stability and integrity implications of critical benchmarks possibly ceasing in a disorderly manner are well understood, and the policy set out below seeks to reflect and take account of them.

Outcome we are seeking

1.8 We will seek to exercise our new use restriction power in a manner that is desirable to advance either or both of our statutory objectives to:

- secure an appropriate degree of protection for consumers
- enhance the integrity of the UK financial system

In considering what degree of protection for consumers may be appropriate, we must have regard to a number of matters set out in the Financial Services and Markets Act 2000 (FSMA), in section 1C(2).

The 'integrity' of the UK financial system includes its soundness, stability and resilience and the orderly operation of the financial markets, as defined under section 1(D) of the FSMA.

Who this affects

1.9 We expect that this Statement of Policy will be of interest to administrators and potential users of critical benchmarks, whether those users are regulated or unregulated. This includes:

- banks and building societies
- investment managers
- life insurance and pension providers
- mortgage lenders and intermediaries
- corporates of all sizes
- consumers who may have or need access to mortgages or other consumer loans that use critical benchmarks

What we will do next

1.10 We will have regard to this Statement of Policy when deciding whether and how to exercise the Article 21A new use restriction power.

1.11 We will use information from market participants and their representatives, as well as relevant available data, when applying our policies. Where necessary we will make assumptions and estimates based on the information available to us.

2 Statement of Policy

- 2.1** Where the administrator of a critical benchmark has notified us that the benchmark will cease to be provided, Article 21A of the BMR gives us the ability to prohibit some or all new use of the benchmark by supervised entities during any wind-down period.
- 2.2** Our new use restriction power can be exercised in relation to any ceasing critical benchmark, except where the benchmark has already been found to be unrepresentative and designated as an Article 23A benchmark – in which case all new use within scope of the BMR will be prohibited by Article 23B(1). So this restriction could be applied to a critical benchmark while it remains representative.
- 2.3** This policy is limited to situations in which the administrator intends that the benchmark will cease to be published in the future. It does not address situations in which the administrator intends to transfer the administration of the benchmark to a new administrator.
- 2.4** We can only exercise our new use restriction power where we consider that this would advance one or both of our consumer protection and integrity objectives. So first we will consider the potential risks to consumer protection and integrity if we do not exercise our power.

Defining terms

- 2.5** 'Use of a benchmark' is defined at Article 3(1)(7) of the BMR. It can be used for financial instruments, financial contracts and investment funds. For ease of reference, throughout this Statement of Policy we refer to use in 'contracts': by this we mean 'use in financial instruments and financial contracts and by and for investment funds'. Please read 'user' in the same way.
- 2.6** Article 21A(2) of the BMR explains what is meant by 'new use'.

Assessing consumer protection and integrity risks

- 2.7** Supervised entities using a benchmark are required by Article 28(2) of the BMR to have robust fallbacks that operate when a benchmark ceases (and if there is a material change to the benchmark). Despite this, we think that any of the following factors (or a combination of them) could still mean that new use of a ceasing critical benchmark could pose potential risks to consumer protection and/or integrity:

- **Resilience – system wide operational risk**

Given the scale of use of critical benchmarks, if new use does not move to alternatives ahead of the critical benchmark ceasing, there could be a more risky cliff edge when the benchmark ceases. This is because both new and legacy use of the benchmark would be moving to alternative benchmarks at the same time. The consequences of this could be, for example:

- greater difficulty in building liquidity in markets based on alternative benchmarks ahead of cessation, with less confidence in price formation or greater transition costs as a result
- less readiness for and experience of operating with alternative benchmarks, with changes in firms' internal operations being implemented at a single point rather than phased in, leading to increased risks to market integrity

A 'big bang' transition of this sort could introduce operational risk into the financial system. This could potentially prevent market infrastructure from functioning effectively or in an orderly way and prevent firms from serving their customers efficiently and effectively. We may consider that a staged transition, where some or all new use of the benchmark is prohibited before the benchmark ceases, better supports an orderly transition away from the benchmark because it helps ensure readiness for cessation.

- **Financial stability – the nature and/or degree of activity in the market(s) underpinning the benchmark**

As set out in the FSB's report 'Reforming Major Interest Rate Benchmarks' (pg13-14), a high volume of use of a benchmark may create financial stability risks, and these risks are particularly acute where this is combined with low levels of activity in the market(s) underpinning the benchmark. This is often referred to as the 'inverted pyramid' issue (ie a large base balancing on a small point). If we are concerned about the current or future proportionality of the use of the ceasing benchmark and the size of its underlying market, we might limit increases in the overall volume of contracts relying on the ceasing benchmark, by restricting new use.

- **Orderliness – whether the benchmark is expected to remain representative for the entirety of the wind-down period**

If we do not expect the benchmark to remain representative for the entire wind-down period, we might consider how likely it is that its representativeness would be restored. A benchmark that is permanently unrepresentative is not suitable for use in new contracts, and we could potentially designate it as an Article 23A benchmark. In this case, **all** use would be prohibited. So where representativeness is, or could be, at risk, we might prevent new use of the ceasing benchmark, to reduce any cliff edge if we made an Article 23A designation later.

- **Orderliness and consumer protection – 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**

Unexpected changes such as volatility or liquidity impacts could arise from a variety of factors. This is more likely where the benchmark is ceasing. For example:

- the benchmark could become volatile due to deteriorating quality of input data or other market circumstances, or
- liquidity in markets using the benchmark could decline

This could create possible market disruption or consumer harm.

- **Orderliness and resilience: adequate confidence and liquidity in alternative benchmarks and market preparedness to use them**

Where alternative benchmarks are available but are not widely used, new use of the ceasing benchmark may prevent the necessary liquidity from developing in alternatives before it ceases. This could affect market functioning.

Where adequate alternatives are not available then it may, however, be important to allow some or all new use of the ceasing benchmark for a period while alternatives develop.

Whether and how to exercise our new use restriction power

2.8 When reaching a view on whether exercising our new use restriction power would potentially advance our objectives:

- For the consumer protection objective:
 - We consider that we would be **able** to intervene if the above factors affected **any** consumer such that it posed a potential risk to an appropriate degree of consumer protection.
 - However, our primary concern will be to provide an appropriate degree of consumer protection for retail consumers of benchmarks (ie, consumers of benchmarks who are individuals not acting in the course of their trade or business). We will be more likely to intervene on consumer protection grounds for retail consumers of benchmarks than for non-retail consumers.
 - We are likely to intervene where the harm to retail consumers may be widespread and prevalent.
- For the integrity objective, there would need to be enough potential new use for the above factors to cause possible disruption to relevant market(s) or risks to financial stability. As this power only applies to ceasing critical benchmarks, which are those used extensively in the financial system, we expect that in most cases there would be enough potential new use to justify our intervening where any of the above factors are met. However, we would assess this case-by-case based on information available to us on the current scale of new use of the benchmark.

2.9 If we determine that intervention may be desirable, **we may consider a limited form of restriction**. For example, we might consider whether restricting new use of a ceasing critical benchmark may only be appropriate:

- for certain contract maturities, such as those that mature after the benchmark will cease
- for certain types of product, user or activity, such as market participants or products which could help build liquidity in alternative benchmarks or are not needed to manage risk related to outstanding positions, or
- after a defined time period, such that new use restrictions would come into effect after a certain amount of time

Further considerations

2.10 In deciding whether and how to exercise the power we would also consider whether not restricting some or all new use of the ceasing benchmark might support our objectives. The following 2 considerations are likely to be relevant:

- **Orderliness and resilience: reducing exposure to the ceasing benchmark**

Some new use of the ceasing benchmark may support our integrity objective, where the new use is aimed at:

- managing down legacy exposures to the benchmark (for example, where new use is needed to unwind an existing legacy exposure)
- mitigating other risks arising from legacy exposures to the benchmark (for example, new use that maintains market participants' ability to risk manage a legacy exposure effectively), or
- other purposes aligned with our objectives for the market to be operationally prepared and resilient to the benchmark ceasing

- **Orderliness and consumer protection: ensuring users have access to suitable replacement benchmarks**

Where adequate alternatives are not available, 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 at 2.7.

Where alternatives are available but not widely used, we might balance the need to develop liquidity in markets referencing alternative benchmarks with the impact on supervised entities and other parties of having to operate in markets with lower liquidity if we restricted use of the outgoing critical benchmark at an early stage.

Where there are widely used alternatives available, operational changes may still be required to use the alternative benchmarks in some markets.

2.11 Further relevant factors we would take into account when deciding whether to exercise our new use restriction power are:

- **International consistency**

We think international consistency is likely to be desirable and so we might consider whether, and if so how, overseas authorities are taking action that would have similar effects in their jurisdiction. In particular, we might consider any impact of our intervention on UK markets and market participants if other authorities are not planning to act. For example, whether it could significantly affect UK market participants' ability to participate in cross-border business, access to liquidity, and ability to hedge.

- **The degree to which we can set out clear and practicable criteria for the market**

Users need clarity on whether they can continue to use the ceasing benchmark in new contracts. If users are uncertain about this, it could lead to market disruption and a threat to consumer protection. Where we are proposing to restrict some but not all new use of the ceasing critical benchmark, we will consider whether and how we can reflect the activities, classes and/or characteristics of contracts that should fall within the restriction in criteria that are readily understandable by users and can be easily put into practice.

2.12 If we decide to exercise our new use restriction power, we would need to decide when the restriction would apply. We may consider the time that market participants have had to plan ahead, alongside other relevant factors set out above. For example, a shorter implementation period might be appropriate if the market was already aware that the benchmark was likely to cease, before the cessation date was confirmed.

