

Statement of Policy on the FCA's power under Article 23C 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 the FCA enhanced powers for managing the orderly wind down of critical benchmarks.
- 1.2** Article 23A of the BMR grants us the ability, in certain circumstances, to designate a critical benchmark as an Article 23A benchmark. This designation will result in automatic prohibition on supervised entities using the benchmark under Article 23B(1) of the BMR.
- 1.3** However, Article 23C(2) gives us the power to permit some or all legacy (ie existing) use of the benchmark to continue. For ease of reference we call this the legacy use power.
- 1.4** This power could help reduce disruption that would otherwise occur from a prohibition on use of an Article 23A benchmark. That is particularly important for parties to legacy contracts that have no or inappropriate alternatives to the benchmark in the contract, and no realistic ability to renegotiate or amend the contract to remove reliance on the benchmark.
- 1.5** Under Article 23F(1)(c) of the BMR, we must publish a Statement of Policy before we exercise our legacy use power. We must have regard to this Statement of Policy when exercising our power and we must explain how we have done so.
- 1.6** We published a consultation on our proposed policy on 20 May 2021. We have considered and taken account of the feedback received. The following Statement of Policy sets out factors we consider may be relevant when making decisions about whether and how to exercise our legacy use power. Not every factor will always be relevant, and we might not consider or apply them all in every case. The list of factors is not exhaustive. The prevailing circumstances at the time we make the decision may mean it is appropriate to only take account of some of these factors, or take account of additional or alternative factors or both.
- 1.7** We will issue a revised Statement of Policy in future if our policy changes.
- 1.8** We discourage the use of permanently unrepresentative benchmarks where appropriate alternatives are available. Users should seek to move away from using them where practicable. This informs our current supervisory approach to firms' use of benchmarks. The policy set out below reinforces this approach.
- 1.9** 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

1.10 We aim to exercise our legacy use power in a way that helps to advance either or both of our statutory objectives to:

- secure an appropriate degree of protection for consumers
- protect and 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), 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

1.11 We expect this Statement of Policy will be of interest to administrators and users of critical benchmarks, whether or not those users are regulated.

1.12 While our legacy use power will directly affect only entities and contracts within scope of the BMR, non-supervised entities such as non-UK firms, non-financial corporations or retail consumers may be party to existing contracts that are affected by a prohibition on use of an Article 23A benchmark. Such prohibition, if not overridden through the exercise of our legacy use power, may trigger or otherwise interact with contractual terms or fund management measures and/or documents that apply to both parties.

1.13 Users of critical benchmarks include:

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

What we will do next

1.14 We will have regard to the Statement of Policy below when deciding whether and how to exercise the Article 23C legacy use power.

1.15 We will use information from market participants and their representatives, as well as our available relevant 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** An Article 23A benchmark is a benchmark that is permanently unrepresentative of the market it is intended to measure and is in the process of being wound down. Article 23B(1) of the BMR prohibits its use.
- 2.2** However, Article 23C(2) of the BMR empowers the FCA to permit some or all 'legacy' (existing) use of the benchmark to continue, where this would advance one or both of our consumer protection and integrity objectives. For ease of reference we call this the legacy use power.

Defining Terms

- 2.3** '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 feedback statement 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.
- 2.4** Article 23C(10) of the BMR explains what is meant by legacy use of a benchmark.

Contractual fallbacks

- 2.5** When referencing a benchmark in a contract it is always good risk management practice to include a provision setting out what should happen if that benchmark ceases or undergoes a material change.
- 2.6** Article 28(2) of the BMR reflects this by requiring supervised entities using benchmarks to have robust written plans for the action they would take in these circumstances. These plans should provide for a range of potential situations, including where a critical benchmark is declared to be permanently unrepresentative. The plans should specify an alternative benchmark where this is feasible and appropriate and should be reflected in contractual relationships with clients.
- 2.7** Contracts that supervised entities entered into after this BMR provision came into force (on 1 January 2018) should contain contractual provisions that move the contract to use an alternative benchmark if a benchmark becomes permanently unrepresentative. Therefore, they should continue to function even if there is a prohibition on use of an Article 23A benchmark.
- 2.8** Where contracts that are within scope of the BMR were entered into before the provisions of Article 28(2) came into force, firms should be amending them 'where practicable and on a best-effort basis' (see [Q&A 8.1](#)).

Potential risk to consumer protection and integrity

2.9 A prohibition on legacy use of the Article 23A benchmark could pose a threat to one or both of our consumer protection and integrity objectives, where contracts either:

- do not contain a provision that moves them away from the Article 23A benchmark at or before the point of the prohibition coming into effect, or
- contain a provision that will take effect if the benchmark can no longer be used, but that effect would be inappropriate (eg unintended, unfair, or disruptive) or inoperable

Either of these situations could potentially create market disruption, a threat to consumer protection, and/or financial instability.

2.10 Accordingly, our first consideration will be **the scale and the nature of legacy contracts that do not have adequate provisions** to deal with a prohibition on use.

2.11 On consumer protection:

- We will be able to intervene if any contract(s) without adequate provisions pose potential risk to an appropriate degree of consumer protection.
- However, our primary concern is to provide an appropriate degree of consumer protection for retail consumers of benchmarks. That is, 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.

2.12 With regard to our integrity objective, there would need to be enough contracts without adequate provisions potentially to cause disruption to relevant market(s) or risks to financial stability for us to intervene.

Actual risk to consumer protection and integrity

2.13 The potential risk identified could be avoided if contracts are amended, terminated or replaced, to remove reliance on an Article 23A benchmark, before or when the prohibition comes into effect. Where it is feasible, we expect firms to do this. However, there may be legal, regulatory or structural obstacles, or major operational challenges, to making these amendments.

2.14 Therefore, the second consideration we will take into account is **whether and to what degree it is feasible for parties to amend these contracts, or to otherwise remove reliance on the benchmark**, in a way that delivers fair outcomes.

2.15 The following factors are likely to be relevant to determining this:

- **Appropriate alternatives:** whether there are alternative benchmarks to which firms can refer in their contracts, and which would be appropriate and fair replacements. We may take account of how widely these are used and the terms on which parties can secure access to them; and whether there is a need to build liquidity and confidence in these rates.

- **Ease of amending the contract:** the number of parties to the contract and how many of them must consent to change it, the ease of identifying the relevant parties, and the type of legal, regulatory and operational procedures required for the relevant parties to consent. For example, this may not be feasible if a contract is held by a very large number of parties and all of them must consent to the amendment, such as through a defined consent solicitation process.
- **Available mechanisms for changing large volumes of contracts** without making bespoke amendments – eg whether industry practice provides standard documents or mechanisms, or both, to allow multiple contracts to be amended at once.
- **The nature of the parties to the contract** for instance, whether they are retail consumers, or small or medium-sized enterprises (SMEs). Their likely awareness, knowledge and understanding of Article 23A designation, and the process for amending the contract, may have an impact on how willing they are to engage with efforts to amend the contract and agree to any amendments.
- **The effect of the prohibition on use on parties** who must consent to, or be involved in, amending the contract, and whether the prohibition on use affects parties differently to create misaligned incentives to amend the contract on fair terms. For example, only some of the parties may be subject to the prohibition (eg one might be a non-UK firm), and the contract terms may penalise these parties if the prohibition means they are unable to fulfil their obligations under the contract. This would place them at a disadvantage in negotiations to amend the contract terms, because other parties would not face the same penalties. Or, amending the contract might rely on, or require the consent of, a third party not affected by the prohibition.
- **Evidence that similar contracts have been amended**, suggesting that amendments are feasible – noting that similarities between products does not necessarily always indicate similarity between contract terms.
- **How much notice the parties have had of the prohibition**, or of the likelihood that this type of prohibition could take effect.
- **Whether the contract is structurally and/or explicitly linked to other use of the benchmark, and this creates a barrier** to amending the contract. For example, if a derivative is embedded within a structured transaction, and other components cannot make the transition, we might need to permit use for the derivative to maintain the precise cashflow.

2.16 We will take account of the scale and nature of contracts that cannot feasibly be amended, or otherwise remove reliance on the benchmark, when judging the actual risk to consumer protection and integrity, and whether exercising our legacy use power would advance our objectives.

Further considerations

2.17 Other important factors we consider may be relevant when reaching a view on whether and how to exercise our legacy use power are:

- **The effect of permitted legacy use on the robustness and/or the sustainability of any benchmark used as an input to the Article 23A benchmark.** As set out in the FSB's report 'Reforming Major Interest Rate Benchmarks' (pp.13-14), a high volume of use of a benchmark may create financial stability risks. These risks are particularly acute when combined with low levels of activity in the markets that

underpin the benchmark. This is often referred to as the 'inverted pyramid' issue – a large base balancing on a small point.

It is possible that another benchmark could be used as an input to an Article 23A benchmark, for example, the Article 23A benchmark is calculated by adding a spread or mark-up to another benchmark. This might be the result of us exercising our power to require changes to an Article 23A benchmark, including changes to its methodology. Where this is the case, we may take account of the following for the benchmark being used as an input to the Article 23A benchmark:

- **Liquidity in the market(s) underpinning it.** The benchmark being used as an input to the Article 23A benchmark could be an appropriate alternative to the Article 23A benchmark. If this is the case, permitting a class or category of contracts to use the Article 23A benchmark could keep those contracts from moving to the benchmark used as an input, and stop them generating new liquidity in the market underpinning that benchmark. In these circumstances, we might consider it would not be appropriate to permit this.
- **Overall volume of use.** If another benchmark is being used as an input to an Article 23A benchmark, then use of the Article 23A benchmark is also an indirect use of the benchmark being used as an input. When we consider how much use of the Article 23A benchmark it is appropriate to permit, we will take account of the likely impact of permitted use on the overall volume of use of any benchmark being used as an input – including indirect use. We will also consider whether this is proportionate to the level of activity in the market underpinning the benchmark being used as an input.
- **International consistency.** We think international consistency is likely to be desirable. As a result, we might consider whether or not overseas authorities are taking action that would have a similar effect in their jurisdiction.
- **Whether contracts are required by law or regulation to contain suitable fallback provisions which mean they should not be negatively affected by the prohibition,** for example, whether they are subject to the requirements of Article 28(2) of the BMR). We know there may still be scenarios where we might need to intervene to address potential consumer protection or integrity risks that could arise from a prohibition on use, perhaps because of non-compliance with Article 28(2). However, we may consider whether we can and should use our power to help bring about compliance. For example, we might permit legacy use for a transitional period but with conditions aimed at addressing the non-compliance.
- **The degree to which we can set out clear and practicable criteria for the market.** Users need clarity and certainty on whether they can or cannot continue using the Article 23A benchmark. As set out above, uncertainty for users could lead to market disruption, a threat to consumer protection and possibly financial instability. We would consider whether and how we could distinguish with clarity and certainty the classes and characteristics of contracts for which we would allow use, from those where a prohibition would remain in place.

Potential limitations and/or conditions on permitted legacy use

- 2.18** If we consider that permitting legacy use would advance our objectives, we may consider whether permitting a limited form of use might be appropriate in some cases. For example, users may be able to amend their contracts, or otherwise remove reliance on the Article 23A benchmark, if we permit firms to use the benchmark for a time-limited period after the prohibition takes effect. Another example might be limiting permitted legacy use to those who have offered their contractual counterparties a fair and reasonable option to amend the contract.

