Lord Agnew Kt
Minister of State
HM Treasury and Cabinet Office
1 Horse Guards Road London SW1A 2HQ

House of Lords
London
SW1A 0AA

20 October 2021

Dear Lord Sharkey, Lord Eatwell and Baroness Noakes,

CRITICAL BENCHMARKS (REFERENCES AND ADMINISTRATORS' LIABILITY) BILL

I am writing to you following the Second Reading debate on the Critical Benchmarks (References and Administrators' Liability) Bill on 13 October. I would first like to thank you again for your engagement on this important Bill. The UK, as the home jurisdiction of LIBOR's administrator, has an important role to play in minimising global financial stability risks and disruption to financial systems from the wind-down of LIBOR. This Bill is an important part of ensuring that smooth transition.

I committed to write to you in response to several questions you raised during the debate.

Lord Sharkey asked about contracts that might never be able to transition away from LIBOR. As you know, the legislative framework put in place by the Financial Services Act 2021 allows the Financial Conduct Authority (FCA) to put in place a synthetic LIBOR rate for up to 10 years. This approach provides a safety net to relevant contracts that have been unable to transition before the end of the year. At this stage, the government is not in a position to speculate about whether there may be any contracts which have not transitioned or naturally run-off by the end of the temporary synthetic LIBOR period. However, the government will work closely with the FCA and the Bank of England to support an orderly wind-down of LIBOR and will continue to monitor the risks in this area.

Lord Sharkey also asked if the government expects the FCA to exclude any other categories of contracts from being able to use synthetic LIBOR, other than those set out in the FCA's open consultation on this topic. The FCA's consultation, published on 29 September, proposed to permit legacy use of LIBOR in all contracts except cleared derivatives, which the FCA is confident have adequate fallback provisions due to conversion mechanisms that will be implemented by clearing houses, and so will be transitioned to alternative rates. The FCA consultation on this approach closes on 20 October, and they will take account of consultation responses before finalising the decision as soon as is practicable. I am sure that you will appreciate that the government cannot pre-empt the outcome of the FCA's consultation, nor comment on the FCA's independent decisions on this matter.

Lord Sharkey also asked about the potential for “disturbances and dispute” as a result of any difference between the current LIBOR rate and what LIBOR will be under the FCA’s synthetic methodology. Constructing a synthetic rate is of course the responsibility of the FCA, and it has undertaken extensive consultation and engagement to agree on how a synthetic LIBOR rate should be calculated. The FCA is clear that its chosen methodology will, in the medium term, broadly produce the same economic outcomes as panel-bank LIBOR but smoothed to reduce day-to-day changes which result from changes to the credit spread.

If a consumer is not content that synthetic LIBOR is the appropriate interest rate benchmark for their contract, they can contact the product provider, or contractual counterparties, to seek to transition the contract to an alternative benchmark. The FCA has selected a 5-year historic median for the credit spread following consultation, to ensure that the fixed credit spread could not have been manipulated by large volumes of transactions over a short time period before it was set. This approach aligns with the global consensus that has been supported by international regulators and adopted voluntarily by many market participants in their own transition arrangements. The FCA continues to emphasise the importance of active transition away from LIBOR leading up to and after end-2021. It is ultimately up to firms to decide which replacement rate to use (for example SONIA, or Bank Rate), but the FCA has been clear that they must treat their customers fairly throughout transition. The FCA’s communications[1] set out that they expect all firms to identify and mitigate conduct risks, including in relation to SME customers, as part of their LIBOR transition programmes. The FCA stands ready to take the necessary action to intervene where it has evidence of customers not being treated fairly through this process.

The FCA’s technical note (circulated alongside the letter from the Economic Secretary to the Treasury of 6 October) also sets out that the International Swaps and Derivatives Association (ISDA) consulted on the idea of an option which smooths the move to the fixed credit spread, however, that option was rejected largely because it was considered that the increased operational difficulty and complexity was disproportionate to the benefit.

More broadly, as the FCA’s technical note makes clear, it is common for the LIBOR rate to vary significantly over time, and so the move to the historical average is not likely to be disruptive for markets. In relation to Lord Sharkey's question about the potential biggest difference or ‘upper bound’ between synthetic and panel bank LIBOR, it is obviously difficult to speculate on what the exact difference between synthetic and panel bank LIBOR will be on the day that panel bank LIBOR ceases. However, as set out in the FCA’s technical note, we are clearly at a moment of extremely low cost of credit largely as a result of monetary policy measures taken to ease the economic effects of the pandemic. I note that the overall impact of the prospective change at end 2021 is small relative to the range in which LIBOR has moved in over the past two years. Furthermore, I agree with the FCA’s analysis that we would expect the synthetic rate to be a fair and reasonable approximation of the panel bank rate over the medium term.

Lord Sharkey and Baroness Noakes also asked why the government has not included a so called “safe harbour” protection for contracts, similar to the approach taken in New York state. I am aware that some industry stakeholders have called for a restriction on parties’ rights to dispute the terms of their contracts on the basis that the FCA’s imposition of a change to LIBOR might somehow invalidate their contract.

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[1] https://www.fca.org.uk/publication/correspondence/dear-smf-letter-next-steps-libor-transition.pdf

It is the government's view that this Bill comprehensively addresses this risk of legal uncertainty, in a proportionate way, while not interfering with other valid claims. The government considered other approaches, including those taken in other jurisdictions. However, as a matter of policy the government does not think that it would be appropriate or proportionate to prevent parties' ability to seek legal redress via the courts for other issues that may arise under affected contracts.

Specifically, the Bill is clear that that references in contracts to a critical benchmark include that benchmark in its synthetic form. Furthermore, by providing in this Bill that contracts are to be interpreted as having always provided for the synthetic form of the benchmark to be used once the benchmark existed in that form, the government has sought to address the risk of a party arguing that the use of the synthetic benchmark constitutes a material change to a contract, or even that it has frustrated the purpose of the contract.

Finally, where contractual parties have acted in line with regulatory expectations to transition the relevant contract to a fair alternative rate, the government does not see that there is a need for further legislative clarity about the validity of such an approach. Constructing a synthetic rate is of course the responsibility of the FCA, and as Baroness Noakes rightly stated, any resulting difference in rate will be out of the control of the parties to the contract.

I also committed to respond to the points raised by Lord Eatwell, and in particular the question of whether the government has considered compensating people who may initially pay a higher rate as a result of the transition to synthetic LIBOR.

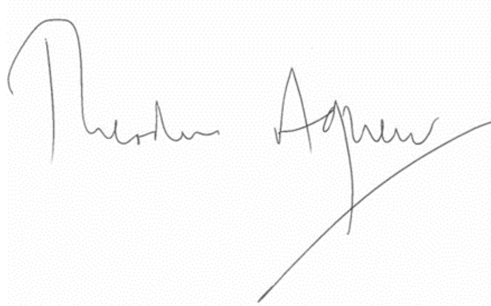
Before I turn to the question of compensation, I think it is important to clarify what any such compensation could be for. There is of course no direct connection between the provisions in this Bill and the attempted manipulation of LIBOR which came to light in 2012. In light of the 2012 scandal, significant improvements were made to the administration and governance of LIBOR, including those recommended in the Wheatley Review and implemented through the Financial Services Act 2012. The UK regulatory regime for benchmarks (including LIBOR) was replaced by the Benchmarks Regulation in January 2018. There is no question of consumers now facing the costs of LIBOR manipulation, nor is this Bill seeking to offer any immunity to those involved in manipulation. As I said in the debate, the reason for transitioning away from LIBOR is because the underlying market which LIBOR seeks to measure is no longer sufficiently active, meaning that LIBOR has increasingly been based on expert judgments rather than actual transactions.

The FCA's synthetic rate seeks to provide a reasonable and fair approximation of what LIBOR would have been had it continued to be based on panel bank contributions, based on a 5-year historical average. It would not be fair to borrowers with contracts referencing other rates – such as the Bank of England Base Rate, which is far more commonly referenced in UK mortgages than LIBOR – to offer compensation to a group of borrowers for a transition to a fair rate based on historical averages.

In fact, as I mention earlier in this letter, the FCA's chosen methodology will benefit mortgage holders and other retail borrowers, who will no longer be exposed to wide variations in the spread element of LIBOR, which is impacted by perceived changes in bank creditworthiness or liquidity conditions in wholesale funding markets. I hope that you find the information provided in this letter helpful. I am sure you will agree with the importance of this legislation for markets and consumers with LIBOR-referencing contracts, and I look forward to discussing the Bill further at Committee stage.

I am copying this letter to all the Peers who took part in the Second Reading debate, and other interested Peers, and I am placing a copy in the Library.

Yours sincerely,



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