

## ***Critical Benchmarks (References and Administrators' Liability) Bill***

### **Memorandum from Her Majesty's Treasury to the Delegated Powers and Regulatory Reform Committee**

#### **Introduction**

1. This memorandum has been prepared for the Delegated Powers and Regulatory Reform Committee to assist with its scrutiny of the Critical Benchmarks (References and Administrators' Liability) Bill ("the Bill"). The Bill was introduced in the House of Lords on 8<sup>th</sup> September 2021. This memorandum identifies the provision in the Bill that confers powers to make delegated legislation, why these powers have been taken and the nature of, and the reason for, the procedure selected.

#### **Purpose and effect of the Bill**

2. Benchmarks are indices that are used in a wide range of markets to help set prices, measure performance, or work out amounts payable under contracts. The provision and use of benchmarks is regulated under the Benchmarks Regulation<sup>1</sup>. "Critical benchmarks" are those benchmarks that are the most systemically important and widely used across the economy. LIBOR is currently the only benchmark that is designated as a critical benchmark under the Benchmarks Regulation. LIBOR is an interest rate benchmark, which measures the average interest rate banks pay to borrow from the unsecured wholesale lending market. LIBOR is published for five different currencies, and in each currency a rate is published for seven different time periods (from overnight up to one year). It is estimated to be referenced in approximately \$300 trillion of financial contracts globally.
3. The LIBOR benchmark is currently in the process of being wound-down, and most LIBOR rates are due to cease at the end of 2021, when the banks that contribute to the production of the benchmark cease submitting input data to LIBOR's administrator. However, the cessation of a critical benchmark, such as LIBOR, could incur financial losses to consumers and impact market stability if not managed appropriately. The cessation of certain LIBOR rates after the end of 2021 would pose a particular problem for those contracts that run beyond the end of 2021, but which cannot transition away from LIBOR, for example due to constraints within the terms of the contracts. These contracts are called "tough legacy" contracts.
4. In light of the systemic risk posed by "tough legacy" contracts, the Financial Services Act 2021 ("FS Act 2021") amended the Benchmarks Regulation to provide the FCA with the necessary powers to oversee an orderly market-led transition away from the LIBOR benchmark. This includes powers to require the firm which administers LIBOR to continue publishing the benchmark using a "synthetic" methodology for a period of up to 10 years. This is for the benefit of those "tough legacy" contracts that are not able to transition away from LIBOR before the end of 2021, the point at which most LIBOR rates will cease to be published based on data from the unsecured inter-bank lending market.

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<sup>1</sup> Regulation (EU) 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. This Regulation has been retained in UK domestic law by virtue of the European Union (Withdrawal) Act 2018

5. Following the introduction of the FS Act 2021, industry representatives approached the Government raising concerns that, without further legislative clarity, the change in LIBOR's methodology could result in uncertainty and legal disputes between parties to contracts that will continue to reference LIBOR after a synthetic methodology is applied. There is a real risk that some contractual parties would seek to exploit this uncertainty. The Government committed to explore this matter further and, given the complexity and wide-ranging impact of the matter, published a consultation in February 2021. Following this consultation, the Government determined that further legislation is necessary in order to address residual risks of legal uncertainty and disputes, and market disruption resulting from the exercise of the FCA's powers to wind-down LIBOR, and to ensure that we are prepared for the possibility of the need to wind-down other critical benchmarks in future.
6. The delegated powers in this Bill are contained in clause 1.

**Summary of clause 1, which inserts Articles 23FA and 23FB into the Benchmarks Regulation, to make provision regarding interpretation of references to benchmarks in contracts and other arrangements**

7. This clause makes it clear that a reference to a critical benchmark in a contract or other arrangement should continue to be interpreted as referring to that benchmark as it exists after the FCA has exercised its powers to apply a synthetic methodology. This provision includes the delegated powers which are described in this Memorandum. The key provision regarding the interpretation of contracts and other arrangements (which defined as a legally binding arrangement between two or more parties) is made in Article 23FA, and is retrospective in nature. It applies to all contracts which refer to the benchmark, whenever made. This provision is intended to provide important clarification where contracts or other arrangements are unable to voluntarily transition to an alternative rate before designation, e.g. due to contractual constraints, and are therefore at risk of being frustrated or subject to termination when a synthetic form of a benchmark is introduced.
8. Article 23FB makes further provision regarding the operation of Article 23FA. In particular, it clarifies how fallback provisions operate in conjunction with Article 23FA. "Fallback provisions" are express provisions in contracts that amend the contract to allow use of an alternative rate or to terminate the contract in particular circumstances (e.g. introduction by the FCA of a "synthetic" methodology for the benchmark, or unavailability of the benchmark due to technical problems). Article 23FB clarifies that the contractual continuity provision in Article 23FA does not in general prevent fallback provision from operating, but that fallbacks that are triggered when a benchmark ceases to exist or is unavailable will not be triggered by the introduction of a "synthetic" benchmark. Together, Articles 23FA and 23FB clarify how references to a synthetic form of a critical benchmark (such as LIBOR) should be interpreted in contracts and arrangements under UK law.

**Description of the powers contained in clause 1**

9. Clause 1 confers three limited delegated powers on the Treasury. These are contained in paragraph 6 of Article 23FB. There is a careful balance to be struck between the public interest in ensuring that critical benchmarks can be wound down in an orderly manner, and making

the necessary legislative intervention to achieve this, and allowing contracts to operate in the manner agreed by the parties. LIBOR is the only benchmark currently designated as a critical benchmark in the UK, and is due to be wound-down at the end of 2021. The Government is clear that the provisions in Clause 1 are needed to support the orderly wind-down of the LIBOR benchmark, and has tested the provisions against a range of LIBOR-referencing contracts, as the most readily available examples of contractual wording that these provisions would need to act on in a clear way.

10. However, the provisions in this Bill will apply to any critical benchmarks which are wound down in future. Given the broad range of contracts or other arrangements that reference critical benchmarks (which can include contracts which are outside the scope of the regulated financial services sector (e.g. leases), it is not possible to anticipate the exact circumstances that would apply in the wind-down of any future critical benchmark. The powers in Clause 1 are necessary to ‘future-proof’ the legislation, providing the Treasury with the means to adjust the operation of the legislation to ensure it effectively supports the wind-down of a potential future, currently unknown, critical benchmark, based on a technical analysis of the contracts at the time.

***Power at paragraph (6)(a) of Article 23FB – power to disapply the contractual continuity provision for certain benchmarks or types of contract or arrangement***

*Power conferred on: the Treasury*

*Power exercised by: regulations made by statutory instrument*

*Parliamentary procedure: negative (by application of Article 49 of the Benchmarks Regulation)*

Context and Purpose

11. Paragraph (6)(a) of Article 23FB provides the Treasury with power to provide that the contractual continuity provision contained in clause 1 does not apply to specified benchmarks or benchmarks of a specified description, or to specified descriptions of contracts or other arrangements. This would mean that the provision in this Bill providing that contractual references to a benchmark include the benchmark in its synthetic form is “switched off” for the benchmark or type of contract or arrangement described in the Treasury’s regulations.
12. The purpose of this power is to ensure that, should a different critical benchmark be wound-down in the future, the Treasury can consider whether there would be any adverse consequences to these provisions acting on some or all contracts that reference that benchmark, and can take the necessary steps to ensure the wind-down of the benchmark proceeds in an orderly way. This could include disapplying the provision for a particular benchmark, or for a particular type of contract or arrangement, based on technical consideration of the terms of the contracts or arrangements in question.

Justification for taking the power

13. While LIBOR is currently the only critical benchmark in the UK, this Bill will apply to the wind-down of other critical benchmarks in the future, should this be necessary. The power at paragraph (6)(a) enables the retrospective provision contained in this Bill to be disapplied, in effect narrowing the intervention in contracts made by the Bill, in appropriate cases. The Treasury has given extensive consideration to how this legislation will work for the LIBOR

benchmark. However, it has not been possible to carry out the same detailed analysis of contracts for other, at this point unknown, critical benchmarks. This power will enable the Treasury to ensure, following analysis at the relevant time, that the application of the retrospective contractual continuity provision does not lead to unintended or adverse consequences, or otherwise hinder the orderly wind-down of that benchmark.

#### Justification for the procedure

14. The provision made by this power would be specific, and would simply narrow the cases in which the retrospective provision made by clause 1 of this Bill applies based on a technical analysis of affected contracts. It would not make any other changes to the way in which clause 1 operates. As such, it is not likely to be of sufficient interest to warrant detailed debate in Parliament, or scrutiny in advance of the regulations being made. It is therefore considered appropriate that any regulations made using this power are subject to the negative procedure.

***Power at paragraph 6(b) of Article 23FB – power to provide that references to “fallback provision” include further express provision of a specified description***

*Power conferred on: the Treasury*

*Power exercised by: regulations made by statutory instrument*

*Parliamentary procedure: negative (by application of Article 49 of the Benchmarks Regulation)*

#### Context and Purpose

15. The power in paragraph 6(b) of Article 23FB allows the Treasury to make further provision about the kind of contractual term which constitutes “fallback provision”, in addition to the provision already described in Article 23FB(4).
16. LIBOR-referencing contracts are the most readily available contracts on which to test the effect of these provisions, and ensure they achieve the intended outcome at a technical level. The Treasury has engaged extensively with stakeholders in an effort to ensure that for LIBOR this Bill will enable contractual fallback provisions to operate as intended. Paragraph (6)(b) is, however, a targeted power to ensure that if further types of fallback provision come to light in future, provision can be made to ensure that it is clear how the legislation should interact with the contractual wording in question, and this legislation achieves its intended effect for those contracts or arrangements.

#### Justification for taking the power

17. As with the power in paragraph 6(a), this power enables the Treasury to ensure that, were another critical benchmark is to be wound-down in future, this legislation supports an orderly wind-down and does not lead to either unintended or adverse consequences.
18. The power at paragraph 6(b) will allow for the definition of “fallback provision” to be expanded upon to ensure that any as yet unknown types of fallback provision are included. This will enable the Government to make it clear that these fallbacks should be able to operate in the manner provided for in the contract or arrangement, notwithstanding the provision made in Article 23FA.

#### Justification for the procedure

19. The provision made by this power will be technical and limited. It will not make significant changes to the framework or scope of the provision made by this Bill, but will enable the Treasury ensure that the definition of “fallback provision” can be added to if needed, so that the clarifications in Article 23FB can apply to any new types of fallback that come to light. As such, it is not likely to be of sufficient interest to warrant detailed debate in Parliament, or scrutiny in advance of the regulations being made. It is therefore considered appropriate that any regulations made using this power are subject to the negative procedure.

#### ***Power at paragraph 6(c) of Article 23FB – power to provide that fallback provision is not triggered in cases of a specified description relating to a benchmark’s designation as a synthetic benchmark***

*Power conferred on: the Treasury*

*Power exercised by: regulations made by statutory instrument*

*Parliamentary procedure: negative (by application of Article 49 of the Benchmarks Regulation)*

#### Context and Purpose

20. Paragraph (6)(c) grants the Treasury power to make further provision for cases in which fallback provision is not triggered for a reason connected to the introduction of a synthetic methodology for the benchmark.
21. The purpose of the paragraph (6)(c) power is to ensure that if there is uncertainty over whether a particular type of fallback provision should be triggered for a reason connected to the introduction of a synthetic methodology, the Treasury can clarify the position in regulations, in order to ensure the legislation achieves its intended effect.

#### Justification for taking the power

22. The power at paragraph 6(c) will enable the Treasury to respond, should unforeseen types of fallback provision come to light, which the Government considers should not be triggered in circumstances related to the introduction of a synthetic methodology for a benchmark. The Government would be likely to make this kind of provision if it became aware of fallback provision which the parties had not intended to be triggered by this kind of change to the benchmark, and it was considered appropriate to make the position clear.
23. As with the other powers in this Bill, this power enables the Treasury to ensure that, were another critical benchmark to be wound-down in future, this legislation supports an orderly wind-down and does not lead to either unintended or adverse consequences.

#### Justification for the procedure

24. The provision made by this power will be technical and limited. It will not make significant changes to the framework or scope of the provision made by this Bill, but will enable the Treasury to clarify, in the event that new types of fallback come to light, that they operate in a manner which is consistent with the continued existence of the benchmark in synthetic form, as provided for in this Bill. As such, it is not likely to be of sufficient interest to warrant detailed debate in Parliament, or scrutiny in advance of the regulations being made. It is therefore considered appropriate that regulations made using this power are subject to the negative procedure.