9 October 2017

Will Parry Esq
Bank of England
Threadneedle St
London
EC2R 8AH

Dear Mr Parry

White Paper: SONIA as the RFR and approaches to adoption

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.[1]

The FMLC Secretariat has monitored the progress of the Bank of England's Working Group on Sterling Risk-Free Reference Rates (the "Working Group"), and read its recent White Paper, *SONIA as the RFR and approaches to adoption*, with great interest.[2]

At point 64 of this paper, the Working Group invites suggestions of additional topics for discussion. Further to this invitation, the FMLC would like draw the Working Group's attention to its previous comments on legal risk arising in the context of benchmark reform in respect of legacy contracts.[3] This extensive body of work includes the FMLC's contribution to the *Final Report of the Market Participants Group on Reforming Interest Rate Benchmarks*, dated 22 July 2014 (the "MPG Report").[4] The FMLC takes the view that the issues of legal risk which have been addressed by the FMLC over the past five years could usefully bear further discussion and consideration in the context of some of the issues addressed in the White Paper. That is, in particular, with respect to the Working Group's recommendation that the potential scope for the transition of legacy contracts which currently reference LIBOR to the Sterling Overnight Index Average ("SONIA") be explored. Such analysis is now particularly salient in light of the FCA's recent announcement that, following end-2021, the FCA will no longer use its powers to persuade or compel banks to submit to LIBOR, which some commentators have taken—not necessarily accurately—to reflect "a decision to end LIBOR".[5]

Contractual continuity and legal risk

SONIA (or rather, reformed SONIA, which is predicted to take effect from March or April 2018) is a measure of the rate at which interest is paid on sterling short-term wholesale funds in circumstances where credit, liquidity and other risks are minimal. It is measured on each London business day as the trimmed mean, rounded to four decimal places, of interest rates paid on eligible sterling denominated deposit transactions, where eligible transactions are executed between midnight and 18:00 and settled that same day, and are greater than or equal to £25 million in value.[6] LIBOR is the rate at which an individual contributor panel bank could borrow funds, were it to do so by asking for and then accepting interbank offers in reasonable market size, just prior to 11.00 am London time.[7] The conversion of legacy contracts from one to the other, as posited by the Working Group, would involve the incorporation of SONIA as the contractual reference rate, in place of LIBOR, in one or more existing contracts which have yet to reach maturity. The FMLC notes that the Working Group has

+44 (0)20 7601 4286
chiefexecutive@fmlc.org

8 Lothbury
London
EC2R 7HH
www.fmlc.org

invited comments on the voluntary—rather than the necessary or compulsory—incorporation of SONIA in legacy contracts. The question of the necessary transition of legacy contracts in a situation of benchmark withdrawal has, however, also been addressed—in respect of both orderly and unexpected withdrawal—by regulators on several other occasions.[8] These include the observation by Andrew Bailey in his speech addressing the future of LIBOR, that there is no guarantee that beyond end-2021 LIBOR will continue to be calculated.[9]

The MPG Report of 2014 identifies four alternative transition pathways for markets to follow in the case of benchmark reform: (i) a "seamless transition" from one methodology to another (later referred to as "evolution" rather than "transition"); (ii) a "successor rate" pathway, whereby one benchmark is withdrawn and replaced by another with a different but similar identity; (iii) a "market-led" transition, involving the voluntary adoption of a different benchmark published in parallel to the legacy benchmark; and (iv) a "cut over" transition, whereby adoption of a new benchmark is encouraged by notice to users that the legacy benchmark will be withdrawn at a future date.[10] It might be inferred from the White Paper that a transition from LIBOR to SONIA would necessarily incorporate elements of one or more of these pathways but this does not appear to have been decided by—or, indeed, to have been within the remit of—the Working Group. The FMLC takes the view that now would be an opportune time for the Bank of England and those with expertise in the area to give careful thought to the question of the most appropriate pathway or pathways for a market transition to SONIA.

In situations of benchmark withdrawal and transition, as flagged most recently in the letter sent to you on 30 December 2016 concerning proposed reforms to the SONIA methodology (the "Letter"), legal risk is considered to arise, if at all, in the form of either widespread market reliance on unsupported fallback rates or, ultimately, in the risk of contract frustration (or, in civil law jurisdictions—*force majeure*). You may recall that this latter risk was characterised by the FMLC in the Letter as one which is remote but not negligible.[11]

In another context, however, the FMLC has also noted that the legal risks of transition are heightened wherever there is an economic differential as between the projected values of one benchmark and those of a successor rate.[12] This is not because the chances of frustration are necessarily increased but rather because it is attractive in these circumstances for some counterparties to raise the possibility of litigation even where their chances of success are remote and because any litigation on the terms of standard market contracts has the potential to prove disruptive. (As you will recall, the MPG Report surveyed market participants and found that, in a situation where a reformed benchmark systematically varied from a current benchmark by more than five basis points, the vast majority of those surveyed were undecided or preferred to transition to a different rate despite the obvious difficulties of doing so.[13])

FMLC recommendations

In terms of recommendations to alleviate any uncertainty that may arise in circumstances in which legacy contracts are converted to a new benchmark, the FMLC draws attention to its December 2012 paper "Benchmark Transition Report: Observations on proposals for benchmark reform" (the "Transition Paper"). Here, the FMLC makes a number of recommendations that could be implemented when transitioning to a replacement benchmark, observing:

a) that changing standard contracts by way of a protocol offers the brightest hope of a smooth transition from LIBOR to an alternative benchmark, and that a wide protocol will promote uniformity across back-to-back contracts and can prevent mismatching of interest rates (albeit this is by no means a panacea, as such protocols often involve lengthy negotiation periods and are not assured of universal accession);

b) that a strong legal opinion to the effect that a Court is unlikely to consider that existing contracts on standard terms have been frustrated in circumstances of benchmark transition could play a pre-emptive role in maintaining market confidence, particularly if published;

c) that the coordination of all relevant trade associations may be required;[14]

d) that the transition to any new benchmark could be mapped, either by the authorities or trade associations (possibly through an auction process);

e) that a detailed timeline of planned developments is desirable for the sake of predictability; and

f) that documentation which is drafted for new contracts, if this proves desirable, may need to be incorporated into existing contracts on the same day to reduce any risk of uncertainty and a mismatch of back-to-back contracts. New contracts which are drafted in the period before the alternative benchmark is introduced should also be accounted for.[15]

The Transition Paper also questions the palliative effect of existing fallback provisions in a situation involving benchmark withdrawal, observing that it is unlikely that such provisions will prove operable on a market-wide basis over the long-term.[16] This is of relevance given Andrew Bailey's (currently open) question as to whether the better approach to transition would be to amend contracts to reference an alternative rate, or to amend the definition of LIBOR through the fallback protocol to replace the current methodology with alternative reference rates.[17]

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely,

Joanna Perkins
FMLC Chief Executive

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1 Sinead Meany took no part in the preparation of this letter, and the views expressed herein should not be taken to be those of the Bank of England.

2 The Working Group on Sterling Risk-Free Reference Rates, "SONIA as the RFR and approaches to adoption" (June 2017), available at: http://www.bankofengland.co.uk/markets/Documents/sterlingoperations/rfr/rfrwgwhitepaper0617.pdf

3 The FMLC would like to draw the Working Group's attention to the following publications:

Letter to the Bank of England on Reform of SONIA (30 December 2016) http://www.fmlc.org/uploads/2/6/5/8/26584807/letter_to_boe_on_sonia.pdf.

Letter to the European Money Markets Institute on the Evolution of Euribor (12 April 2016) http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_response_to_emmi_consultative_position_paper_on_evolution_of_euribor.pdf

Response to Discussion Paper by the European Securities and Markets Authority on Benchmarks Regulation (31 March 2016)
http://www.fmlc.org/uploads/2/6/5/8/26584807/_fmlc__up__11680394_v_1_fmlc_response_to_esma_discussion_paper_on_the_benchmarks_regulation.pdf

Letter to the Financial Stability Board on the Regulation of Commodity Benchmarks (2 April 2015)
http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_letter_to_mr_rupert_thorne_(fsb)_02.04.15.pdf

Letter to the European Commission on a Proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts (3 March 2015)

http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_letter_to_european_commission_on_benchmark_reform.pdf

Letter to Financial Stability Board on the Publication of its Consultation Document on Foreign Exchange Benchmarks (13 August 2014)
http://web.archive.org/web/20170108031058/http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_-_letter_to_fsb_-_fx_benchmarks_consultativ....pdf

Paper on Discussion of Legal Uncertainty Arising from the Proposal for a Regulation on Indices used as Benchmarks in Financial Instruments and Financial Contracts (18 March 2014)
http://web.archive.org/web/20170108031102/http://www.fmlc.org/uploads/2/6/5/8/26584807/fmlc_issue_177_benchmark_reform_paper_2014_12.pdf.

Benchmark Transition Report: Observations on proposals for benchmark reform (1 December 2012)
http://web.archive.org/web/20170108031106/http://www.fmlc.org/uploads/2/6/5/8/26584807/011212.pdf.

4 MPG "Final Report of the Market Participants Group on Reforming Interest Rate Benchmarks", dated 22 July 2014, available at: http://www.fsb.org/2014/07/r_140722b/. The findings of the MPG Report were considered by the Official Sector Steering Group (the "OSSG") of the Financial Stability Board. Accordingly, the FSB published its own recommendations on Reforming Major Interest Rate Benchmarks, in a report dated 22 July 2014. The FSB Report is available at: http://www.fsb.org/2014/07/r_140722/.

5 See the speech by Andrew Bailey, Chief Executive of the FCA, published on 27 July 2017 and available here: https://www.fca.org.uk/news/speeches/the-future-of-libor; and see commentary available here: https://www.bloomberg.com/news/articles/2017-07-27/libor-to-end-in-2021-as-fca-says-bank-benchmark-is-untenable-j5m5fepe.

6 Bank of England "The reform of SONIA: Consultation feedback and the design of SONIA" (March 2017) p.7, 19, available at:
http://www.bankofengland.co.uk/markets/Documents/soniareformresponse0317.pdf.

7 The definition of LIBOR is available on the ICE LIBOR website, and can be accessed at https://www.theice.com/iba/libor.

8 See Article 28 of Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds (the "Benchmarks Regulation") (*Changes to and cessation of a benchmark*). Article 28(1) requires administrators to publish a procedure concerning the actions to be taken by the administrator in the event of changes to or cessation of a benchmark. Article 28(2) requires supervised entities—other than administrators—to produce and maintain robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided. See also the FSB's report "Reforming Major Interest Rate Benchmarks" (22 July 2014) (link provided at endnote 4, *supra*).

9 See Andrew Bailey's speech, endnote 5, *supra*.

10 See the MPG report, pp.13-14. See endnote 4, *supra*.

11 See the "Legal risk and financial contracts" section of the Letter to the Bank of England on Reform of SONIA (30 December 2016), link provided at endnote 3, *supra*.

12 See the Letter to the European Money Markets Institute on the Evolution of Euribor (12 April 2016), link provided at endnote 3, *supra*.

13 The MPG Report, p.136. See endnote 4, *supra*.

14 The FMLC observes that ISDA participates in the Working Group on Sterling Risk-Free Reference Rates in a non-voting capacity.

15 See Transition Paper pp.25-26, and 28-32, link provided at endnote 3, *supra*.

[16] Ibid, p. 25, 31.

[17] See Andrew Bailey's speech, endnote 5, *supra.*