The Reform of Key Interest Rate Benchmarks: Progress and Challenges

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Slide 2—27 June 2012

The evolutionary journey of the world's foremost interest rate benchmarks began, as you will all recall, in June 2012 when the CFTC issued a penalty notice for LIBOR manipulation against Barclays.

In that penalty notice, the CFTC required Barclays to anchor its LIBOR submissions in transactions. Those transactions could be subject to adjustments—for example, by discarding erroneous values or by weighting results by time or volume—but the CFTC penalty notice did not anywhere reflect the idea that banks' submissions to LIBOR could be informed purely by the submitter's own expert judgment. Rather, the penalty notice can be read as a declaration of regulatory war on the idea of fictionalised submissions.

Martin Wheatley, however, acting, no doubt from a concern for the future of a benchmark which references a rapidly diminishing market (i.e. the unsecured interbank lending market), reintroduced expert judgment as a qualifying input data point in his review of LIBOR in September of the same year.

One might consider, then, that the second step in the evolutionary journey was a step to the side or even backwards but if that is the case, then it was the troops' final hesitation at the outset of a swift march forward.

Slide 3—Reform of Key Interest Rate Benchmarks: A Timeline

Just how far that march has taken us, and how swiftly, can be seen from this timeline. There has barely been a pause for reflection.

The last four-and-a-half years have witnessed the publication of international standards by IOSCO, a significant report on key interest rate benchmarks by the FSB and the introduction of an internationally unprecedented and uniquely comprehensive regulatory framework by the European Union.

The benchmark administrators themselves have played their part. All three major IBOR benchmarks have witnessed changes in their administration and proposals for reform of their calculation methodologies.

Meanwhile, national regulators have been hard at work. The FCA, in particular, has written a new chapter in its market Handbook dealing with the regulation of specified benchmarks and has introduced so-called FRAND pricing rules, limiting the prices that benchmark administrators can charge infrastructure bodies for licensing their benchmarks.

And the NY Federal Reserve and the Bank of England have both established industry groups so as to consult on possible market alternatives to the LIBOR benchmark which first caused all this trouble.

Slide 4— Reform of Key Interest Rate Benchmarks: Where We Are Now

It is worth asking, then, where all this frenetic activity has brought us.

As I mentioned a moment ago, the three major IBOR benchmarks have all consulted on and planned for new methodologies. The European Money Markets Institute ("EMMI"), which administers EURIBOR, has perhaps proposed the most ambitious of these reforms. It proposes, in effect, to eliminate banks' responsibility for arriving at a cost of funds value by requiring them simply to submit raw transaction data, after which the administrator itself will calculate an individual cost of funds value for each bank and then perform a median calculation on the whole class. One positive effect of this will be to eliminate expert judgment in submissions. One concerning effect, however, may be that benchmark fixings will increase in both volatility and absolute value, giving rise to what is now commonly referred to as a "wealth transfer" between borrowers and lenders. The EMMI has suggested that any difficulties of this kind can be ironed out during a Pre-Live Verification Programme, which it is currently undertaking

Proposals for the reform of TIBOR and LIBOR, on the other hand, have retained expert judgment as a feature of banks' submissions and the consultations on these proposals typically emphasise the need for continuity and stability above the ideological purity of the reforms. Some may say this is a wise order of priorities, some may say the proposals do not go far enough.

Another key interest rate benchmark that has seen significant changes in its administration is the Sterling Overnight Index Average or SONIA. That was considered in the FSB report as a possible contender for replacing LIBOR in market contracts and it remains on the table for this purpose. Meanwhile, the administration of the benchmark has been transferred to the Bank of England, which proposes to widen the class of input data and switch from a mean to a median calculation.

Working Groups established by central banks have been busy too. The Alternative Reference Rate Committee ("ARRC") is examining the feasibility of replacing term reference rates, such as $LIBOR, with an overnight reference rate or with the average of such rates. It is closely examining three collateralised overnight repo rates.

The Sterling Risk Free Rate Working Group ("SRFRWG") has identified candidates for the new sterling risk-free rate, one of which is a proposal by for a Sterling Secured Overnight Executed Transactions ("Sonet") rate. The others are Bank of England reformed SONIA, as an unsecured rate; ICAP sterling Repo Index Rate, as a secured rate.

Slide 5—Benchmark Withdrawal, Transition and Evolution: The Issue of Legacy Contracts

The potential for so much rapid change to give rise to legal risks was noted by the FSB in its 2014 Report. In particular, the FSB considered a legal risk analysis incorporated into a wide-ranging and thorough-going research report compiled by a Market Participants Group under the chairmanship of Professor Darrell Duffie, who spoke on this panel last year.

The FSB Report observed that benchmark reform can raise the risk of litigation and contract frustration but insisted that these risks should not prevent reforms from going ahead.

Slide 6—FMLC on the Evolution of Interest Rate Benchmarks

The question of legal risk has been considered and analysed on multiple occasions by the Financial Markets Law Committee, of which I am the Chief Executive. The Committee has written about the risks of contract frustration and force majeure and has undertaken a high-level comparative analysis of the risks in different jurisdictions.

The Committee is largely sanguine about the likelihood of such risks materialising in the context of the proposed IBOR and SONIA reforms while noting that they cannot be wholly ignored and may be greater in some jurisdictions than others.

Slide 7—History Gives Cause for Comfort

As I said last year, however, the real cause for comfort may not be the legal analysis but the historical one. Market participants are seemingly—and felicitously, one might add—resistant to litigating over benchmark evolution, probably in recognition of the fact that once the malevolent genie of contract frustration is out of the bottle, the consequences for the markets are likely to be not only disruptive and extensive but also wholly unpredictable.

In a recent account prepared for the purposes of responding to the EMMI, I listed a dozen cases of benchmark transition in London which had occurred without the manifestation of legal risk. On this slide, I recount just five of these.

Slide 8—Conclusion

I am going to finish on a cautionary note, however, one which, if I can mix my metaphors, may have a silver lining for P.R.I.M.E. and others concerned with the provision of dispute resolution services.

Just as a fine-weather sailor ignores the risks of a sea voyage and the mutable character of the ocean at his peril, so regulators and administrators ignore the legal risks of benchmark transition at theirs. Markets rely to a very high degree on standard terms and a case alleging the frustration of a contract on those terms does not need to have a strong chance of success to prove disruptive.

While the IBOR benchmarks maybe evolving with due consideration for the risks involved, that is not necessarily true of the hundreds of other benchmarks on which the markets depend. One of the unintended consequences of regulatory reform has been a strong desire on the part of some administrators to withdraw benchmarks in order to avoid conflicts of interest. One example may be the rapid withdrawal, within a month of establishing a successor rate, of a gilt prices index published by the UK Debt Management Office, a transition presaged in a recent report by Sir David Miles.

It seems to me that we are at risk in some quarters on relying too far on our natural optimism about benchmark transition and on the relatively peaceful history it has had to date.

Contractual frustration may be a sleeping giant but a giant it is nonetheless and undoubtedly a malevolent one. We should take care not to wake it.