Benchmark Transition: Legacy Contracts and Legal Risks

FINANCIAL MARKETS LAW COMMITTEE

Infoline's Risk Free Rate conference—Navigating the Transition to a Risk Free Rate

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Slide 1—Title slide

Hello and thank you to Infoline for inviting me here to speak to you today.

Slide 2—Reform of interest rate benchmarks

A wholesale review of key IBOR benchmarks (LIBOR, EURIBOR and TIBOR) was initiated by the Financial Stability Board (FSB) in February 2013, and this ultimately called for an end to the financial markets' dependency on IBOR benchmarks.

The FSB review culminated in a report, *Reforming Major Interest Rate Benchmarks*, published in July 2014 which concluded that:

- existing "IBOR" benchmarks should be strengthened by underpinning them to the greatest extent possible with transaction data.
- alternative, nearly risk-free rates (or "**RFRs**") should be developed and participants in the derivative markets should be encouraged to use these rates in place of the IBORs.

Slide 3—National RFR study groups

Following the publication of the FSB report, its recommendations on benchmark transition and evolution were vigorously addressed:

- The Federal Reserve (FRB), the Bank of England (BoE), the Swiss National Bank (SNB) and the Bank of Japan (BoJ) quickly established market consultative groups with a view to identifying appropriate RFRs in their respective currencies.

- The European Central Bank also established a Working Group to identify and adopt an alternative risk- free overnight rate in the euro area as an alternative to both Euro LIBOR and EURIBOR but not until September 2017.
- Meanwhile, proposals for LIBOR, TIBOR and EURIBOR evolution were planned and published by ICE Benchmark Administration (IBA) and the Japanese Bankers' Association TIBOR Administration (JBATA)—which both implemented structural changes as a result—and the European Money Markets Institute (EMMI).

Slide 4—RFRs identified

2017 marked considerable success in making progress towards the FSB's second objective—the identification of RFRs—particularly in respect of reference rates which might be adopted by the markets in place of LIBOR.

- the BoJ study group reporting on 28 December 2016 that it would adopt an uncollateralized overnight call rate calculated TONAR as its preferred RFR.
- In April 2017, the BoE's Working Group on Sterling Risk-Free Reference Rates (SRFRRC) announced the Sterling Overnight Index Average (SONIA) as its preferred RFR on the back of reforms to the methodology announced the previous year.
- In June, the Federal Reserve's Alternative Reference Rates Committee (ARRC) selected the Secured Overnight Financing Rate (SOFR—to be published by the NY Fed with the Office of Financial Research), as its preferred RFR.
- And, finally, in October, the National Working Group, established by the SNB, recommended the Swiss Average Rate Overnight (SARON) as an alternative benchmark to Swiss franc LIBOR.

In each case, the RFR identified as an alternative to LIBOR was an overnight rate.

The year revealed less happy news, however, in relation to the FSB's first objective. National authorities appeared to acknowledge the insuperability of the challenges facing their attempts to implement reform. This acknowledgement was implied:

- first, in a statement by the European Securities and Markets Authority (ESMA) in conjunction with EMMI to the effect that data analysis undertaken as part of efforts to reform EURIBOR indicated that it would not be feasible to evolve the current EURIBOR methodology to one based solely in transactions; and
- second, in a speech made by Andrew Bailey of the Financial Conduct Authority (FCA) in July 2017, the broad thrust of which was that there should be a move to transition markets

away from LIBOR towards alternative reference rates by end-2021 and that, accordingly, the FCA would cease to compel panel banks to contribute after that date.

The shape of things to come, then, emerged more fully into view in the course of 2017. In the words of Andrew Bailey:

> We do not think we will complete the journey to transaction-based benchmarks if markets continue to rely on LIBOR in its current form. And while we have given our full support to encouraging panel banks to continue to contribute and maintain LIBOR over recent years, we do not think markets can rely on LIBOR continuing to be available indefinitely.
>
> Work must therefore begin in earnest on planning transition to alternative reference rates that are based firmly on transactions. Panel bank support for current LIBOR until end-2021 will enable a transition that can be planned and can be executed smoothly. The planning and the transition must now begin.

Slide 5—Transition pathways

The various central bank working groups are proceeding with full consideration of the risks and opportunities presented by benchmark transition. These risks were first identified, and a schema for analysing them was first developed, in a report by a Market Participants Group (MPG) established by the FSB in 2013.

The MPG Report identified 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. The transition from an IBOR benchmark to an RFR must necessarily fall into one of the latter three categories, since the whole premise of the exercise is that the alternative rate is fundamentally different from the original. Although the pathway contemplated by central banks and their working groups is not yet fully crystallised, it seems likely that it will involve a period of "market-led" transition, which may, in some cases, be followed by the withdrawal of the IBOR and a hard "cut over".

Slide 6—Legal risks

If we return, for a minute, to Andrew Bailey's speech and hypothesise that LIBOR cannot be sustained after end-2021, it is transfer of *legacy* contracts to the RFR which is likely to give rise to the most significant economic and legal questions because, inevitably, the collapse of the benchmark will have the effect of defeating the parties' expectations as those were settled at the outset of the contract.

Among the legal risks for legacy contracts in these circumstances is said to be the risk of contract frustration. This risk materialises when performance of the contract by one or both parties is rendered impossible. The chances that a contract will be held by a court to have been frustrated are said to be vanishingly small, however, wherever the contract is drafted so as expressly to allocate the risks of the allegedly frustrating event as between the parties. This is exactly what most financial markets contracts on market standard terms aim to achieve with clauses that provide for fallback arrangements in the event of benchmark withdrawal.[1]

If financial instruments avoid the cliff-edge of frustration (as one would expect them to do), they may yet be caught on the horns of their own terms. Some contracts include clauses which provide for their termination in the event of "*force majeure*" or impossibility. Parties may seek to argue that benchmark withdrawal renders performance of the contract impossible and that their obligation to perform the contract is discharged. Products and their hedges may come to a premature end as a result.

Where contracts do contain the "fallback" clauses mentioned above, these may be cumbersome to apply on a daily basis across an entire market. In fact, they may be so cumbersome to apply as to give rise to a risk that they will fail, giving rise to new risks of frustration in turn.

Even if they do not fail, fallbacks may prove disruptive to apply on a market-wide and permanent basis in part because, being tailored to individual circumstances, they will lead to different values for different contracts which may mean that products which were once perfect hedges start to diverge in market value from the instruments and exposures they are intended to offset.

[1] The fallback clause in many market standard documents refers to a series of alternative measures which the parties must take in the event the principal reference rate becomes unavailable. The first fallback may be "reference banks"—incorporating a fixing derived from an average calculation performed on values submitted to the calculation agent by a number of banks who have agreed to act in the capacity of reference banks for exactly this purpose—and the second or third fallback may be "calculation agent", incorporating a fixing determined by the parties' calculation agent, as appointed under the terms of the contract.

Even if the legal risks of frustration, contract termination or the loss of a hedge can be minimised, however, this does not necessarily mean that benchmark transition from IBOR rates to the RFRs can proceed without a hitch. Several other pressing questions remain to be resolved.

Slide 7—The basis of everything…

One question concerns the use of different calculation methodologies in different currencies and the move away from London as the location for the calculation of all but one of the RFRs (i.e. SONIA). To date, LIBOR has provided one methodology for calculating the cost of deposits in USD, CHF and GBP in the London markets. Now, interested parties are asking what the consequences will be for the foreign exchange derivatives markets and other areas of financial activity of diversifying the location of the calculation across currencies.

This question may be less of an impediment that it appears at first sight. Although there may be some impact from the divergence in methodology on cross-currency swaps—markets and market contracts are unlikely to suffer disruption on account of arriving at divergent methodologies for different currencies, if all other aspects of transition proceed smoothly. There are a couple of considerations which support this view:

- The first is that the markets have recently experienced a widening in cross-currency basis. This is the basis spread added (mainly) to USD liquidity funded by means of foreign exchange swaps using the Japanese yen or the euro as a funding currency. This spread started to widen at the beginning of 2014, driven chiefly by a decrease in the supply of, and an increase in demand for, USD. The natural consequence has been that market participants are already acclimatised to an increasingly wide basis spread and have, to some extent, been prepared by this for any further widening (or, indeed, narrowing) as the result of introducing different methodologies for interest calculations in different currencies.

- The second consideration is the existing disparity in the profiles of the funding markets across different LIBOR currencies. For example, the market in EUR LIBOR loans is weighted towards loans with a longer maturity compared with, say, YEN LIBOR transactions, the bulk of which tend to be short term. This means that the existing methodology already does not work in the same way (i.e. on the basis of the same input data flow) across currencies. It also means that LIBOR users would not experience the transition of legacy contracts in the same way across currencies, even if the same methodology were adopted for all the new benchmarks.

Slide 8—What are your values?

The most important questions yet to be addressed are probably economic or financial ones about the value of the contract. RFRs, by definition, reflect less credit risk and, for that reason, the fixings tend to be lower. In the context of a swap contract with an unexpired term of several months, or even years, that difference could mean that the transaction has a significantly different market value than it would have had. Roughly speaking, this issue is predominantly a market one in the case of new contracts and a legal and operational one in the case of legacy contracts.

The issue for new contracts is whether lenders and swapdealers are willing to enter into contracts that will, without any adjustment to other terms, pay less interest. One consideration which will doubtless weigh with market participants is that the collateral which provides security for swaps deals generally attracts interest at the relevant overnight accommodation rate (i.e. at the relevant RFR), a fact which has already led to the use of OIS rate discount curves in pricing swaps.

The issues for legacy contracts, however, are more complicated. Parties to these contracts had settled economic expectations at the point of their agreement and replacing LIBOR with an RFR in their contract during its term would confound their plans. These are circumstances in which ordinarily it might be appropriate for parties to bring an end to their contract under a negotiated settlement but in this context that would be probably impossible (given the volume of contracts referencing LIBOR); certainly disruptive; and highly likely to introduce both basis and legal risk in relation to back-to-back contracts.

This problem is not new. A similar issue arose in relation to currency transition when the single currency was introduced. Legacy contracts had to incorporate the new currency (EUR) or be satisfactorily resolved in some other way when the old European currencies were withdrawn. One element of the arrangements introduced at that time was the introduction of a standard "conversion factor" for each of the old currencies which, if incorporated, was designed to maintain the value of existing obligations on redenomination.

Slide 9—Show some maturity!

Another obvious issue is that fixings for the IBOR benchmarks are produced in multiple tenors, or maturities. LIBOR, for example, in addition to being an overnight rate, is a term rate produced in maturities of one week, one month, two months, three months, six months and 12 months. The input data in each case is transactions of the relevant maturity. Thus, the LIBOR six month daily fixing is calculated—subject to the availability of transaction data—on the basis of funding transactions between banks with a maturity of six months. By definition an overnight rate will always be calculated on the basis of overnight transactions and that means the rate will be economically different than a rate calculated on the basis of transactions with greater maturity (which carry greater credit exposure).

So, the final issue I am going to address today is the question of how to introduce an overnight RFR as an appropriate substitute for a benchmark with longer tenors. Although at least one expert commentator has argued that longer tenors should not be introduced into the world of RFRs, the answer reportedly favoured by industry is that the SONIA administrator should publish rates fixed at the longer tenors so that one value is adhered to by the market as a whole.

A working group is examining the possibilities for calculating these values. In theory, aspects of the calculation could include a range of factors, including the extrapolation of rates from the existing input data on brokered overnight deposits and the use of statistical techniques simulating probabilistic outcomes. The terms of reference of the working group, however, specify parenthetically that it will be reviewing data inputs and calculation methodologies which focus on the OIS market: "(e.g. based on pricing data from SONIA futures contracts, OIS order books on MTFs, or transaction data from swap data repositories)". One way to understand this is to consider that the value fixed on any given day for a three-month term SONIA rate would reflect the discounted fixed rate payable under an average three-month SONIA swap.

Once the appropriate data pool for the longer tenors has been selected, a calculation methodology will be looked at. It seems likely that industry participants will favour an auction methodology.

In any event, it will be important for those setting the calculation methodology to consider how to address any present or future concerns about the depth and breadth of transaction data available in the OIS market, the integrity of the data and of the means of collecting it and the means of avoiding circularity in the calculation (a three-month SONIA swap is priced on the basis of expectations about how the overnight rate will perform in a world of investment opportunity costs and so establishing a floating term rate from the fixed rate, in essence, returns to the question of expectation.)

Slide 10—Risk mitigants

In the present context the options for a smooth resolution or transition of the bulk of legacy contracts would appear to be few. They can be roughly divided into those solutions which can be achieved by market participants acting on their own (or through the agency of a trade association); and those solutions which require input by the official sector:

i) One solution is to secure market participants' collective agreement to "repaper" (i.e. vary) their contracts in bulk, incorporating the new reference rate and a new, multilaterally agreed, conversion factor to bring obligations into economic line with projected LIBOR values. This might be done, in part, under the protocol procedure introduced by industry associations to vary market standard terms;

ii) Some fallback clauses will already incorporate language about successor rates designed to cater for circumstances of benchmark transition but, please note, that this language will not work to achieve a transition unless and until the relevant IBOR benchmark is withdrawn;

iii) Another possibility coordinating action around fallback provisions in market standard terms so that these would operate, upon the withdrawal of LIBOR, automatically to incorporate the new RFR as the rate identified by all "reference banks" or the "calculation agent", say.

The easiest route, however, would be:

iv) to publish a new daily "LIBOR+" rate on the usual venues comprising the RFR plus the conversion factor (in combination, as a single fixing), effectively replacing LIBOR, in the hope that the existing contractual reference rate definition would incorporate this rate.

None of these mitigants is perfect: the first and third are acutely labour intensive and run the risk of omission. They may also pose Competition Law challenges around market coordination.[2] The second and third both depend on the withdrawal of the IBOR benchmark (LIBOR in this case). And the fourth places a key discretionary determination (namely the calculation of the conversion factor) in the hands of a single commercial or public entity (which is not necessarily aligned with the objectives of recent regulatory reforms) and it also depends upon the cooperation of third parties, e.g. Reuters and Bloomberg.

<u>Slide 11 - Conclusion</u>

It remains to be seen which of these solutions will be adopted by the majority of market participants but the decision will not be made by firms individually, in a vacuum. They will benefit from the work of the RFR working groups, as well as guidance from international and national regulators. Supervised entities will also be subject to the constraints of the E.U. Regulation on Indices Used as Benchmarks (Reg. 2016/1011), which entered into application on 1 January 2018 and which imposes obligations to select robust alternatives to existing rates and to have in place cogent plans for transition in the event of benchmark withdrawal (see Article 28).

[2] An agreement on pricing will *prima facie* contravene Article 101 of the Treaty on the Functioning of the European Union and section 2 of the Competition Act 1999, (unless the arrangement represents a contribution to technological or economic progress, or improves the production or distribution of goods, to the ultimate benefit of consumers).

There are undoubtedly significant questions and difficulties which must be addressed if the path from the IBOR benchmarks to alternative reference rates is to be as smooth as possible for market participants expected to undertake the journey. The options for tackling the challenges of transition are limited. Nevertheless, the proper inference to draw is that the transition path looks tough but not impassable.