Benchmark Transition:
Legacy Contracts and Legal Risks

FINANCIAL MARKETS LAW COMMITTEE

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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, which ultimately called for an end to the financial markets' dependency on the IBOR benchmarks.
- The FSB review culminated in a report, Reforming Major Interest Rate Benchmarks, published in July 2014 which concluded that:

Existing "IBOR" benchmarks and other potential interest reference rates based on unsecured bank funding costs should be strengthened by underpinning them to the greatest extent possible with transaction data

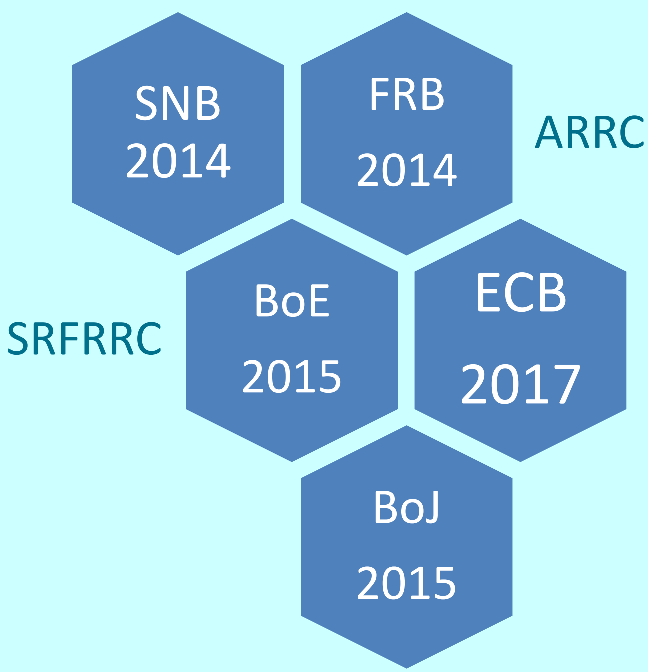
- IBOR methodologies to be anchored in transaction data

Alternative**, nearly risk-free rates (RFRs**) should be developed and participants in the derivative markets should be encouraged to use these rates in place of the IBORs

- RFRs to be used in place of IBORs for derivatives

National RFR study groups

- The Federal Reserve Bank (FRB), the Bank of England, and the Swiss National Bank (SNB) quickly established market consultative groups with a view to identifying appropriate RFRs to replace U.S. Dollar, Sterling, and Swiss Franc LIBOR, respectively, and the Bank of Japan established a study group on RFRs for unsecured interbank lending in yen in June 2015. (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).

2017: RFRs identified

SNB
2014
SARON

FRB
2014
SOFR

BoE
2015
SONIA

ECB
2017
?

BoJ
2015
TONAR

In other news…

The European Securities and Markets Authority (ESMA) in conjunction with EMMI published a statement that data analysis undertaken as part of efforts to reform EURIBOR showed it would not be feasible to base the index solely in transactions.

Andrew Bailey of the Financial Conduct Authority (FCA) in July 2017 made a speech, the broad thrust of which was that there should be a move to transition markets away from LIBOR towards alternative reference rates by 2021.

Transition pathways

- A schema for analysing possible transition pathways away from the IBOR benchmarks was first developed in a report by a Market Participants Group (MPG) established by the FSB prior to the publication of its own report in 22 July 2014. The MPG Report identified four alternative transition pathways for markets to follow in the case of benchmark reform:

Seamless transition

- from one methodology to another (later referred to as “evolution” rather than “transition”)

Successor rate

- whereby one benchmark is withdrawn and replaced by another with a different but similar identity

Market-led

- involving the voluntary adoption of a different benchmark published in parallel to the legacy benchmark

Cut over

- whereby adoption is encouraged by notice that the legacy benchmark will be withdrawn at a future date

Legal risks

Frustration

Force majeure

Fallback failure

Hedging failure

The basis of everything…

FMLC

MIND
THE
GAP

What are your values?

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.

Show some maturity!

IBOR benchmark

12 months	
Six months	
Three months	
Two months	
One month	
One week	
Overnight	Overnight

Typical RFR

Risk mitigants

Market-led solutions	Repapering definitions
	Relying on fallbacks and implied terms
	Repapering fallback clauses
Other solutions	Publishing conversion factors
	?Using existing IBOR publication venues

Conclusion / The End

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