HERBERT SMITH FREEHILLS

FINAL EU LEGISLATIVE FIX FOR LEGACY LIBOR: IMPACT ON TRANSITION RISK FOR UK ENTITIES

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Legal Briefings

On 2 February 2021, the European Council paved the way for the EU's legislative solution for the transition of legacy LIBOR contracts to become law, by adopting amendments to the Benchmark Regulation (EU) 2016/1011 (**BMR**), which will now enter into force and apply from 13 February 2021.

The final version of the EU's legislative fix contains some welcome improvements on the European Commission's initial proposal, most notably in the reduced scope for potential conflict with the LIBOR legislative solutions proposed by other jurisdictions (see our blog post considering the original EU proposal here: Legislating for LIBOR transition: UK/EU jurisdictional battle or complementary regimes?).

In this blog post, we summarise the EU's new framework for the legislation, highlight the key changes that have been made since publication of the initial proposal and discuss the likely impact on LIBOR transition risk.

In the context of comparing global legislative proposals for LIBOR cessation, the expected extension to end-June 2023 of the continued publication of certain USD LIBOR tenors is relevant (following the ICE Benchmark Administration Consultation on Potential Cessation published in December 2020). The consultation confirms that ICE intends to cease publication of all other LIBOR settings (including all tenors of GBP LIBOR and EUR LIBOR), as planned, at the end of 2021. It is worth noting that the legislation enacted now will (unless amended) still apply to legacy USD LIBOR contracts caught within the relevant framework at that later date. It remains important, therefore, to understand how all of the different legislative solutions fit together, complement one another or potentially overlap.

NEW FRAMEWORK FOR THE EU LEGISLATIVE SOLUTION

The EU's chosen mechanism for introducing a legislative fall-back for certain benchmarks in cessation (including LIBOR) remains the same as its original proposal: to amend the BMR to enable the Commission to select replacement rates. However, the final drafting of the legislation departs from the initial proposal in a number of material respects. These changes largely follow the negotiating mandate published by the European Council on 6 October 2020.

We set out below the key elements of the planned amendments to the BMR, highlighting the aspects that are most likely to have an impact on transition risk:

Mechanism

- **Statutory successor to LIBOR to be decided by the Commission.** The BMR will grant powers for the Commission to designate statutory successors for affected benchmarks. This will include the replacement for the benchmark itself, a spread adjustment and any corresponding essential confirming changes.

- **Industry-agreed replacement rates**. In selecting the statutory successors to LIBOR (and other benchmark) rates, the Commission will take into account recommendations made by the central bank responsible for the currency area in which the relevant benchmark is being wound down, or by the alternative reference rate working group (for example, the US's Alternative Reference Rates Committee (**ARRC**) and the Sterling Risk-Free Rate Working Group in the UK). The Commission will also conduct a public consultation and take into account the recommendations of other relevant stakeholders, including the regulator of the benchmark administrator and the European Securities and Markets Authority (**ESMA**).

- **Trigger events.** The statutory replacement rates will become applicable upon the occurrence of certain trigger events, including a statement of non-representativeness from the regulator with responsibility for the benchmark administrator.

Scope

- **Which benchmarks are affected?** The legislative solution is not limited to critical benchmarks under the BMR, but extends to any benchmarks based on the contribution of input data and any third-country benchmarks where cessation/wind-down would significantly disrupt the functioning of financial markets in the EU or pose a systemic risk to the financial system in the EU (the latter for third-country benchmarks only). It is clear, therefore, that the scope of the legislative solution still includes LIBOR, notwithstanding the fact that LIBOR no longer qualifies as a critical benchmark under the BMR since the UK's departure from the EU.

- **Which legacy LIBOR contracts are affected?** The scope of the initial proposal by the Commission covered only "financial instruments, financial contracts and measurements of the performance of an investment fund". In the final draft, the scope has extended significantly to apply to any contract or financial instrument referencing an affected benchmark, provided the contract in question falls within the territorial scope of the legislation (see below). The final version of the EU's legislative fix therefore extends to a broader range of contracts and financial instruments than originally envisaged.

- **What about legacy contracts with existing fall-backs?** The EU legislative fall-back will only be engaged by contracts where there is no, or "no suitable", fall-back provision. The legislation now includes some detail as to what will constitute an "unsuitable" fall-back, following concerns raised by ISDA and other market bodies (see ISDA's response to the Commission's initial proposal). Importantly, the legislation will not cut across any previous amendments by parties to include a more robust fall-back (which was ISDA's concern). As to what will classify as an "unsuitable" fall-back the legislation provides that this will include fall-backs: (a) that do not provide a permanent replacement; (b) where third party consent is required and has been denied; and (c) where it provides for a replacement for a benchmark that no longer reflects the market/economic reality that the benchmark in cessation was intended to measure and could adversely impact financial stability. In terms of assessing whether a fall-back falls foul of the final category, the legislation provides for a protocol to be followed, involving the relevant national authority, the Commission and ESMA. This provides a mechanism for the EU's legislative solution to apply widely to contracts that include some form of existing fall-back, but where one of the parties objects to the contractually agreed fall-back provision.

- **Extraterritorial scope.** The EU's legislative solution is only applicable to EU law contracts, with the exception of non-EU law contracts where the relevant jurisdiction does not provide for its own legislative solution (provided all parties to the contract are "established" in the EU). The extraterritorial scope has therefore materially narrowed since publication of the initial proposals (see below for a discussion of how this is likely to impact transition risk).

- **Safe harbour.** The safe harbour provided by the legislation is limited to addressing the permanent cessation of the benchmark by providing contractual continuity. While the ambit of the proposed safe harbour was not articulated in the initial proposal published by the Commission, it was expected that the legislation would provide for a broader form of safe harbour (for example, in ICMA's reaction to the initial proposal).

IMPACT ON LIBOR TRANSITION RISK

We identify below the key elements of the EU legislative solution that are likely to have an impact on LIBOR transition risk.

1. Potential for winners and losers

Consistent with the point we have made in previous blog posts on the legislative solutions of various jurisdictions, the inherent risk of the EU legislation is that it is a blunt tool. It will automatically change the interest rate payable under the contract when the relevant trigger is activated and the Commission designates replacement benchmarks. The replacement rates are unlikely to represent the bargains that the parties would have struck had they been able to/chosen to amend their contracts.

This means that the interest rate payable under LIBOR contracts will change overnight – it will be both immediate and obvious – and will inevitably give rise to the possibility of "winners" and "losers". From a litigation perspective, this heightens the risk of mis-selling claims either by those who agree to transition to alternative rates or those whose contracts are transitioned to the statutory successor rate. In this context, it is significant that the EU legislation does not provide for a broader form of safe harbour (see below).

As ever, there is the risk of creating mismatches between different parts of a portfolio, where some products move to the statutory successor rate, but others are amended via bilateral agreement or (for example, in the case of hedging products) the ISDA Protocol.

Moreover, the EU has left the key question – what the statutory successor rate will be – open. As with the UK and US approaches, that rate will be determined at some, unspecified, point in the future. This makes it very difficult for firms to assess currently the extent of the risk that falling back to any of the statutory successor rates entails.

2. Narrow safe harbour

The Commission could have included a broader form of safe harbour; for example, to provide immunity from counterparty claims brought as a result of the automatic change in the interest rate when the legislative fall-back is imposed. A broader form of safe harbour of this sort has been proposed by the ARRC in the legislative solution for contracts governed by New York law (and largely tracked in a Senate Bill bill introduced in the New York State legislature on 28 October 2020). However, the Commission has chosen not to follow suit with the EU solution.

We have identified above the risk of winners and losers under the legislative solution and it seems inevitable that counterparty claims will follow. By failing to include a broader form of safe harbour/immunity, there is a very real risk of speculative litigation and consequent market disruption.

3. Narrowed extraterritorial scope

One of the most helpful changes to the EU legislative fix since the initial proposal, is to narrow its extraterritorial effect and reduce the likelihood of conflict between the legislative solutions of different jurisdictions.

There was a real risk that the original proposal would have resulted in the EU solution competing with (for example) the UK solution, with the EU successor rate applying to English law legacy contracts if one of the parties was an EU supervised firm. Rather than treading on the toes of non-EU law contracts, the final version of the EU legislation clearly divides up the pie of legacy contracts, so that the EU solution will only apply to EU law contracts, unless the law of the third country does not have its own legislative fix (and the parties to the contract are established in the EU).

This seems to be a neat solution to the conflicts issue. However, it will be interesting to see what (if any) changes/clarifications are made to the UK and US legislative solutions to complement this approach, as currently both of these jurisdictions have solutions that seek to have wide extraterritorial effect. For example, the draft Financial Services Bill is not limited to contracts governed by UK law and applies to all UK supervised entities. This is tempered by express requirements for the FCA to have regard to the likely effect outside the UK when exercising its various powers delegated under the draft Bill. In particular, this applies to the FCA exercising its power of prohibition (Article 21A), exemption (Article 23C) and change of methodology (Article 23D).

4. Wide range of contracts falling within scope

The EU's legislative solution has the potential to apply to a very wide range of legacy LIBOR contracts.

The Commission has deliberately extended its powers to a broader range of contracts and financial instruments, no doubt driven by the EU Council's negotiating mandate seeking such changes. However, this is coupled with a very inclusive approach to contracts with existing fall-backs. In particular, the mechanism by which the relevant national authority, the Commission and ESMA determine whether an existing fall-back can be ousted because it "fails to reflect market/economic reality", has the potential to be interpreted widely and therefore increase the application of the EU's legislative solution.

The combined effect of these changes could, for contracts falling within the territorial application of the EU legislative solution, significantly reduce the rump of tough legacy LIBOR contracts.

It is as yet unclear how this will compare with the solution in the UK, pending the final version of the Financial Services Bill and the outcome of the FCA's consultations into its powers derived from the legislation. No doubt the UK Government and the FCA will be mindful of future comparisons as to the relative success of the different legislative solutions. This has the potential to drive a more generous approach to the scope of the UK's legislation, particularly in the context of how "tough legacy" LIBOR contracts are defined. This question is to be considered in the context of the FCA's consultation on Article 23C, which is due to be carried out in the first half of this year.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

JENNY STAINSBY
GLOBAL HEAD – FINANCIAL SERVICES REGULATORY
REGIONAL HEAD OF PRACTICE – DISPUTES, EMEA, LONDON
+44 20 7466 2995
Jenny.Stainsby@hsf.com

RUPERT LEWIS
PARTNER, HEAD OF BANKING LITIGATION, LONDON
+44 20 7466 2517
Rupert.Lewis@hsf.com

HARRY EDWARDS
PARTNER, MELBOURNE
+61 3 9288 1821
Harry.Edwards@hsf.com

NICK MAY
PARTNER, LONDON
+44 20 7466 2617
Nick.May@hsf.com

CERI MORGAN
PROFESSIONAL SUPPORT CONSULTANT, LONDON
+44 20 7466 2948
Ceri.Morgan@hsf.com

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