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LEGISLATING FOR LIBOR TRANSITION: UK/EU JURISDICTIONAL BATTLE OR COMPLEMENTARY REGIMES?

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Legal Briefings

The European Commission has published its proposals for an EU legislative solution for the transition of legacy LIBOR contracts.

This announcement follows hot on the heels of recent announcements for similar legislative fixes in the UK (read our blog post: UK Government announces LIBOR legislative fix: summary of proposals and our initial observations) and the US (read our blog post: LIBOR transition: What does the US regulator's proposed legislative fix mean for UK financial markets?).

In this article, we provide an overview of the Commission's proposals; compare the legislative solutions from the UK, US and EU; and comment on the effect this EU law development is likely to have on LIBOR transition risk.

OVERVIEW OF THE EU PROPOSALS

The Commission's chosen mechanism for introducing a legislative fall-back for LIBOR is to amend the Benchmark Regulation (EU) 2016/1011 (**BMR**) to enable the Commission to select replacement benchmarks for LIBOR rates (or any other widely used reference rates), where the relevant benchmarks cease. The Commission has published the text of the legislative proposal, which deserves careful consideration.

The key elements of the proposed amendments to the BMR are as follows:

- **Statutory successor to LIBOR to be decided by the Commission.** The BMR will grant powers for the Commission to designate statutory successors for benchmarks

whose cessation would result in significant disruption in the functioning of financial markets in the EU (e.g. LIBOR rates).

- **Industry-agreed replacement rates.** In selecting the statutory successors to LIBOR rates, the Commission will take into account recommendations made by risk free rate working groups convened by the central banks for each LIBOR currency (for example, the US's Alternative Reference Rates Committee and the Sterling Risk-Free Rate Working Group in the UK.

- **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 of statutory replacement rate.** All contracts referencing a benchmark in cessation that involve an EU supervised entity as a counterpart and where there is no, or no suitable, fall-back provision.

- **Mutually agreed opt-outs.** Parties can opt out of the adoption of the applicable statutory successor rate by selecting and agreeing on a different rate.

- **Accompanying measures.** The Commission proposes to issue recommendations inviting Member States to complement the statutory successor rates for use by supervised entities with national statutes mandating the use of the EU statutory successor rates for use in contracts between non-financial counterparts that are governed by the laws of their jurisdiction.

- **Timeframe for review.** The amendment to the BMR providing for the legislative fall-back will be reviewed by the Commission in five years.

COMMISSION'S EXPLANATION AS TO SCOPE AND APPROACH OF THE EU LEGISLATIVE FIX

The text of the proposed legislation is accompanied by an explanatory memorandum, which seeks to articulate the Commission's approach to, and the scope of, the EU legislative fix. The key points to highlight are as follows:

- The overarching message from the Commission is that parties to products referencing a benchmark in cessation - such as LIBOR - should renegotiate where possible, and the legislative solution should be relied on only for those contracts where renegotiation is not possible prior to cessation.

- The Commission has decided that reform of the BMR is the right tool to establish a statutory replacement rate that mitigates the adverse consequences for legal certainty and financial stability that might ensue if LIBOR rates (or any other benchmark whose

cessation would result in significant disruption in the functioning of financial markets in the EU), were discontinued without such replacement rates being both available and integrated into legacy contracts that involve a supervised entity within the scope of the BMR.

- The BMR is directly applicable without requiring national legislation, and will therefore restrict the possibility of divergent measures being taken by competent authorities at national level, and will ensure a consistent approach and greater legal certainty throughout the EU.

- Interesting, the Commission considered and rejected an approach whereby amendments to the BMR would have provided the competent national authority for the administrator of a widely used interest rate benchmark in cessation, with regulatory powers to change the methodology that underpins the benchmark (referred to as “conversion powers”). This decision followed caveats made by the FCA in response to the UK’s proposed legislative fix, which left the Commission with doubt as to whether conversion powers are effective to cater to all instances that a conversion rate would need to cover. For example, according to the FCA: “… regulatory action to change the LIBOR methodology may not be feasible in all circumstances, for example where the inputs necessary for an alternative methodology are not available in the relevant currency.”

COMPARISON BETWEEN LEGISLATIVE FIXES IN THE UK, EU AND US

The key elements of the respective legislative proposals from the UK, EU and US are summarised in the table below.

	UK	US	EU
Legislation amended	Benchmarks Regulation 2016/1011 (as amended by the Benchmarks (Amendment) (EU Exit) Regulations 2018) (**UK BMR**)	[New primary] legislation under New York law	BMR
Non-representativeness trigger	Yes	Yes	Yes
Amendment mechanism	FCA has power to change methodology of a critical benchmark	Automatic transition from LIBOR to “recommended benchmark replacement” upon activation of trigger	Automatic transition from LIBOR to “recommended benchmark replacement” upon activation of trigger
Scope of legacy contracts affected	Only “tough legacy” contracts, but not yet clear how this will be defined	All legacy contracts meeting set criteria (e.g. no fall-back provisions)	All legacy contracts meeting set criteria (e.g. no, or no suitable, fall-back provisions)
Replacement rate	TBC by the FCA	TBC by the ARRC	TBC by the Commission
Safe harbour (from litigation for using the recommended benchmark replacement)	No	Yes	Yes

The UK position currently seems the most uncertain due to the limitation to “tough legacy” contracts, and the fact that we do not yet have draft legislation to understand the proposed solution fully.

KEY RISKS ARISING FROM THE EU PROPOSED LEGISLATIVE SOLUTION

Consistent with the point we made in our blog posts on the UK and US legislative solutions, the inherent risk of the proposed EU legislative solution 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 can be expected that parties will likely look for loopholes in the safe harbour which the EU has proposed.

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.

INTERACTION BETWEEN THE DIFFERENT LEGISLATIVE FIXES THAT HAVE BEEN PROPOSED

A difficult issue for banks emerges from the proposals as a result of the risk of divergent approaches being taken to the successor rates under the legislative fixes. The proposals raise some interesting (and complicated) challenges from a conflict of laws perspective, to which no obvious answer is offered by the proposals themselves.

The first issue is raised by the mechanism which the EU has decided to use in its proposal (the BMR) and the impact of Brexit. The European Union (Withdrawal) Act 2018 provides that EU legislation which is directly applicable, including the EU BMR, will form part of UK law at the end of the transition period and gives powers to the government to amend this legislation so that it operates effectively after Brexit. This means that two versions of the BMR will operate in parallel: the EU version and the UK version (the UK BMR). As per the table above, the UK legislative fix for LIBOR is being achieved via the UK BMR, whereas for the EU, it is via the EU BMR. From the end of the transition period (which is of course due to take place prior to the cessation of LIBOR and the trigger for the legislative fixes), UK-based firms will be required to comply with the UK BMR, rather than the EU BMR. For UK-based firms, therefore, the UK legislative fix for LIBOR therefore should trump the EU fix.

However, there is also an interesting question about the scope of application of the EU's proposal. On its face, the EU draft legislation states that the statutory replacement rates which the Commission selects will apply to **all** contracts referencing a benchmark in cessation that involve an EU supervised entity as a counterpart. That would appear to envisage the EU's successor rate applying to legacy English (or other non-EU) law contracts to which an EU-supervised firm is a party*, rather than the successor rate that is adopted under by, for example, the UK or the US regulators even if the other counterparty is regulated by a UK or US regulator and the relevant contract is subject to English or New York law. This may not ultimately matter as a matter of substance if the successor rates adopted by the EU and other jurisdictions are consistent. However, if the successor rates are not the same (and this appears to be a possibility as the EU has only committed to take into account recommendations made by the working groups in the other jurisdictions), this may be significant and give rise to disputes about which regime should apply to contracts. Moreover, if a product which is subject to one regime is hedged by a contract which is subject to a different regime there is the potential for different successor rates to apply under those legislative regimes. Of course, firms can seek to address this in advance by proactively amending both agreements in a way that mitigates or eliminates the basis between the fall-backs adopted, and this is what the regulators continue to urge as the overriding message.

An interesting point of comparison is on similar recent examples where EU law was intended to trump a different governing law of a contract (such as bank resolution measures under BRRD), EU supervised entities have been required to obtain contractual recognition of the effect of the EU law on the contract. That approach could be adopted here, but given the large stock of legacy non-EU law contracts containing references to IBOR, it would seem difficult for EU supervised entities to implement in practice.

**Perhaps on the basis that this aspect of the BMR might be said (at least before the courts of an EU member state) to be an overriding mandatory provision of EU law under Article 9(2) of Rome I, as a result of its crucial importance to the economic stability of the EU, and apply irrespective of the parties election on choice of law.*

KEY CONTACTS

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

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