UK GOVERNMENT ANNOUNCES LIBOR LEGISLATIVE FIX: SUMMARY OF PROPOSALS AND OUR INITIAL OBSERVATIONS

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Legal Briefings

In a written statement on 23 June 2020 made by Rishi Sunak, The Chancellor of the Exchequer, the UK Government has announced its intention to introduce a legislative solution for the transition of so-called "tough legacy" LIBOR-linked products. It intends to include measures in the forthcoming Financial Services Bill to ensure that, by end-2021, the FCA has the appropriate regulatory powers to automatically transition tough legacy contracts away from LIBOR (as we know it) without the need for bilateral or multilateral contractual amendment. The FCA has issued two supporting statements: FCA statement on planned amendments to the Benchmarks Regulation and Benchmarks Regulation – proposed new powers.

We consider the key elements of the proposals and make a number of initial observations as to the potential market and legal impact below.

SUMMARY OF PROPOSALS

Reasons underlying the proposals

The Government recognises that progress towards interim milestones for LIBOR transition has been slowed by the COVID-19 pandemic, citing the various recent statements published by the Working Group on Sterling Risk-Free Rates (**RFRWG**) and the FCA (see our blog post: LIBOR transition: The risks of interim milestone delay for the cash market due to COVID-19).

Without wishing to dilute the message that active transition away from LIBOR remains the best route for contractual and economic certainty, the Government acknowledges that there will be a narrow pool of “tough legacy” contracts that have no appropriate fallback mechanism and cannot be renegotiated or amended by the end of 2021. For these tough legacy contracts, the Government has concluded that legislative steps are necessary to assist transition, agreeing with the Tough Legacy Taskforce report published by the RFRWG (see our blog post: UK Tough Legacy Taskforce recommends LIBOR legislative fix: key risks and next steps).

Mechanism for legislative fix

The proposed primary legislation will not directly impose legal changes to LIBOR-referencing contracts governed by UK law, but instead will grant the FCA certain "appropriate" regulatory powers, via the following mechanism:

- The Financial Services Bill will introduce amendments to the Benchmarks Regulation 2016/1011 (as amended by the Benchmarks (Amendment) (EU Exit) Regulations 2018) (**UK BMR**).
- The amendments to the UK BMR will extend the circumstances in which the FCA may require an administrator to change the methodology of a critical benchmark (e.g. LIBOR) and clarify the purpose for which the FCA may exercise this power.
- The new powers will be available where the FCA (as the supervisor of the benchmark administrator) makes an announcement that LIBOR is no longer representative (for example, where some submitting banks no longer make submission for given LIBOR currencies or tenors) and will not be restored to representativeness.
- The new powers will enable the FCA to direct the administrator of LIBOR to change the methodology used to compile the benchmark if doing so will protect consumers and market integrity.
- The methodology that will be used instead has not yet been determined and it will be left to the FCA to do so. The FCA intends to seek stakeholder views on possible methodology changes in subsequent consultations. However, all indications are that “legislative LIBOR” will be produced using some iteration of the risk-free rates chosen by each LIBOR currency area (i.e. SONIA for the sterling market) with a fixed spread adjustment added to provide a proxy for the credit risk element of LIBOR.

The Government intends to take these measures forward in the forthcoming Financial Services Bill, but the more important developments and detail will be communicated through a series of statements of policy by the FCA, in which it will confirm its approach to the new powers provided by the legislation.

INITIAL OBSERVATIONS

1. Change of approach from the Government and the regulators

For a number of years, the UK Government and the regulators have carefully and deliberately avoided giving any clear signal that a legislative fix for the transition of LIBOR-linked contracts would be forthcoming. This is likely to have been primarily driven by the concern that to do so may result in portions of the market slowing their LIBOR transition efforts. The latest announcements therefore represent a dramatic change of tack.

According to the statements made by the Government and FCA in the context of this announcement, this change of approach has been triggered, in part at least, by the delay to transition efforts as a result of the COVID-19 pandemic. However it seems clear that, in addition, the authorities have recognised the difficulty/impossibility of transitioning certain tough legacy contracts away from LIBOR, notwithstanding the efforts from many sections of the market to achieve this.

2. Lack of detail provided as to the proposed legislative solution

These announcements are significant but are very light on detail and a number of key questions remain, for example:

- Which contracts will be caught by the legislation? The announcement suggests that it will cover only “tough legacy” contracts, but how will this be defined?
- What will be the new methodology for calculating legislative LIBOR? Presumably sterling LIBOR will transition to SONIA plus a spread, but what version of SONIA will be used (spot, compounded in arrears, forward looking term), how will the spread adjustment be calculated, and will there be any variation in the methodologies applied to different asset classes?
- Which LIBOR currencies and tenors will continue (in the form of legislative LIBOR) and which will not? The FCA has suggested that methodological change may not be appropriate or feasible in all LIBOR currency tenor pairs and so certain pairs may cease entirely.

It seems that the market will need to wait for the draft Financial Services Bill and, in particular, the policy statements to be published by the FCA, in order to understand fully the scope of the proposed legislative solution and its implications for those sections of the market that are most difficult to transition. Given that the FCA envisages “extensive engagement” with market participants and other stakeholders over the coming months to inform this policy work, there may be a significant delay before the market has real clarity on these issues.

Accordingly, while the market has been offered some comfort that a cliff-edge scenario ultimately will be avoided, there is still enough uncertainty surrounding the proposals to make sure that most market participants will not take their foot off the pedal of LIBOR transition – which is presumably exactly the position that the Government and regulators intended to achieve as they continue to attempt to strike a delicate balance.

3. What will the UK legislative solution mean in practice?

The UK solution means that LIBOR-linked contracts will continue to reference LIBOR – and as such there will be no direct amendment to those contracts. Rather, the way in which the reference to LIBOR in those contracts will play out, will be entirely different. Instead of the current LIBOR methodology, "legislative LIBOR" will apply. The new methodology will bear no resemblance to the previous process of panel bank submissions based on the (theoretical) rate at which banks lend to one another in the interbank unsecured funding market. It will be LIBOR in name only.

This is in many ways an elegant solution, because it means any legacy fallback mechanisms that would be engaged by the permanent cessation of LIBOR will not be engaged unless and until legislative LIBOR ends (thereby avoiding problematic fallbacks in legacy contracts; for example, those that revert to the last available published LIBOR rate, thereby converting a floating rate contract to a fixed rate).

However, there is a potential downside of this approach. Care will be needed in the mechanism that brings about this result, to ensure that contracts that have already been amended to include more robust fallbacks are not caught out. Those that were designed to take effect on the permanent cessation of LIBOR (i.e. contained no pre-cessation trigger) may not engage those negotiated fallbacks as intended or possibly at all (assuming legislative LIBOR will continue for the duration of the longest tough legacy contract). Such contracts could switch to legislative LIBOR, rather than the fallback the parties chose, if they fall within the scope of the proposed legislation.

4. Contrast in approach in the UK vs the US

The UK's proposed legislative solution is fundamentally different to the approach being taken in the US, set out in draft legislation prepared by the Alternative Reference Rates Committee (the US equivalent of the RFRWG) (see our blog post: LIBOR transition: What does the US regulator's proposed legislative fix mean for UK financial markets?).

The US approach involves direct changes to contracts governed by US law. It is a central pillar of the draft US legislation that – following a public statement from one of a number of specified persons (including the US Federal Reserve or one of the regulators) – certain changes will take place automatically in all US law contracts that reference LIBOR as a benchmark interest rate. For example, contracts without fallback language (or which fall back to a LIBOR-linked rate) will automatically transition from LIBOR to a "recommended benchmark replacement" (likely SOFR) plus a spread adjustment. To deal with contracts containing other problematic fallbacks, such as polling for LIBOR or other interbank funding rates, the draft legislation states that such fallbacks will effectively be ignored.

The proposed legislative solution in the UK arguably offers a neater solution, removing the need for complex drafting of this kind. Although the price of that is a longer period of uncertainty while the FCA considers the methodology which it decides to adopt.

5. Interaction with pre-cessation triggers

It seems likely that the FCA will make an announcement that LIBOR is no longer representative after end-2021, when panel banks are no longer compelled to submit data and confirm they intend to stop submitting. The FCA has said that it will make an assessment of representativeness each time a panel bank departs (see this speech by Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA, 28 January 2019).

This announcement will be the trigger for both the FCA's powers to change the methodology of LIBOR (i.e. it will trigger the replacement of LIBOR with legislative LIBOR) and will also be the trigger for contracts that have been amended to include pre-cessation fallbacks (e.g. derivative contracts where both parties have adhered to ISDA's proposed single Protocol).

Any statement of non-representativeness will be within the control of the FCA, and will trigger at the same time, the switch of both unamended legacy LIBOR contracts and amended contracts with a pre-cessation trigger. This is good news, particularly for market participants seeking continuity across a portfolio. However, there is a real risk of divergence in the applicable replacement rate, as discussed further below.

6. Potential impact on litigation risk

The proposed legislative solution itself may give rise to a number of litigation risks. In particular:

Automatic change in interest rate payable resulting in "winners" and "losers"

- The most obvious impact of the proposed legislative solution is that it will automatically change the interest rate payable under the contract when the methodology for calculation of LIBOR changes. A party paying an interest rate referenced to LIBOR on the date (t) that a statement of non-representativeness is made, will be paying a different rate on day t+1 when the rate switches to legislative LIBOR. However, the spread adjustment will not make the transition present value neutral on t+1 because it will almost certainly be calculated as the difference between the two benchmarks over a set period of time (e.g. the past 5 years). In this sense, it is a blunt tool and unlikely to represent the bargain which the parties would have struck had they been able to/chosen to.

- The fact that the interest rate payable under LIBOR contracts will change overnight gives rise to the inevitable possibility of "winners" and "losers", i.e. with parties receiving less or paying more interest under legislative LIBOR from t+1 than they would have received/paid had LIBOR continued without the methodological change. One of the notable benefits of the proposed legislative solution is that the differential will not be as transparent, i.e. it will not be possible to compare the two rates. Even if there are panel banks willing to submit data when no longer compelled to do so – the administrator of the benchmark will no longer publish LIBOR calculated in that way. The legislative solution thereby likely prevents the continuation of a so-called "*zombie*" LIBOR.

- However, the change in interest payable will be immediate and obvious on t+1 and this will provide fertile ground for disputes. In particular, there will be mis-selling risks in relation to both the original product referencing LIBOR (e.g. that the customer was mis-sold a LIBOR-linked product when it should instead have been sold a SONIA-linked product, particularly for products post-dating the FCA's first announcement in July 2017 that LIBOR would be discontinued); but also for contracts actively amended to switch from LIBOR (e.g. that the customer would have been better off not amending and relying instead on the legislative solution).

Portfolio mismatches

- There will be a particular risk of creating mismatches between different parts of a portfolio, where some products move to legislative LIBOR, but others are amended via bilateral agreement or (for example, in the case of hedging products) the ISDA Protocol. A stated criterion of the FCA is to find a methodology that reduces the risk of divergence between the values of legislative LIBOR and the fallbacks that would come into effect following a non-representativeness determination. However, it seems likely that there will be some differences, as explained by ISDA's CEO, Scott O'Malia in a statement made on 26 June 2020:

> "For one thing, derivatives markets have opted to use overnight RFRs compounded in arrears, which require amendments to contractual terms in addition to referencing a different rate. Given tough legacy contracts currently reference a forward-looking term IBOR and cannot be amended, it indicates a 'synthetic LIBOR' will be a forward-looking term rate based on the RFRs plus a spread adjustment. Indeed, the FCA says that use of overnight RFRs compounded in arrears 'may not be possible to replicate within the restrictions of the existing LIBOR framework'."

Potential breach of BMR

- There is a further risk of public or private law claims on the basis that continued publication of legislative LIBOR breaches the requirements of the BMR. The BMR provides that if a benchmark's representativeness cannot or will not be restored, then its publication must cease within a "reasonable period of time". The FCA has confirmed that the representativeness of LIBOR will not be restored by the proposed methodology change. As such, it may be argued that the continued publication of legislative LIBOR is in breach of the BMR.

Slowing transition efforts

- Finally, there is a risk that (contrary to the directions and intentions of the regulator) there will be a slowing in transition efforts, which will result in a larger pool of unamended LIBOR-linked contracts when LIBOR ends. If such contracts are not caught by the proposed legislative solution (e.g. because "tough legacy" contracts are defined narrowly), then there will be serious questions about what fallbacks apply and even the validity of the contracts. Accordingly, in our view, parties would be well advised to press on with their transition efforts, particularly once the ISDA Protocol and Supplement to its 2006 Definitions are published (expected by the end of July).

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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