LIBOR: WILL UK REGULATORS FOLLOW BOLD MOVE BY US REGULATORS

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Deals and cases

Responding to news that the Alternative Reference Rates Committee (ARRC) in the US has published a proposal for New York legislation to minimise legal uncertainty and adverse economic impacts associated with LIBOR transition, Rupert Lewis, head of banking litigation at Herbert Smith Freehills, says that: “the London market will watch this development with great interest. The proposed legislative fix in the US would represent a bold move as it aims to give market participants the confidence to transition large books of legacy LIBOR products to the recommended benchmark replacement without the fear of being sued by counterparties. In particular, the proposed legislation would give banks ‘safe harbour’ from litigation if they use the ‘recommended benchmark replacement’ selected by the regulators.

Lewis continues: "What is really striking is the fact that ARRC considers that a legislative fix is needed urgently. This suggests the US authorities think the stakes are simply too high to leave it to market participants and trade bodies to find their way to solutions between now and the end of 2021 (when it is planned that LIBOR will be discontinued). They are looking to grasp the nettle now.

"And yet the proposed legislation is not without difficulties and is likely to create winners and losers. The most obvious difficulty with this solution is that it will change the interest rate payable under the contract when the switch away from LIBOR takes place. This is because risk free replacement rates (such as SOFR in the US and SONIA in the UK) are overnight rates with virtually no term credit risk priced in, and so they are inherently lower than LIBOR.

“Even with a spread adjustment to account for this difference (catered for in the draft legislation), it is a blunt tool and the possibility of winners and losers is inevitable. For banks, it may also create mismatches between different parts of their portfolios, as the legislation envisages that the spread adjustment may be different depending on the type of product. The obvious question that arises from a London market perspective is whether the FCA or the Bank of England will follow suit. In previous pronouncements, the FCA has made clear that the London market should not assume a legislative fix will be forthcoming, not least because it was not within its gift to give. But there is no doubt that this announcement from ARRC will place pressure on the UK regulators to follow suit. The Bank of England's working group on sterling risk free rates has promised to publish a paper on tough legacy contracts in the second half of Q1 2020, so hopefully we will have some further clarity on this front soon."

MEDIA CONTACT

For further information on this news article, please contact:

MIKE PETROOK, COMMUNICATIONS MANAGER

LONDON
Tel: +44 20 7466 3939
Mob: +44 7850 516 778
Email: mike.petrook@hsf.com