HERBERT SMITH FREEHILLS

IBOR TRANSITION: REGULATORY/LITIGATION RISK

LIBOR cessation will have a profound impact on the financial services industry. It is inevitable that institutions will face litigation and regulatory risks as a result of the transition. It is important that those risks are understood so that careful steps can be taken to mitigate such risks during the transition process.

In our view, the key litigation and regulatory risks which arise can be categorised into three areas, which are considered further below.

However, throughout the transition process, there has been a recognition that there may be some contracts where it will be very difficult, or even impossible, to achieve the necessary amendments prior to the cessation of LIBOR. These contracts are often referred to as “tough legacy contracts”. The volume, value and complexity of such contracts will have a clear impact on the litigation and regulatory risks arising for financial institutions. To address concerns about the risks of a "cliff-edge" scenario for tough legacy contracts, the key jurisdictions involved in LIBOR transition (the US, EU and UK) have proposed legislative interventions. The scope of, and risks arising from, these proposals are considered further below.

KEY LITIGATION AND REGULATORY RISKS

CONTRACTUAL CONTINUITY

Many legacy contracts which include references to LIBOR do not contain robust existing fall-backs. In some instances, those fall-backs are commercially unattractive – for example where the operation of a fall-back to the last available LIBOR rate that was published effectively converts a floating rate to a fixed rate. However, in other instances the fall-back will be unworkable or the implementation of the fall-back itself may give rise to disputes.

This may lead to arguments about the ability of the court to interpret contracts in a way that avoids a commercially unattractive or unworkable result. Alternatively, the court may be asked to imply terms to make a contract workable, or to allow the court to step in and perform the contractual mechanism (i.e. calculation of the relevant interest rate, based on expert evidence). However, in the absence of such contractual mechanisms, there is a very real risk of arguments that LIBOR cessation will frustrate the contract or engage any force majeure clause.

MIS-SELLING RISKS

The risks of litigation or conduct issues arising as a result of LIBOR cessation are clear both in respect of (i) the continued sale or distribution of LIBOR-linked products (e.g. where issues of contractual continuity may arise); and (ii) the transition of LIBOR-linked products to RFRs (e.g. even allowing for a spread adjustment, there will inevitably be a value transfer on transition, resulting in "winners" and "losers" and a potential incentive for claims or conduct investigations.

In addition, differences in the fall-backs for different product markets will likely create basis risk for customers who hold portfolios of products. This is because there are likely to be nuances across different product markets in both the economic effect of fall-backs and in the timing of their triggers. This will be particularly acute where one or more of products are intended to hedge other products impacted by the transition.

The uncertainty around the legislative fall-backs also creates risks for firms given the inability to understand the economic consequences of failing to amend legacy contracts, as highlighted below.

GOVERNANCE AND APPLICABLE SENIOR MANAGER REGIMES

The complexity of the transition process, and the inherent risk that it poses both to financial services firms and their customers, means that regulatory scrutiny is likely to be high. Firms are on notice that they are expected to have carefully designed and well-resourced project plans to manage the transition of their contracts. Accordingly, robust and clear governance arrangements for the programme, with specific internal project teams subject to senior management oversight and with external resource and expertise where appropriate, will be critical.

In particular, those institutions which operate in jurisdictions that have a senior management accountability regime (such as the Senior Management Certification Regime in the UK, the Bank Executive Accountability Regime in Australia and Hong Kong's Manager-in-Charge and Registered Institutions Senior Manager Accountability Regimes) will need to ensure that they have effective processes in place to discharge the obligations of their senior managers under those regimes.

PROPOSED LEGISLATIVE INTERVENTION FOR TOUGH LEGACY CONTRACTS

Until recently, the regulators have been careful to play down the potential for legislative provisions which are designed to prevent a "cliff-edge" scenario for these tough legacy contracts at the end of 2021. It is likely that this reluctance was driven to a large extent by the concern that it would encourage the industry to ease off its transition efforts. However, the last few months have seen significant developments in this area, as the level of concern surrounding the risks of the cliff-edge grow.

The UK Government responded to this by announcing its intention to introduce a legislative solution for the transition of tough legacy contracts (see our blog post), and on 21 October 2020 introduced the Financial Services Bill to Parliament, which provides an overarching legal framework giving the FCA new and enhanced powers to manage the wind-down of a critical benchmark, i.e. LIBOR (see our blog post).

In summary, the Financial Services Bill seeks to reduce the risk of litigation arising from disputes about the continuity of so-called "tough legacy" LIBOR contracts. In simple terms, it does this by providing new and enhanced powers for the FCA where it has determined that a critical benchmark is at risk of becoming unrepresentative, or has become unrepresentative, and that its representativeness cannot reasonably be maintained or restored. In such circumstances, the FCA will have the power to designate a change to the methodology by which LIBOR is set so that references in "tough legacy" contracts to LIBOR will effectively be treated as a reference to the new methodology (the synthetic LIBOR rate), rather than a rate which no longer exists.

The proposed legislative solution itself may give rise to a number of litigation risks. 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, to a rate that is currently uncertain (and will remain so for some time). The change in interest payable will be immediate and obvious which will provide fertile ground for disputes; it is again a blunt tool and unlikely to represent the bargain which the parties would have struck had they been able to/chosen to. In particular, there will be mis-selling risks in relation to both the original product referencing LIBOR, but also for contracts actively amended to switch from LIBOR (for example, if they would have been better off under legislative LIBOR). It remains to be seen how the scope of the solution will be defined (i.e. what will count as "tough legacy") and disputes may arise as to whether contracts fall within or outside that scope.

Other risks include 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. There is a further risk of public or private law claims on the basis that the continued publication of legislative LIBOR breaches the requirements of the UK BMR.

Separately, the Alternative Reference Rate Committee (ARRC) has published a proposal for New York state legislation to assist the transition of New York law financial contracts away from USD LIBOR (see our blog post) and the European Commission (**Commission**) has announced proposals for an EU legislative solution for the transition of legacy LIBOR contracts (see our blog post). 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.

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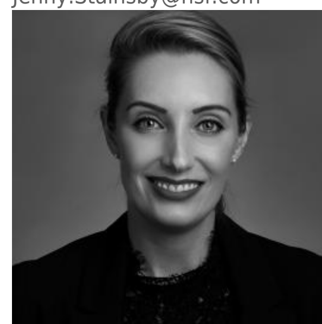

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