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Competing Libor-Transition Proposals Create More Problems

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As the Dec. 31, 2021, end date for Libor approaches, it is becoming increasingly apparent that it will not be possible for market participants to amend all legacy contracts to add Libor fallback provisions or replace or ameliorate problematic fallback provisions.

In some cases, such as in many securitizations and floating-rate notes, the consent of all holders of the securities may be necessary for any amendment yet it is impossible to find all of the holders, much less obtain their unanimous consent. This will leave thousands of so-called "tough legacy" contracts, which, if not amended, will either change from a floating Libor-based rate to a fixed rate — i.e., the last published Libor rate — or land in a sort of contractual limbo, with uncertainty as to how they are to operate when Libor ceases to exist.

To address this problem, proposals for potential legislation have emerged in three different jurisdictions in the last six months. In this article, we provide an overview of the approaches proposed so far in the U.S., U.K. and EU and comment on their likely effectiveness in dealing with the problems posed by tough legacy contracts.

The Alternative Reference Rates Committee's Proposal for New York

In October 2018, the meeting minutes of the Alternative Reference Rates Committee, or ARRC, in the U.S. first noted the possibility of using legislation to address the tough legacy problem. Over the months that followed, various possible approaches were discussed at both state and federal levels. In early March, the ARRC released a draft of a statute that could be enacted by the New York state legislature.

The ARRC draft is based upon the approach used by New York and a handful of other states in the late 1990s that enacted statutes providing for continuity of contracts referencing European currency units upon their replacement by the Euro in 2002.[1]

According to the ARRC draft, a party to a contract referencing Libor would be prohibited from refusing to perform or declaring a breach as a result of either Libor's discontinuance or the counterparty's use of a "recommended benchmark replacement," which is specified as the secured overnight financing rate, or SOFR, plus a "spread adjustment."[2]

The draft also provides that SOFR is a commercially reasonable substitute for and a commercially substantial equivalent to Libor and creates a safe harbor from litigation for the use of the recommended benchmark replacement.

The ARRC draft statute would override any contractual Libor fallback language that references a Libor-based rate — e.g., a fallback to the last available print of Libor — and require use of the recommended benchmark replacement. It also would nullify any fallback language that requires dealer polling and amend contracts lacking any Libor fallback language to make SOFR plus a spread adjustment the Libor fallback.

The draft legislation would not alter any existing Libor fallback provision that specifies a non-Libor based rate as the fallback.

Where a party has contractual discretion or judgment regarding the Libor fallback rate, the draft legislation would immunize such party from litigation, and thus, liability, if they select the recommended benchmark replacement as the fallback rate. The draft also would permit parties to a contract to opt out of mandatory application of the draft legislation.

The ARRC draft legislation has a number of clear challenges and potential shortcomings:

1. As of this writing, the ARRC draft has not been proposed in the New York state Legislature, which has been focused on addressing the needs of New Yorkers arising out of the COVID-19 pandemic. It is not anticipated that the draft legislation will be considered this year, and it is unclear whether it will make it onto the agenda in 2021 with sufficient time to make a practical difference if enacted.

2. If enacted, the ARRC draft may face an immediate legal challenge because it may be argued to violate the contracts clause of the U.S. Constitution and potentially state constitutions as well.

3. The ARRC draft does not say what contracts it applies to, nor does it define the key terms "contract," "security" and "instrument," which could lead to disputes about whether a contract has been amended by it or not.

The U.K. Government Proposal

On June 23, the U.K. government announced that it intends to ensure that the Financial Conduct Authority's, or FCA's, powers are sufficient to manage an orderly transition from Libor by amending the Benchmarks Regulation 2016/1011 as transposed into English law at the end of the transition period for the U.K.'s withdrawal from the EU.[3] The proposed amendments would:

1. Grant the FCA powers to require an administrator of Libor to alter its methodology for calculating the benchmark if Libor ceases to be representative of the market and its representativeness will not be restored. This would not restore the benchmark's representativeness, but could sustain publication of a robust rate until its cessation; and

2. Allow the FCA to permit the use of the resulting "synthetic Libor" for a narrow category of tough legacy contracts where it considers this appropriate.

While this proposal appears to be an effective way to deal with tough legacy issues, there are a number of potential shortcomings:

1. There is no guidance as to what methodology will be used to calculate the new synthetic Libor. The FCA says it will consult with stakeholders on possible methodology changes, meaning it will almost certainly be many months before details of how the rate will be calculated are confirmed.

2. The FCA accepts that it may well not be able to create a new methodology for some Libor tenors or currencies.

3. It is unclear how tough legacy contracts will be defined. The Working Group on Sterling Risk-Free Reference Rates refers to "tough legacy" contracts as "those contracts that cannot be dealt with in any other way" apart from continuing to reference Libor. It is unclear whether, for example, a contract where the parties simply cannot reach commercial agreement on the replacement for Libor would be included. It may be that the FCA will have powers to adjudicate whether a particular legacy contract is included, or it might be that these proposed powers will simply be a default position for any legacy contract continuing to refer Libor — i.e., every unamended legacy contract is treated as a tough legacy contract.

The U.K. government intends to introduce these amendments in the forthcoming Financial Services Bill, following which the FCA should publish policy statements explaining how it will enforce its enhanced powers.

Until the specific legislative amendments are available and the FCA has indicated how it intends to apply its powers, it is not possible to fully understand and comment on the implications of this proposal for parties to legacy contracts.

In the meantime, the position continues to be very uncertain and, despite the FCA's encouragement, parties may be reluctant to make progress with seeking agreed fallbacks or amendments pending how any changes will interact with the FCA's exercise of these new powers.

The EU Proposal

On July 24, the European Commission proposed amendments to the Benchmarks Regulation 2016/1011 to empower the European Commission to designate a statutory replacement rate if and when a benchmark, such as Libor, ceases and where that would result in significant disruption in the functioning of financial markets in the European Union.

This proposal would directly impose legal changes on Libor-referencing contracts to which an EU-supervised entity is a party and where there are no, or no suitable fallback provisions. The changes would take place upon the occurrence of certain trigger events, including an "unrepresentativeness" trigger.

As with the other proposals, while this approach has its benefits, there are also potential obstacles to its success:

1. It remains unclear what the statutory replacement rates will be. The fact that the European Commission said that it would take into account the recommendations of official working groups does however suggest that the statutory replacement rate for a given currency will be the rate that is recommended by the relevant working group.

2. This proposal applies only to contracts to which an EU supervised entity is a party. For contracts not involving an EU-supervised entity, the European Commission encourages member states to adopt national statutory replacement rates.

3. The statutory replacement rate would replace the reference to the benchmark where a contract contains a fallback provision that (1) accommodates only a temporary suspension of a benchmark whose cessation would result in significant disruption in the functioning of financial markets in the EU, or (2) itself refers to such a benchmark. According to the proposal, an "historic screen rate" fallback, which applies the last quoted fixing of the relevant benchmark, would fall within this definition. However, there is no clear guidance as to what other types of fallback provisions are included. This might lead to uncertainty or disagreement over how a contract should be interpreted.

Although these legislative proposals have been published, it is unclear whether more detail will be published in due course, and the European Commission has not provided any timetable for further clarification.

Analysis

As noted above, each of these three approaches has benefits and potential shortcomings. Together, though, they create an unstable and uncertain situation for market participants, despite their potential to solve the tough legacy problem as the market transitions away from Libor.

This is exacerbated particularly in relation to the U.K. and EU proposals by the need to wait and see the outcome of consultations with market participants and working groups.

From a public policy perspective, all three approaches are unusual in that they protect those who have not fully understood or acted to address how their contracts will behave upon the end of Libor. Meanwhile, those who have read their agreements, understood how they will behave — or that there is uncertainty about how they will behave — when LIibor goes away and planned accordingly stand to have their expectations upended.

Moreover, the multiplicity of approaches among the U.S., UK and EU — and potentially other jurisdictions — gives rise to uncertainty for market participants rather than eliminating it. For example, counterparties in the U.S. that have contracted under English law may be surprised to learn — or disagree about whether — they now must use the FCA's "synthetic Libor" rather than SOFR-plus-a-spread under the New York statute.

Also, non-EU market participants may not know whether they are dealing with an EU-supervised entity, leading to doubts and potential disputes about whether the EU benchmarks amendments or some other regime applies.

This uncertainty may pose particularly difficulties for hedged positions, where a cash product may be governed by one law and its hedge by another. In those circumstances, the parties may end up with different regimes applying to each instrument, leading to a mismatch of applicable rates, potentially costly basis risk as well as possible disputes.

This problem is especially acute for the EU's proposed legislative intervention. On its face, the EU solution will apply directly to any contract referencing Libor that involves an EU-supervised entity, regardless of the law of the contract itself.

However, it is extremely difficult to understand how a contract governed by English or New York law could be overridden or amended by European legislation — bearing in mind the U.K.'s transitional position in accordance with its withdrawal agreement with the EU expires at the end of this year.

This may lead to uncertainty and disputes about which regime applies, especially if the successor rates adopted by the U.S., U.K. and EU proposals are not the same.

Ultimately, the reason given for the transition away from Libor is financial stability. A prerequisite to financial stability is certainty for market participants, given the inevitable disruption that will be caused by legacy contracts during the transition away from Libor.

Although each of these approaches has benefits and potential shortcomings, regulators and governments in the U.S., U.K. and EU should work toward as harmonized an approach as possible. Regrettably, there is limited evidence that is occurring at this stage and many of the key details remain unresolved.

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[1] See, e.g., N.Y. Gen. Oblig. L. §5-1601 et seq. (enacted in 1997).

[2] The draft legislation allows for recommended benchmark replacements other than SOFR, but none currently exists or is mentioned in the draft.

[3] From the end of the transition period on Dec. 31, 2020, U.K.-based firms will be required to comply with the U.K. BMR rather than the Benchmarks Regulation 2016/1011 (the "EU BMR").