The Evolution of Financial Benchmarks and Legacy Contracts

Dr Joanna Perkins

Financial Markets Law Committee

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Barclays shall determine its Submission(s) based on the following Factors, Adjustments and Considerations, unless otherwise prohibited by or contrary to an affirmative obligation imposed by any law or regulation, or the rules or definitions issued by a Benchmark Publisher. ***Barclays' transactions shall be given the greatest weight in determining its Submissions, subject to applying appropriate Adjustments and Considerations*** *in order to reflect the market measured by the Benchmark Interest Rate…*

(CFTC Penalty Order, 27 June 2012)

The Regulation of Financial Benchmarks: A Timeline

1. June 2012 CFTC and FCA Penalty Notices published. CFTC Penalty Notice directs Barclays on LIBOR submissions.
2. September 2012 Wheatley Review Final Report
3. March 2013 New FCA Rules introduced for "specified benchmarks" (i.e. LIBOR)
4. April 2013 IOSCO Principles for Financial Benchmarks
5. September 2013 European Commission Proposal for a Regulation on Indices Used as Benchmarks in Financial Instruments and Financial Contracts
6. July 2014 FSB Report on Reforming Major Interest Rate Benchmarks
7. April 2015 Seven UK benchmarks now specified as a result of Fair and Effective Markets Review led by BoE
8. June 2015 FSA consults on "FRAND" pricing for benchmarks
9. July 2015 ICE Benchmark Administration consults on evolution of LIBOR, a regulated benchmark
10. October 2015 EMMI consults on the evolution of EURIBOR to comply with regulatory standards
11. November 2015 European common agreement on a Regulation on Indices
12. December 2015 E.U. Regulation on Indices, common agreement text published
13. February 2016 ESMA consults on "policy orientations" for Level 2 measures under E.U. Regulation on indices used as financial benchmarks
14. February 2016 FCA adopts rules on "FRAND" pricing vis-à-vis infrastructure users
15. April 2016 Adoption of the Regulation on financial benchmarks by the European Parliament

Benchmark withdrawal, transition and evolution:

The issue of legacy contracts

In pursuing the objective of moving to transactions-based rates, transition risks and costs should be minimised as much as possible. These risks and costs can include legal risks arising from litigation and contract frustration and increased hedging costs resulting from reduced liquidity in instruments referencing the alternative rate or from the greater volatility that may naturally occur in more transactions-based reference rates. However, whilst risks and costs arising from legacy contracts should not be ignored, they should not be used to prevent changes regarded as necessary from a systemic perspective.

(FSB, *Reforming Major Interest Rate Benchmarks*, 22 July 2014)

FMLC Letter to EMMI on the Evolution of Euribor

*"It is often said that benchmark withdrawal would represent a **frustration** risk for financial contracts and occasionally the same thing is said of benchmark transition or evolution on the premise that the evolved benchmark no longer shares die identity of the original benchmark.*

*A similar issue, which is perhaps more prevalent in civil law systems, is the risk of **force majeure**, whereby a party is excused performance under a contract because performance has become impossible or impracticable owing to the intervention of an unpredictable and overwhelming supervening event. In common law systems, although there is no freestanding doctrine of force majeure, contracts sometimes include **force majeure clauses** contemplating events that may render performance impossible or impracticable and make provision for the parties to be excused further performance. When a force majeure clause is triggered it will normally bring an end to the contract.*

*Frustration will only occur where the parties to the contracts can be said to have wholly failed to allocate the risks of benchmark withdrawal. The parties may be taken to have allocated these risks in a number of different ways. A financial contract may make express provision for benchmark withdrawal—as with a **fallback clause**—or it may be found, at common law, to incorporate an **implied term** which covers the eventuality...*

A report published by a Market Participants Group (the "MPG")... sets out legal risk factors for certain key jurisdictions in the Eurozone and provides that, in those jurisdictions, the doctrine of implied terms is not available. The risk that a contract comes to a disorderly end in the event of benchmark withdrawal or transition may, in light of this, be slightly higher in civil law systems, although fallback provisions will help to mitigate any risk."

UK Specified Benchmarks

Financial Services Act 2012, Section 93(4)
"Relevant benchmark" means a benchmark of a kind specified in an order made by the Treasury.

The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2015
The benchmarks known by the following names are specified—

1. The London Interbank Offered Rate, also known as LIBOR;
2. ISDAFIX;
3. Sterling Overnight Index Average, also known as SONIA;
4. Repurchase Overnight Index Average, also known as RONIA;
5. WM/Reuters London 4 p.m. Closing Spot Rate;
6. London Gold Fixing;
7. LBMA Silver Price;
8. ICE Brent Index.

With regulation have come a number of actual or proposed changes to the ownership, administration and/or fixing methodology of these benchmarks. Collectively, changes to the eight "specified" benchmarks now regulated in the UK probably represent the biggest single evolutionary shift in the financial benchmark landscape since the introduction of LIBOR in 1970 for use in what may have been the first Euro-currency (US dollar) floating rate note.

History gives cause for comfort...

Four examples of interest rate transition:

1. In 1981, the Minimum Lending Rate (MLR)—the minimum interest rate at which the Bank of England announced that it would make short-term money available to the market—ceased to be published. A market-wide transition to the prevailing clearing rate (i.e. the base rate published by members of The Committee of London Clearing Bankers) occurred seamlessly and apparently without the need for revisions to contracts on standard terms.

2. In 1998, the BBA, which was the administrator of LIBOR at the time, took a decision to calculate LIBOR, not as a "prime bank" reference rate but rather as a rate reflecting panel banks' "own cost of funds". It therefore significantly amended the published question which identifies the benchmark's underlying interest. This change occurred apparently without legal incident.

3. On 31 January 2014, the BBA ceased to act as the administrator for LIBOR and the benchmark was transferred to its current administrator: IBA. This handover occurred without incident for financial instruments, notwithstanding contractual references to "BBA LIBOR" or "the British Bankers Interest Settlement Rate" were still common in standard form contracts at the time.

4. In 2002 and then again in 2007 significant changes were made to the Brent Crude Oil benchmark methodology by introducing a wider range of crude oils of different grades. The quality change that occurred as a result of these transitions had a direct effect on pricing and thus on the economic interest of parties to futures and forward contracts referring to the benchmark. Despite this, each transition was completed seemingly without any realisation of legal risk.

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Conclusion