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LIBOR transition, litigation risk and the new Critical Benchmarks Bill

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In this podcast, Alina Neal, Of Counsel in the Finance Litigation team and Sean Crowley, Partner in the Finance team look at the changes ahead for finance parties in relation to LIBOR transition and consider some of the litigation risks arising, including the application of the Critical Benchmarks Bill.

Introduction

Interest rate benchmarks, such as LIBOR, are used to calculate the interest rate in financial products. These rates are written into loans, bonds and mortgages, and many other contracts, with LIBOR being the most common interest rate benchmark in the UK.

Since the 1980s LIBOR has been used widely as an interest rate benchmark for many financial products. LIBOR is based on banks' submissions of their interbank borrowing rates. However, since the financial crisis in 2008, banks no longer fund themselves in this way. The absence of an underlying active market meant that LIBOR was sustained by the use of "expert judgement".

From 31 December 2021, the Euro, Swiss Franc, Japanese Yen and Sterling LIBOR will no longer be published. Given that LIBOR underpins around USD$300 trillion in financial contracts globally, the scale of the task involved in moving away from LIBOR has been Herculean and has presented a number of significant challenges for lenders.

In the UK, the Bank of England and the FCA have identified the Sterling Overnight Index Average, known as SONIA, and which is administered by the Bank of England, as the preferred rate to replace LIBOR in the UK.

In contrast to LIBOR (which is a forward-looking term rate with a built-in credit and liquidity premium which is heavily reliant on expert judgement submissions) SONIA is a nearly "risk free" rate. It is a backwards-looking overnight rate anchored in real transaction data. The profoundly different way in which LIBOR and SONIA work means that it is impossible to effect a straightforward exchange of one rate for the other. A loan linked to SONIA will be an entirely different product to a loan linked to LIBOR, requiring support from completely different IT systems and different contractual provisions to address its calculation, as well as a fundamental rethink of secondary pricing related issues such as break costs and fallback rates based on cost-of-funds.

Whilst efforts have been made to adapt SONIA to make it fit the particular needs of the syndicated loan market the fact remains that, unlike loans linked to forward-looking LIBOR, the interest payable on a loan linked to SONIA will only be known at the end of the interest period.

Over the past couple of years the consistent message delivered by regulators has been that lenders and borrowers should seek to actively transition away from LIBOR to new alternative rates such as SONIA. The Financial Conduct Authority has kept the pressure up on supervised entities by making it clear that failure to engage with the transition process will be a conduct issue.

However, the fact remains that only a matter of days now remain until 31 December and many lenders, despite their best efforts, still have quite a lot to do in order to secure transition of their loan books.

For this reason, moves are now underway to put in place contingency plans, so as to avoid a cliff edge (and the resulting market chaos) when the key Sterling LIBOR tenors cease to be published on 31 December. I will say more on this later.

Why is LIBOR being phased out?

In short, LIBOR is being phased out as a loan benchmark because of its vulnerability to manipulation, evidenced by the scandals which came to light in 2012 involving LIBOR manipulation by the rate-setting banks. LIBOR manipulation by these banks led to fines totalling billions of pounds, with several senior bankers losing their jobs as a result of the manipulation, and a number facing criminal charges. For instance, Tom Hayes from the Swiss bank UBS, was jailed for 11 years for distorting the index. The scandal sowed widespread distrust in the financial industry and led to a wave of fines, lawsuits, and regulatory actions in the UK and US. Further, as Sean explained, following the 2008 financial crisis, the volume of underlying transactions also dropped so significantly that, taken as a whole, LIBOR became unsustainable.

Takeaway point from the LIBOR mis-selling claims

In the wake of the 2012 scandal, a significant amount of LIBOR litigation has gone through the UK courts. Principally, claims have been brought on the basis of misrepresentation, mis-selling or fraud. For LIBOR-related misrepresentation claims, claimants have had to prove that when they entered into contracts, they did so specifically in reliance on the fact that LIBOR was not being manipulated.

Whilst that precise scenario may not necessarily be replicated in future mis-selling cases, the LIBOR mis-selling litigation has generated various legal findings that may remain relevant to future litigation. We look at three key points:

- First, in relation to misrepresentation claims the courts have established that the representation (that LIBOR was not being manipulated) must have been "actively present" in the relevant individual's mind. It's not going to be enough for a claimant to argue that they relied on a generalised implied representation or assumption that LIBOR was not being manipulated. For more information on this see our article here.

- In relation to limitation, case law has established that for the purposes of s32 of the Limitation Act 1980 (the provision which delays the start of the limitation period in cases based on the defendant's fraud), time begins to run on the date at which either the claimant discovered the fraud or could **with reasonable diligence** have discovered it. In the context of these types of claims based on LIBOR misrepresentation, the courts have held that reasonable diligence would have led to the discovery of material facts by, at the very least, the date on which regulatory findings in the form of a "Final Notice" from the FCA were issued, and by the widespread publicity surrounding the issues at the time.[1]
- Another key area of legal precedent in relation to mis-selling relates to whether a bank is acting as an advisor or simply as an execution-only "counterparty" or "salesperson". The recent decision by the Supreme Court in Manchester Building Society v Grant Thornton LLP[2] has clarified that in determining the scope of an advisor's duty, one of the key questions to address is the purpose for which any advice was provided. For more information on this point, see our article here. Exclusion clauses/non-reliance clauses have also generated significant case law which may well prove relevant in due course.

What litigation risks might there be in the transition away from LIBOR?

Given the problems associated with the potential LIBOR replacements, the requirement for banks to advise on replacement rates which meet their customers' needs represents a significant challenge. In addition to the regulatory risks, there are clear litigation risks. A failure to disclose the fact of or risks associated with new or existing LIBOR-linked contracts may lead to mis-selling claims, particularly if the bank becomes the resulting beneficiary. On the other hand, banks will be wary of opening themselves up to the risk of negligence claims (or at the very least negative client outcomes) if they steer clients towards alternatives which ultimately have an adverse financial outcome.

The difficulty for banks in the context of LIBOR transition is that finding a replacement rate for a client which meets that client's needs introduces a degree of communication on the risks inherent in the transaction – as well as the rate transition itself. This opens the door to the same issues inherent in the LIBOR mis-selling claims.

Lenders also need to identify, insofar as possible, the way in which alternative rates will work. While this is challenging, particularly in the current market environment, it is crucial. In the event of future litigation, evidence of thoughtful analysis having been undertaken is

[1] See: Boyse v Natwest Markets & RBS [2021] EWHC 1387 (Ch)
[2] [2021] UKSC 20

likely to minimise the risk of a finding that regulatory, contractual or tortious obligations have been breached.

It will be important to clearly delineate the role being undertaken. Financial institutions may want to avoid providing advice (for example, leading a specific client through its decision-making process), in which case it will be important to show that only information about the choices available is being provided, with the ultimate decision being taken by the borrower and other relevant parties. Non-reliance clauses will be particularly important in these scenarios.

In the time available in this podcast, we haven't addressed the challenges and litigation risks associated with switching products related to loans, such as hedging instruments, to risk free rates. Switching hedged loans to risk free rates is a particularly tricky area due to the challenges associated with aligning the transition of the two products – both in terms of timing and the new reference rate. A mismatch will result in basis risk, which may or may not be an issue for a particular loan or transaction. Our experts would, of course, be more than happy to discuss this with you further.

In conclusion, what is clear is that, notwithstanding the legislative changes proposed in the new critical benchmarks regime, with such a substantial change to interest rate benchmarks there will be significant litigation risk. I will now hand over to Sean to review the key proposals in the Critical Benchmarks Bill.

Brief look at the Critical Benchmarks Bill and the key proposals

Although the emphasis has very much been on the importance of market participants actively transitioning from LIBOR to alternative (usually risk free) rates, it has also been recognised that there will be certain so-called "tough legacy" contracts. These are essentially those contracts where it proves impossible for the contract counterparties to agree transition away from LIBOR to an alternative benchmark rate before the end of this year.

To avoid "cliff edge" disruption in the financial markets (which would occur if LIBOR were suddenly to cease being published at the end of the year with no contingencies) on the 29th of September the UK Financial Conduct Authority confirmed the continued publication for the duration of 2022 of 1-, 3- and 6-month sterling and Japanese yen LIBOR under a "synthetic" methodology, based on term risk-free rates. These synthetic LIBOR rates cannot be used for new loans – their use is restricted to transition of legacy products.

The theory behind the publication of synthetic LIBOR rates is that continued use of synthetic LIBOR will allow some contracts to reach their natural maturity and roll-off. However, the FCA has been very clear that in most cases, it should be viewed as providing a further period to complete transition of legacy contracts, rather than an alternative. Synthetic LIBOR is not to be viewed by parties as being a permanent solution. Furthermore, the availability of synthetic LIBOR rates will be subject to annual review and therefore the ongoing availability of synthetic LIBOR beyond 2022 cannot be assured.

To ensure that the new synthetic LIBOR rates are capable of applying to a wide range of contracts the Government has introduced to Parliament the Critical Benchmarks (References and Administrators' Liability) Bill. This is currently at the Third Reading stage in the House of Lords[3].

Broadly, this legislation aims to ensure that references to Sterling LIBOR in existing contracts will be interpreted as references to a synthetic LIBOR rate where a transition has not been made in time. The Bill also provides that contracting parties cannot argue that use of synthetic LIBOR constitutes breach of contract, material change or frustration and also gives the administrator of the benchmark a degree of immunity.

The scope of the proposed legislation is deliberately broad. It is intended to apply to all contracts and arrangements governed by the laws of the UK. It is also intended to be capable of applying to contracts that *describe* LIBOR (even if the words "LIBOR" are not actually used).

The Bill also aims to cater for the situation in which a contract provides for a contractual fallback in the event that LIBOR ceases to be available (either temporarily or permanently). It is fair to say that the way this works in the legislation is pretty fiddly. However, the FCA has explained that, in broad terms, if a contract contains provisions that will move the contract away from LIBOR as a result of unrepresentativeness or permanent unrepresentativeness of LIBOR (a so-called "pre-cessation" trigger), this should usually mean that the contract moves away from the relevant sterling or Japanese yen LIBOR setting to the relevant benchmark set out in the fallback provisions at the time, or just before, it becomes unrepresentative.

However, in relation to those contracts referencing 1, 3 or 6m sterling or yen LIBOR that only include fallbacks which operate when a benchmark ceases permanently, these fallbacks are not likely to be triggered while these LIBOR settings continue to be published using a synthetic methodology for a wind-down period (although this will obviously depend on the wording of individual contracts). Rather, these fallbacks are likely to operate only when the relevant LIBOR settings cease to be published in any form.

Only syndicated sterling loans drafted relatively recently are likely to include contractual fallback mechanisms or "rate switches" which kick in upon the occurrence of "pre-cessation" trigger events. Most syndicated loans will instead include contractual provisions providing contractual fallbacks which apply in the event of the temporary unavailability of the LIBOR Screen Rate (with the fallbacks commonly being to Lenders' cost of funds).

[3] See: Critical Benchmarks (References and Administrators' Liability) Bill [HL] - Parliamentary Bills - UK Parliament

Consequently, it appears that many sterling and yen syndicated loans which have not actively transitioned to a new rate will, after 31 December 2021, automatically move to reference synthetic LIBOR.

There are some issues which parties will need to grapple with if this happens. For example, one issue is that synthetic LIBOR is not going to be published for Sterling for any period less than a month. However, on syndicated loans it is often necessary to calculate interest for "stub periods" of less than a month and the documents will contain no workable methodology to deal with this.

It also seems inevitable that the automatic "switch" to synthetic LIBOR could result in financial consequences for some parties. Lenders will probably be most vulnerable to regulatory censure and potential litigation where they have failed to engage fully and proactively with the transition process. The Financial Conduct Authority has certainly delivered a consistent message that supervised firms need to engage actively with the transition process and that failure to do so will be a conduct issue.

Notably, the Bill does not include any "safe harbour" to protect parties using synthetic LIBOR from the risk of litigation. Instead, it confirms that the deeming provision neither creates any new liabilities nor extinguishes any existing causes of action. This approach of course consistent with the reluctance of English law to interfere in the freedom of contract. However, it is a different approach to the approach being taken in the US: the US tough legacy legislation has a broad "safe harbour" from claims.

Another issue which is important (and extremely complicated) is the interaction between the various "tough legacy" legislation which is being enacted (or to be enacted) in different jurisdictions. While now is not the time to discuss this in any detail, it is fair to say that the interplay between the various pieces of tough legacy legislation is far from clear and could potentially give rise to complex conflict of laws issues. This is no doubt music to the ears of financial litigators, but a real headache for transactional lawyers.

Conclusions

It is clear that a lot of hard work has been going on by regulators and legislators to try and minimise the scope for chaos when the plugs are pulled on a number of key LIBOR screen rates on 31 December.

It will, however, remain to be seen exactly what impact the discontinuation of LIBOR and the imposition of a synthetic rate on certain contracts and parties will have on the market and what litigation risks this will cause.

It is, though, hard not to come back to the quote of the general counsel of the Federal Reserve Bank of New York who described the discontinuation of LIBOR as "a DEFCON 1 litigation event".

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