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Panel of **R**ecognized **I**nternational **M**arket **E**xperts in **Finance**

The Reform of Key Interest Rate Benchmarks: Progress and Challenges

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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)

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Reform of Key Interest Rate Benchmarks: A Timeline

1. June-September 2012 CFTC and FCA Penalty Notices, Wheatley Review Final Report published.
2. March 2013 New FCA Rules introduced for “specified benchmarks” (i.e. LIBOR)
3. **April 2013 IOSCO Principles for Financial Benchmarks**
4. September 2013 European Commission proposes a Regulation on Indices Used as Benchmarks (“BMR”)
5. **July 2014 FSB Report on Reforming Major Interest Rate Benchmarks**
6. October 2014 ICE Benchmark Administration (“IBA”) consults on evolution of LIBOR
7. November 2014, NYFRB launches Alternative Reference Rate Committee, considers alternatives to $LIBOR
8. December 2014, JBA consults on reforms to TIBOR benchmark
9. March 2015, Bank of England launches Sterling Risk Free Rate Working Group
10. April 2015 Seven new UK benchmarks “specified” as a result of Fair and Effective Markets Review, inc. SONIA
11. July 2015 IBA consults on revised plans for evolution of LIBOR methodology
12. August 2015 JBA consults on evolution of TIBOR methodology, proposes input data “waterfall”
13. October 2015 EMMI consults on the evolution of EURIBOR methodology to comply with regulatory standards
14. November 2015 Bank of England consults on expanding input data collection for SONIA benchmark
15. December 2015 European common agreement on a text for the BMR
16. February 2016 ESMA consults on “policy orientations” under BMR
17. February 2016 FCA adopts rules on “FRAND” pricing for specified benchmarks vis-à-vis infrastructure users
18. March 2016, IBA publishes road map for LIBOR evolution
19. April 2016 Adoption of the BMR by the European Parliament
20. May/September 2016 ESMA consults on implementing measures and technical standards for BMR
21. June 2016 BMR published in E.U. Official Journal
22. October 2016 Bank of England consults on reform of SONIA
23. November 2016 JBA consults on implementation of TIBOR reforms

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Reform of Key Interest Rate Benchmarks: Where we are now

EURIBOR

- EMMI has outlined an roadmap for the evolution of EURIBOR whereby input data provided to the administrator will consist of panel banks' daily "raw" transactional data. From this and having applied certain filters, the administrator will calculate each bank's submission and then perform a median group calculation on the submissions so derived. It has also proposed certain "gap filling" techniques, including the use of historical transaction data.

TIBOR

- JBA TIBOR Administration has consulted on a waterfall methodology to be used by submitters, using data from: (1) the observable unsecured call market (2) the observable Japan Offshore Market and Interbank NCD market; (3) the observable NCD market (other than the Interbank NCD market); (4) large term deposits, short-term government bonds market, GC repos market and OIS market; and (4) Expert Judgment.

LIBOR

- IBA has outlined a roadmap for the evolution of LIBOR. Input data will, in future, consist of submissions derived from: 1) the Volume Weighted Average Price (VWAP) of panel banks' eligible transactions; 2) contributions derived from transactions (including adjusted and historical transactions, interpolated data etc); and 3) expert judgment "appropriately framed".

SONIA

- SONIA will in future capture a broader range of unsecured overnight deposits, by including bilaterally negotiated transactions alongside brokered transactions. The Bank of England (which has taken over administration of the rate) proposes to switch to measuring the average rate using a volume-weighted median, rather than a volume-weighted mean.

ARRC and **SRFRWG**

- The **ARRC** is examining the feasibility of replacing term reference rates, such as $LIBOR, with an overnight reference rate or with the average of such rates. It is closely examining three collateralised overnight repo rates.
- The **SRFRWG** has identified candidates for the new sterling risk-free rate, one of which is a proposal by for a Sterling Secured Overnight Executed Transactions ("Sonet") rate. The others are Bank of England reformed SONIA, as an unsecured rate; ICAP sterling Repo Index Rate, as a secured rate.

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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)

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FMLC on the Evolution of Interest Rate Benchmarks

"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."

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History gives cause for comfort…

Five 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 4 January 1999, the national currencies of participating Member States were replaced by the euro as their single currency. The British Bankers' Association ("BBA") ceased to fix LIBOR for the ECU and replaced it immediately on the same screen page with a LIBOR fixing for the Euro (one for one). Settlement rates for national currencies for which LIBOR was previously calculated and which were then merged into the Euro (e.g. LIBOR in Deutsche Mark) were published during a transition period—which expired on 31 December 2001—but the fixings were synchronised with the Euro LIBOR fixings and separate panels for rates in national currency units were withdrawn. Banks were advised to redenominate deals and reconfirm trades with counterparties; an EURIBOR became the designated successor to most national currency floating rate price sources, within the Euro Area. This transition was supported by legislation at the national level in Euro Area Member States. These transitions occurred remarkably smoothly.

4. 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.

5. 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

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