

# P.R.I.M.E. Finance

## Panel of Recognized International Market Experts in Finance

### From CHF LIBOR to the SARON Alternative



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# Agenda

## I. Background

II. SARON as an alternative to CHF LIBOR

III. Potential legal risk



# The CHF LIBOR market is big...

- Main contract types indexed to CHF LIBOR are OTC and exchange traded derivatives, corporate loans, retail mortgages and floating rate bonds.

Asset Class	Approx. Outstanding Value in 2013
OTC and exchange traded derivatives	USD 6 trillion
Corporate loans	USD 20.8-31.2 billion
Retail mortgages	USD 71-143 billion
Floating rate bonds	USD 24 billion

- The majority of the outstanding financial contracts is linked to 3-month and 6-month LIBOR.
- Other applications of LIBOR clauses
  - Late payment clauses in commercial contracts often refer to CHF LIBOR as an interest rate.
  - CHF LIBOR is sometimes used as a performance benchmark for money market funds and other asset managers.



# ... and is impacted by international LIBOR developments.

- In July 2017, the Financial Conduct Authority (FCA) decided to no longer persuade or compel banks to submit to LIBOR after 2021.

«[...] The absence of active underlying markets raises a serious question about the sustainability of the LIBOR benchmarks that are based upon these markets. [...] In our view it is not only potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them.

[...] And a further lesson of the past few years is that work on transition is unlikely to begin in earnest if market participants continue to assume LIBOR will last indefinitely. In Switzerland, for instance, it has been clear for some time that the TOIS reference rate would not survive. But only once a date was agreed for its discontinuation did serious work on transition to the new reference rate, SARON, begin.

[...] I and my colleagues have therefore spoken to all the current panel banks about agreeing voluntarily to sustain LIBOR for a four to five year period, i.e. until end-2021.

[...] Our intention is that, at the end of this period, it would no longer be necessary for the FCA to persuade, or compel, banks to submit to LIBOR.»

- *Speech by Andrew Bailey, Chief Executive of the FCA, 27 July 2017*



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# The SARON Alternative ...

- The Swiss Average Rate Overnight (**SARON**) is a secured overnight interest rates average referencing the CHF interbank repo market. It was launched in 2009 by the Swiss National Bank in cooperation with the SIX Swiss Exchange.
- In response to Bailey’s speech, the members of the national working group on Swiss franc reference rates (**NWG**), established as the key forum for considering proposals to reform reference interest rates in Switzerland, agreed on 24 October 2017 to recommend SARON as the alternative for CHF LIBOR.
- For the ongoing work, NWG members decided to form two sub-working groups to examine CHF Libor-based product types and dependencies
  - “Loan and deposit market” group
  - “Derivatives and capital market” group



# ... offers many benefits ...

- IOSCO-compliant
- SARON is based on actual transactions and tradable quotes
- Low potential for conflicts of interest, since SARON is based on actual data from the CHF repo market
- High level of transparency (Most CHF market activity is concentrated on the EUREX Repo platform)
- Broad base of contributors



# ... but faces several challenges.

- Low trading volume for longer maturities (i.e. 3-month / 6-month) given that SARON is an overnight average rate
- Different risk premia of collateralized rates (repo) and uncollateralized rates (CHF LIBOR)
- Substantial transition cost when switching from CHF LIBOR to SARON
- Hedging risks from trading legacy LIBOR positions against new SARON hedges
- Economic risk of potential renegotiation of contracts





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# Legal risk ...

- Possible legal risk for contracts incorporating market standard terms which reference CHF-LIBOR and are governed by Swiss law.
- The more the reformed benchmark differs from what CHF LIBOR currently stands for, the higher the level of uncertainty and the more pronounced the risks.
- The legal risk profile for legacy contracts depends on whether they contain market disruption fall-back provisions which would operate to capture the implementation of the reform, as well as on the general provisions of the Swiss Code of Obligations (**CO**).
- It is generally viewed that such market disruption fall-back provisions would not reduce legal uncertainty, as they are not designed to capture the switch to a new benchmark rate. Instead, the general provisions of the CO would take effect.



# ... from the application of the general provisions of the CO ...

- In the absence of pre-existing fallback provisions, the general provisions under the CO and Swiss Federal Court jurisprudence would apply. Four general principles could be invoked in response to a benchmark change that would affect the continuity of a contract:
  - **Supplementary interpretation of contract**
    - Key aspect is whether SARON can be considered the nearest available and officially sanctioned proxy
  - **Subsequent impossibility**
    - It seems unlikely that a change to SARON would make performance impossible
  - **Clausula rebus sic stantibus**
    - Uncertain as to the legal outcome
  - **Error as to the basis of the contract**
    - Uncertain as to the legal outcome



# ... may be mitigated by an orderly transition.

- The more sudden the transition, the more drastic the potential consequences.
- “Hot Switch” Transition vs. Gradual implementation of benchmark reform
  - Under a hot switch, a benchmark reform has the potential to cause serious legal problems.
  - A gradual phasing out without a fixed transition period would be the best solution.
  - If it were possible to keep the CHF LIBOR operational until expiry of all legacy contracts, no serious legal risks would have to be accounted for.
- Market-based solutions may also support the transition
  - For loans:
    - Amend standard agreement (Loan Market Association)?
    - Legislation needed for domestic mortgage market?
  - For OTC derivatives:
    - Institute an ISDA protocol for Swiss OTC derivatives market?

