THE LIBOR CONTROVERSY

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CONTENTS

BENCHMARK RATES

A DAILY MEASURE OF COST OF BORROWING IN INTER-BANK MARKET

- **LIBOR, EURIBOR and other benchmark rates play central role in global financial system**
  - Extensively used in financial contracts across cash transactions (e.g. loans, bonds, repos) and derivatives (e.g. interest rate futures, interest rate swaps, credit default swaps)
  - London Inter-Bank Offer Rate (LIBOR) intended to represent an average rate at which leading banks can borrow (unsecured) from each other prior to 11a.m. on a given day
  - Created in 1980's when inter-bank liquidity was a much more important source of funding for banks
  - LIBOR quoted daily in respect of various currencies including GBP, USD, JPY, CHF and for various tenors including 1, 3, 6, 9 and 12 months
  - Originally administered by British Bankers' Association. Following the manipulation scandal, administration transferred to ICE Benchmark Administration (IBA) (an Intercontinental Exchange entity (ICE). ICE is owner of NYSE and other exchanges)
  - LIBOR quotations provided to ICE daily by 'submitters' (individuals at panel banks managing their bank's cash position, typically from money market desks)
  - ICE determines LIBOR for each applicable currency and tenor based on quotes submitted, discarding quotations in upper and lower quartile and taking average of remainder
- **Benchmarks and how they are administered largely taken for granted prior to 2008 global financial crisis**

THE INHERENT FLAWS

QUOTATIONS ARE A JUDGEMENT CALL

- **Panel banks are required to submit rates daily, based on their assessment of their offer-side unsecured wholesale borrowing opportunities at that time**
  - No requirement that quotations submitted reflect actual inter-bank borrowing transactions of submitting bank (LIBOR is not generally transaction based)
  - Submitters must base quotes on all relevant factors, which may include consultation with traders holding positions impacted by prevailing LIBOR
  - As seen during 2008 global financial crisis, submitters expected to give quotations, even where there appears to be little or no corresponding liquidity for their bank
  - In contrast to 1980's, inter-bank funding a very small proportion of banks' overall funding sources
  - Liquidity provided by central banks since 2008 (e.g. through repo transactions) is very large in relative terms
- **Notwithstanding flaws and the manipulation scandal, market participants and regulators recognise systemic importance of benchmarks and have taken steps to preserve conceptual status quo while more reliable alternatives are developed**

MANIPULATION

CONFLICTS OF INTEREST AND WRONGDOING

- **From 2012, regulators and law enforcement agencies began to find panel banks and individual bankers culpable of manipulating LIBOR and other benchmarks**
  - Broadly, two themes
    - Certain banks had occasionally in ordinary course (and seemingly persistently during 2008 global financial crisis) sought to submit quotations that were below their actual offer-side rate at that time, for fear that the financial stability of their bank may be questioned (NB. submissions are public)
    - Certain individual submitters colluded with derivatives traders at their bank (and indirectly at other banks) with or without encouragement of senior management to submit quotations at a level which would benefit their bank and/or individual traders personally
  - For example, a bank holding a LIBOR-based position due for re-fixing on a particular date might benefit from a higher or lower LIBOR, depending upon terms of that instrument. Traders overseeing positions encouraged submitters to quote high or low, as applicable, on the fixing day, with a view to benefitting their bank and/or enhancing their individual trading performance. In many cases, data evidenced that submitters acquiesced
  - Electronic communications between traders and submitters and other evidence such as traders' diary entries was in some cases particularly damning
- **Before 2012, panel banks in general did not seem to properly recognise existence of conflict between traders and submitters or its market significance. Accordingly, little or no structural measures had been taken at compliance level to address this issue**

LEGAL AND REGULATORY RESPONSES

FINES, CRIMINAL SANCTIONS, REPUTATIONAL DAMAGE, TRANSITIONAL STEPS

- Initial focus from 2012 on enforcement action by FSA (now FCA) in UK and European Commission against banks found to have manipulated benchmarks
- Final Notices of FSA/FCA evidence painstaking regulatory investigations of what happened, which in turn formed basis for potential judicial claims and prosecutions (communications between traders and submitters provides unfortunate reading)
- Criminal sanctions including prison sentences for bankers in UK and US. Punitive fines imposed on banks by US Department of Justice, FSA/FCA and European Commission
- Banks naturally thereafter reluctant to continue LIBOR submissions due to liability concerns
- Hence, regulators then shifted focus towards regulatory rigour and preserving conceptual status quo, in view of systemic importance of LIBOR and other benchmarks, while incentivising or compelling market participants to develop replacement benchmarks
- EU approach is to legally compel banks to support Euro benchmarks during transition (EU Benchmark Regulations)
- FCA in UK has power to compel submissions but reached consensual agreement with banks to preserve LIBOR until 2021. Post 2021, LIBOR if any would be voluntary
- Potential class actions in US? English cases so far touch on manipulation rather obliquely but counterparties on wrong side of specific trades referenced in rogue communications between traders and submitter may hold more problematic claims (if they can be proven and are not time-barred)

PROPERTY ALLIANCE GROUP V RBS [2018]

POTENTIAL RECISION OF SWAPS DUE TO LIBOR MANIPULATION?

- **PAG v RBS one of many English cases where manipulation so far cited unsuccessfully. 2003-2008, PAG obtained 4 fixed-to-floating GBP LIBOR interest rate swaps that went heavily out of the money in low base rate environment following global financial crisis**
- **In 2011, PAG terminated swaps incurring USD 8.2m close-out cost and subsequently sought to recover amount paid on various grounds, including (lengthy and nuanced) implied misrepresentations by RBS alleged by PAG regarding proper administration of LIBOR, which may have entitled PAG to rescission of swaps (i.e. clawback of termination costs)**
- **High Court held no implied LIBOR representations given and in any event, insufficient evidence that RBS had manipulated GBP LIBOR in particular, although it had been culpable regarding LIBOR in other currencies. PAG's case generally poor on its facts**
- **Court of Appeal held RBS had impliedly represented it has not manipulated GBP LIBOR and did not intend to in future but point moot because manipulation not established**
- **Decision nonetheless important for cases where regulatory or other findings as to manipulation of particular LIBOR can be linked to contracts referencing that LIBOR**
- **CoA approved *Geest v Fyffes* implied misrepresentation test: '*would reasonable representee naturally assume true facts did not exist and if they did exist, that he or she would necessarily be informed of them*'**
- **Words or conduct of alleged representor consistent with alleged implied representation are required (followed by HC in Marme v NatWest Markets [2019] which also held that representee must have thought about alleged misrepresentations when contracting)**

POTENTIAL REPLACEMENTS AND FALLBACKS

RISK FREE AND TERM BENCHMARKS UNDER CONSIDERATION

- **Considerable work being done by industry bodies, regulators, central banks and global financial institutions in UK, continental Europe and US to develop or prepare for alternatives. Broadly three work-streams:**
  - Preservation and regulation of LIBOR/EURIBOR administration during transition
  - Risk Free Rates (RFRs)
  - Term-based Rates analogous (to extent possible) to LIBOR concept
- **Sterling Overnight Index Average (SONIA) and Term SONIA Reference Rates (Bank of England)**
- **USD Secured Overnight Financing Rate (SOFR) based on repos of T-bills (Alternative Reference Rates Committee)**
- **USD ICE Bank Yield Index**
- **Transition of EONIA to Euro Short Term Rate (€STR) and €STR-based term structure**
- **Concern about reliability of credit default swap curves as basis for benchmarking cash market**
- **Benchmarks based on overnight rates inherently simpler to develop as transaction-based. But joint market survey in June 2018 led by ISDA, SIFMA, AFME & ICMA indicated corporate treasurers view term-based LIBOR equivalents as a priority. Also showed strong market awareness but weak action around need to replace benchmarks**
- **Critical importance of consistency of benchmark methodology between cash and derivatives markets**
- **LMA commentary helpful but not the genesis – legal drafting will follow market developments**

EXISTING LMA APPROACH

LEGISLATING FOR THE UNKNOWN

- **Standard approach under existing LMA template facility agreement reflects uncertainty as to next generation of benchmarks**
  - Express fallbacks where required LIBOR ceases to be available are better suited to a temporary suspension of LIBOR than its outright abolition, as now anticipated
    - Hence linear interpolation and shorter/longer interest period fallbacks require LIBOR to be available for other periods, even if required period not on screen. Historical LIBOR is de facto fixed rate (commercially unsatisfactory and ineligible for certain FRN investors)
    - Ultimate fallback to actual cost of funds of each lender will not be acceptable to borrowers in long term. Hence LMA document anticipates renegotiation of pricing method in parallel
  - LMA document allows amendments required to address abolition of LIBOR to be agreed between obligors and majority lenders
  - Hence the document adopts a ‘wait and see’ approach, because nobody yet knows what methodologies market will adopt

OPTIONAL LMA RIDER

LEGISLATING (IN MORE DETAIL) FOR THE UNKNOWN

- **Optional LMA rider seeks to be more prescriptive about circumstances in which majority lenders with the obligors may effect a substitution of existing benchmark and what changes can be made to agreement**
- **Unlike standard LMA approach, the rider seeks to address a (realistic) situation where LIBOR continues to be quoted but is superseded in practice by another benchmark**
- **Users encouraged to consider whether majority lender threshold should be lower than usual 66 2/3% for approval of related amendments**
- **Unlike standard LMA approach which is not prescriptive, the LMA rider attempts to list the types of changes to agreement that would be required and which may be approved by majority lenders**
  - In doing so, the optional wording may be uncomfortable for facility agents that need to be satisfied that proposed amendments are within scope of changes anticipated in wording and therefore subject to majority not all lender approval
  - Changes to pricing to address "*any transfer of economic value from one Party to another*" are for majority not all lender approval. It seems unclear whether this is intended to apply as between lenders (e.g. if as a result of a new benchmark method one lender incurs a matched funding cost while another lender gains, due to method adopted)
- **Includes a 'snooze you lose' for banks not responding to amendment proposal by a deadline**
- **A simple extension of standard wording to allow majority lenders to change benchmark method if they believe LIBOR being quoted no longer primary benchmark may be preferable**

SOME FURTHER READING

FSA/FCA Final Notices to banks relating to findings of benchmark manipulation, commencing 27 June 2012 (RBS)

Property Alliance Group v RBS [2008] (High Court and Court of Appeal decisions)

Marme v NatWest Markets & others [2019] (High Court)

IBOR Global Benchmark Transition Report June 2018 arranged by ISDA, SIFMA, AFME & ICMA

Alternative Reference Rates Committee Guiding Principles 9 July 2018

Working Group on Sterling Risk-Free Reference Rates discussion paper on Conventions for referencing SONIA in new contracts (and related LMA consultation) March 2019

Working Group on euro risk free rates presentation, Frankfurt 26 February 2018

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