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The UK's announcement of plans for synthetic LIBOR: panacea or pandora's box?

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In this article the authors consider the scope of the contracts to which the UK's plans to tackle “tough legacy” contracts may apply, potential claims under the Human Rights Act 1998, and the potential impact on domestic private law LIBOR-related litigation.

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KEY POINTS

- Plans announced in June 2020 to give the FCA enhanced powers to tackle “tough legacy” LIBOR contracts using “synthetic LIBOR” are intended to apply to a “narrow pool” of contracts.
- It is still unclear how such contracts will be defined, whether the pool will in fact be narrow and how precisely the legislation and enhanced FCA powers will operate in relation to such contracts.
- The reality appears to be the imposition of synthetic LIBOR on parties to “tough legacy” contracts.
- The proposed legislation and action by the FCA may therefore be vulnerable to challenge under the Human Rights Act 1998, particularly in the absence of an appropriate compensation mechanism.
- LIBOR's global reach means that global co-ordination is required. The ARRC's and European Commission's proposals are very different to the UK's plans. The UK's final product may, therefore, be somewhat different to that recently indicated.
- Conduct and private litigation risks remain high, and parties should not delay active transition.

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INTRODUCTION

In July 2017, Andrew Bailey, then Chief Executive of the FCA, stated that it would “no longer be necessary for [the FCA] to sustain [LIBOR] through [the FCA's] influence or legal powers”.[1] LIBOR is set to end in December 2021. Three years after its 2017 statement, the FCA welcomed[2] the UK government's announcement of 23 June 2020 to give the FCA enhanced powers in relation to LIBOR.[3] The government intends to take these measures forward in the forthcoming Financial Services Bill.

The UK government and FCA have made it clear that they expect the vast majority of legacy contracts to have transitioned from LIBOR by the end of 2021. Indeed the proposed legislation is intended to “strengthen existing law to prohibit use of [LIBOR] where its representativeness will not be ensured”. The proposed legislation will seek to address the problems posed by “tough legacy contracts”, which Rishi Sunak, Chancellor of the Exchequer, contends is a “narrow pool”.

The FCA's new regulatory powers would enable the FCA to direct a methodology change for the calculation of LIBOR when the FCA has found its representativeness will not be restored and “where action is necessary to protect consumers and/or to ensure market integrity”.

What *appears* to be proposed for tough legacy contracts is that a new rate, determined by an entirely different methodology to current LIBORs would nonetheless be called LIBOR and published as LIBOR — a so-called “synthetic” LIBOR (Synthetic LIBOR). It is anticipated that Synthetic LIBORs would be forward-looking term rates based on RFRs (Term RFRs), and/or simply RFRs plus a fixed spread reflecting the expected difference between LIBOR and RFRs.

Some in the market have suggested that the FCA will merely be given the power to make a new rate available to parties to tough legacy contracts which they are at liberty to use or refuse. It seems to us,[4] however, that the certainty the government seeks to provide for “tough legacy contracts” requires something stronger. The problem caused by tough legacy contracts is that the parties *cannot* agree a transition away from LIBOR to an alternative rate. It would, therefore, be largely nugatory for the FCA to devise a new rate to be used at the whim of parties to such contracts and this would not resolve the problem posed by these contracts. Further, Rishi Sunak expressly stated that parties who rely on regulatory action enabled by the legislation envisaged “will not have control over the economic terms of that action”. This suggests that a tough legacy contract which refers to LIBOR, will be deemed to refer to the Synthetic LIBOR. *That is the premise of the views expressed in this article.*

At the time of writing, draft legislation is expected in late Q3/Q4 2020. Beyond that it is unclear when the draft legislation will become law. As regards Synthetic LIBOR calculation methodologies, the FCA will seek stakeholder views over the coming months. It is unlikely that the methodology or its scope will be clarified for some time. RFR product conventions are still developing and the creation of Synthetic LIBORs is likely to depend on the take up of the ISDA IBOR Fallback Protocol. It is unclear if, or when, authorised Term RFRs will be available (with the picture differing between currencies).

Furthermore, *theoretically* (although not *realistically*) Synthetic LIBORs could exist in all five LIBOR currencies. LIBOR is used globally, and not just by FCA regulated entities. Therefore, it is difficult to see how Synthetic LIBORs can or should be introduced without co-operation and co-ordination between the UK government/FCA and their counterparts around the world. The UK government appears to appreciate such difficulties; Rishi Sunak stated that “the FCA may consider, among other factors, international impacts before exercising its new powers, given LIBOR's global usage”.

However, co-operation and co-ordination between the UK/FCA and its global counterparts appears lacking.

For example, on 6 March 2020, the ARCC released proposals for New York State legislation to address contracts referencing US Dollar LIBOR and which are governed by New York law. On 24 July 2020, just one month after the UK's announcement, the European Commission (Commission) published a proposal for amendments to the Benchmark Regulation (EU) 2016/2011 (BMR).[5] The ARRC's and the Commission's proposals are

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very different to the UK's plans. If the UK's plans and the ARRC's or the Commission's proposals are adopted, this raises a plethora of potential issues; for example, potential litigation regarding which replacement rate shall apply given differing regimes, and potential forum shopping to exploit rate differentials.

At the very least, the UK's plans appear far less advanced and developed than the ARCC's and Commission's proposals. Given the implications arising from LIBOR's global, systemic relevance, it therefore remains to be seen how the UK's plans will in fact develop.

International perspectives will be the focus of a forthcoming article in JIBFL.

In this article, we consider the scope of the contracts to which the UK's plans may apply, and on potential claims under the Human Rights Act if the plans are implemented. Finally, we touch briefly on the potential impact of the UK's plans on the scope for domestic private law LIBOR-related litigation.

TOUGH LEGACY CONTRACTS: A NARROW POOL?

It remains unclear what will constitute a "tough legacy contract" subject to Synthetic LIBORs. Rishi Sunak describes these as those that "genuinely have no or inappropriate alternatives and no realistic ability to be renegotiated or amended". However, the answer to whether a contract qualifies depends on when the question is to be asked — which is unclear. As at today, there may be a "realistic ability" of amendment by the end 2021, so the contract is not "tough legacy". As at the end of 2021, with limited firm engagement with customers in the interim, the contract is likely to be "tough legacy".

"Tough legacy contracts" is a nebulous term which has evolved to cover a wide range of LIBOR-referencing contracts which expire after 2021 and typically have one or more of the following characteristics:

- those contracts which are not suitable for transition to RFRs, usually because appropriate term rates are required but are not (yet) available. The RFRWG (Working Group on Sterling Risk-Free Reference Rates) has identified that 10% of the Sterling LIBOR loan market by value is unsuitable for transition to SONIA compounded in arrears.[6] This 10% comprises mostly lower value loans to smaller borrowers, so represents more than 10% by number;
- there are no fallbacks;
- fallbacks exist but do not contemplate permanent cessation of LIBOR and so lead to commercially unattractive/unforeseen outcomes;
- fallbacks are impractical (eg cost of funds clauses);
- the investor base is diverse rendering it difficult or impossible to obtain consent to contractual amendments;
- unsophisticated counterparties;
- contracts included in a category whose sheer volume in number and/or no standardisation of contract terms render amendment by end 2021 unfeasible;
- complex or structured arrangements/transactions which contain LIBOR-linked elements; in order to avoid misalignment in cashflows, all the constituents of and arrangements/transactions themselves adopt the "tough legacy" mantle;
- a party relies on LIBOR transition to escape its obligations under the contracts/improve its position (eg by invoking frustration, *force majeure*, mistake).

Accordingly, it is far from clear that contracts to be subjected to Synthetic LIBORs would in fact constitute a "narrow pool".

HUMAN RIGHTS CHALLENGES

Changes to the methodology by which LIBOR is calculated will change the interest rate payable under contracts. In many instances this will have the effect of transferring wealth from one party to another. This will give rise to the potential for challenge on the basis of individuals' human rights, particularly their right to property under Art 1, Protocol 1 of the European Convention on Human Rights (ECHR) (A1P1), unless the legislation and action taken by the FCA pursuant to that legislation can be justified and shown to be proportionate. A corporate entity has human rights too.

Under the Human Rights Act 1998 (HRA 1998) courts are obliged to interpret primary and secondary legislation in a manner which is compatible with ECHR rights.[7] Whilst primary legislation cannot be struck down for infringing ECHR rights, it can be declared incompatible under s 4. As the FCA is a public authority it is unlawful for it to act in a way which is incompatible with a Convention right pursuant to s 6 HRA 1998.[8] The courts, as public authorities, must also act in a manner consistent with Convention rights, thereby enforcing the "horizontal" nature of human rights between two private parties. As Lord Rodger commented in *Wilson v Secretary of State for Trade and Industry*[9] [2003] UKHL 40:

"… since courts are public authorities for purposes of the [Human Rights] Act, a court order pronounced against one private party at the instigation of another may potentially infringe the first party's Convention rights. If giving effect to a Convention right under the Act means that the order has to be refused or modified, then that affects the rights of the party who sought it."[10]

An individual can obtain any relief or remedy which a court considers just and appropriate, including damages, should the FCA act in breach of its s 6 obligations. The FCA's statutory immunity does not extend to actions for damages where it is alleged that human rights have been infringed.[11]

A1P1 provides:

"Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law.

The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties."

Interference

By changing the methodology by which LIBOR is calculated and consequently the interest rate payable under contracts, the loser will arguably be deprived of property/a possession (a contractual

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right to a particular interest rate/sum of money) to which they were previously entitled under the previous methodology for which they contracted.

The term "possession" has an autonomous meaning under the ECHR. The European Court of Human Rights (ECtHR) takes a broad view of what amounts to a possession and has held that it includes rights under contracts.[12] In *Association of General Practitioners v Denmark*[13] the contractual entitlement of Danish GPs under a collective agreement to indexation of their remuneration was accepted as amounting to a possession. Legitimate expectations of obtaining an asset have also been protected pursuant to Art 1, Protocol 1.[14] Whether the particular right does amount to a possession will turn on the terms of the specific contract, but in our view a right to a particular interest rate under a contract has a "present economic value" capable of amounting to a possession under A1P1.[15]

In *Wilson*, in the House of Lords, Lord Nicholls held:

"… 'Possessions' in article 1 is apt to embrace contractual rights as much as personal rights …

The response of the Secretary of State and others is that all the rights acquired by First County Trust under the agreement were from their inception subject to the limitations prescribed by the Consumer Credit Act. A restriction on the scope of the rights acquired by a lender under a transaction is not within article 1 of the First Protocol. A person who acquires property subject to limitations under national law which subsequently bite according to their tenor cannot complain that his rights under article 1 of the First Protocol have been infringed.

I do not agree … *Here the transaction between the parties provided for repayment of the loan and for the car to be held as security. What is in issue is the 'lawfulness' of overriding legislation. The proposition advanced by the Secretary of State would mean that however arbitrary or discriminatory such legislation might be, if it was in existence when the transaction took place a*

> *court enforcing human rights values would be impotent. A Convention right guaranteeing a right of property would have nothing to say. That is not an attractive conclusion."*[16]

Such an interference will only be lawful if it can be shown that it was in the public interest, it was provided for by law and by general principles of international law and it was proportionate.

Public interest

Protection of consumers and the stability of the banking system are likely to constitute valid public interests. The ECtHR has held that national authorities enjoy a broad margin of appreciation in choosing how to deal with matters such as the stability of banks and the interests of their depositors and creditors deserve enhanced protection.[17]

Our domestic courts are also likely to accord appropriately wide deference to the FCA when approaching the issue of justification in view of its institutional competence in deciding how to approach the problem of LIBOR transition,[18] particularly if it has undertaken wide consultation with stakeholders.

Turning once more to *Wilson*, Lord Nicholls held:

> **"… It is common ground that section 127(3) [of the Consumer Credit Act] pursues a legitimate aim.** The fairness of a system of law governing the contractual or property rights of private persons is a matter of public concern. Legislative provisions intended to bring about such fairness are capable of being in the public interest, even if they involve the compulsory transfer of property from one person to another … ."[19]

It is not yet clear whether Parliament will legislate and provide the FCA with powers before the end of 2021 which would have the effect that the new scheme only prospectively changes contractually agreed interest rates in the future, or whether, the legislation will need to have retrospective effect. This would need to be made very clear by Parliament and legislating retrospectively would require a clearer aim and greater justification.[20]

Proportionality (fair balance, compensation, margin of appreciation)

The final stage in assessing whether an individual's human rights have been infringed is proportionality. An interference with A1P1 must strike a fair balance between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights. In other words the court must ascertain whether by reason of the State's action or inaction the person concerned had to bear a disproportionate and excessive burden.

Lord Reed in *Bank Mellat v HM Treasury (No 2)* [2014] AC 700 outlines the current four-stage test of proportionality as regards Convention rights which is applied in our domestic courts:

> "… (1) whether the objective of the measure is sufficiently important to justify the limitation of a protected right, (2) whether the measure is rationally connected to the objective, (3) whether a less intrusive measure could have been used without unacceptably compromising the achievement of the objective, and (4) whether, balancing the severity of the measure's effects

> on the rights of the persons to whom it applies against the importance of the objective, to the extent that the measure will contribute to its achievement, the former outweighs the latter.”[21]

It is impossible to assess in the abstract how the balance of proportionality will be struck in an individual case, whether there is a challenge to an individual FCA decision or a full challenge to the government's legislative solution. It is a balancing exercise which is inherently tied to the particular facts and parties. However, the following may be relevant in a court's analysis of proportionality:

- the FCA should ensure that any consultation with stakeholders is thorough and that as many parties' interests as possible are taken into account in crafting Synthetic LIBORs;
- certain parties or classes of parties may be particularly negatively affected by the change and may be able to point to alternative ways of changing the methodology which would not have affected their interests as negatively. A degree of deference will be afforded to the FCA by domestic courts on this issue but it will need to be in a position to robustly justify its decision-making to resist such arguments;
- compensation terms are often relevant to the assessment of whether a contested

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measure imposes a disproportionate burden on an affected party. In *James and Others v UK* the ECtHR held that: “clearly compensation terms are material to the assessment whether the contested legislation respects a fair balance between the various interests at stake, and, notably, whether it does not impose a disproportionate burden on the applicants”.[22]

This is not something that appears to have been discussed by the government or FCA. However, this is something which ought to be seriously considered to avoid the prospect of a flood of A1P1 claims by losers in the LIBOR transition period.

It is far from certain at this stage whether the government's current plans will be HRA and ECHR compliant. The devil will ultimately lie in the detail. How the FCA strikes the balance between the various interests at stake and how it evidences the reasons behind any legislative solution are likely to be of considerable importance.

IMPACT ON DOMESTIC PRIVATE LITIGATION

The mischief that the Financial Services Bill proposes to address appears to be consumer protection and ensuring market integrity.

This is to be contrasted with the mischief of ARRC's proposed statute for contracts under New York law which is “designed to minimize costly and disruptive litigation”.[23] Similarly, the Commission's plans are “designed to avoid, or at least minimise, costly litigation by providing legal certainty” and to “provide a safe harbour from litigation for supervised entities that use (reference) the statutory replacement rate”.

Unsurprisingly, therefore, the UK's plans are likely to have less impact than the ARRC's/Commissions proposals on reducing the likelihood of domestic private law LIBOR-related litigation based on, for example, frustration, *force majeure* or breaches of implied terms of good faith/Braganza duty arising from contractual discretions. If anything, the reduction in such litigation is likely to be confined to the “narrow pool” of tough legacy contracts — which brings us full-circle to the question of how such contracts will be defined. Further, it is difficult to see how the prospects of success of a declaration of frustration prospectively (per *The Evia* (No.2) [1983] 1 AC 736) will change materially until there is clarification on the proposed legislation and proposed scope and calculation of synthetic rates. Finally, the likelihood of mis-selling claims remains high, particularly as regards LIBOR-linked products sold since July 2017.

CONCLUSION

Without legislation, the difficulties of managing aspects of LIBOR transition seem insurmountable.

However, the extent to which the UK's plans address these challenges is unclear, with much remaining unknown regarding the detail. In the absence of a suitable compensation scheme, the legislation apparently intended by the plans may be vulnerable to challenge under the HRA 1998. Litigation risks based in private law remain significant, as do conduct risks.

Accordingly, firms should not be under any illusion that the UK's announcement permits them to delay active transition.

Finally, it should not be overlooked that the ultimate shape of the legislation may change given the practical need for global co-ordination and alternative proposals by the ARRC and the Commission. International perspectives will be the focus of a follow-up article in JIBFL.

[1] https://www.fca.org.uk/news/speeches/the-future-of-libor

[2] https://www.fca.org.uk/news/statements/fca-statement-planned-amendments-benchmarks-regulation

[3] https://www.parliament.uk/business/publications/written-questions-answers-statements/written-statement/Commons/2020-06-23/HCWS307/

[4] Albeit the government's plans do remain vague.

[5] https://ec.europa.eu/finance/docs/law/200724-benchmarks-review-proposal_en.pdf

[6] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/use-cases-of-benchmark-rates-compounded-in-arrears-term-rate-and-further-alternatives.pdf

[7] Section 3.

[8] This obligation is subject to s 6(2) which indicates that s 6(1) does not apply if primary legislation meant that the public authority could not have acted differently. It is envisaged that the primary legislation in issue in present circumstances will not be so detailed so as to impose specific obligations on the FCA. It is therefore unlikely that the FCA could rely on the s 6(2) exception.

[9] A historic case where the House allowed an appeal against a declaration of incompatibility made by the Cout of Appeal in reliance on Art 1 Protocol 1.

[10] At para 174.

[11] See sch 1ZA, para 25(3) FSMA 2000.

[12] Eg licences to serve alcohol or fishing rights: *Tre Traktörer Aktiebolag v Sweden* [1991] 13 EHRR 309, para 53; *O'Sullivan McCarthy Mussel Development Ltd v Ireland* [2018] ECHR 471, para 89. See also domestic authorities *Murungaru v SSHD* [2008] EWCA Civ 1015. However, loss of future profits will not constitute a possession within A1P1: *Denimark Ltd v UK* (2000) 30 EHRR CD 144.

[13] (1989) 62 DR 225.

[14] See eg *Pressos Compania Naviera SA and Others v Belgium* [1995] ECHR 471, para 31.

[15] See *Breyer Group plc & Others v DECC* [2014] EWHC 2257 (QB), para 51. See also more recently *Solaria Energy UK Ltd v Department for Business, Energy and Industrial Strategy* [2019] EWHC 2188 (TCC) which is currently under appeal.

[16] Paragraphs 39-41.

[17] *Capital Bank AD v Bulgaria* [2005] ECHR 752, para 136.

[18] See for example the Supreme Court Judgment in *R (on the application of Tigere) v Secretary of State for Business, Innovation and Skills* [2015] UKSC 57; [2015] 1 WLR 3820, where the majority recognised that a wide margin is usually allowed to the state under the Convention when it comes to general measures of economic or social strategy at para 27.

[19] Paragraph 68.

[20] See *Wilson*, at para 186.

[21] At para 74.

[22] At para 54. See also *Grainger v UK* (2012) 55 EHRR SE13 which concerned litigation arising out of Northern Rock's nationalisation, at para 37.

[23] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Proposed-Legislative-Solution.pdf