NEED FOR LEGISLATIVE INTERFERENCE FOR LIBOR TRANSITION IN INDIA: LESSONS FROM NY, UK AND EU

Written By ***Suneha Kasal* & Swini Khara*****

** 5th Year, B.A LL.B Student, NALSAR, University of Law, Hyderabad, India*

*** 5th Year, B.A LL.B Student, NALSAR, University of Law, Hyderabad, India*

ABSTRACT

The London Interbank Offered Rate (LIBOR) will cease to operate as the primary benchmark rate for financial instruments by the end of 2021. In light of this massive transition and challenges associated with it, Reserve Bank of India has taken steps to explore, develop and assist in adoption of an alternative risk-free reference rate. However, from a legal standpoint, the challenge of amending the financial instruments referring to LIBIOR is left uncharted in Indian markets. Large number of financial agreements referring to LIBOR will continue to survive the cessation of the LIBOR and fresh agreements having exposure to LIBOR are still being entered into. Given the scale of the task involved and the time period being relatively short, timely amendments cannot be excepted out of all the financial instruments with LIBOR exposure. This article identifies the ill-preparedness of Indian financial market and warrants the need for India to provide for a legislative fix to deal with issues arising out of LIBOR contracts without or with inadequate fall-back provisions, categorised as 'Legacy Contracts'. In absence of legislative interference, the result could be a large volume of cases involving a large volume of transactions and substantial financial market disruption, burdening the state resources. This piece draws inspiration from legislative solutions from various jurisdictions like the United Kingdom, the European Union and the State of New York in order to recommend legal measures to be adopted in India. This would ensure smooth move towards alternative risk-free rates without increasing litigations or creating market disruption.

London Interbank Offer Rate (LIBOR), tagged as the world's most important number, will cease to operate as the primary benchmark rate for financial instruments by the end of 2021. As of 2020, an estimated $532 billion worth of financial contracts has exposure to LIBOR in India.i LIBOR is globally referred to determine the interest rates of a wide variety of loans, securitizations, derivative products, and government-issued debt instruments. India's key domestic synthetic benchmark MIFOR (Mumbai Interbank Forward Offer Rate) is also derived from this outgoing rate. Alongside these typical financial instruments, there exists an enormous number of trade contracts that reference LIBOR.[ii]

The Financial Conduct Authority (FCA) of the U.K. decided to gradually phase out[iii] LIBOR in 2017 and announced its future cessation in March 2021.[iv] The decision to replace LIBOR can be attributed to the increased tendency of banks to submit interest rates on the basis of their speculations rather than basing it on actual transactional data because of the sheer decline in the market on which this reference rate was based on. The LIBOR scandal of 2012 with increased allegations of rate manipulations shook the confidence of market participants. These acts of manipulation of the rate involved both lowering the rate and reporting false rates, to create illusion of the strength of the banks and to make profits off the LIBOR based derivative instruments, respectively. Overt-reliance on the banks' expert judgment had made LIBOR unrepresentative of the market, opaque, and vulnerable to manipulation.

However, the cost involved in ceasing the usage of this rate is high. Thus, several efforts were made to reform the LIBOR from strengthening the reporting process to involving market participants in LIBOR production. These efforts were hindered because of the declining underlying market for LIBOR. Therefore, the option of replacing rather than fixing the rate was opted.

Accordingly, the Reserve Bank of India (RBI) has taken steps to explore, develop and assist in adopting alternative risk-free reference rates (ARR).[v] As part of these steps, RBI issued 'Dear CEO' letter to all the major banks sensitizing them to the problem of transition. This has encouraged a few Indian banks like SBI and ICICI to take measures away from LIBOR by executing transactions on the basis of Secured Overnight Financing Rate (SOFR).[vi] Indian banks are stepping out to get the lay of the land by transacting based on ARR for the first time.

However, from a legal standpoint, the challenge of amending financial instruments referring to LIBOR is left uncharted in Indian markets. A large number of contracts referring to LIBOR will survive its cessation. The problem aggravates as new agreements based on this rate continue to be entered into, giving rise to a range of issues.[vii]

A large number of agreements in India are primarily based on the formats issued by the Asia-Pacific Loan Market Association (APLMA) and the Loan Market Association (LMA). Such agreements most of the time, either absolutely lack or contain inadequate fallback provisions, and these contracts are categorized as 'Legacy Contracts'. Fallback provisions are meant to provide an alternative rate in situations wherein the agreed benchmark rate is not available. However, many times, these fallback provisions are not robust enough as they only conceptualize cases where the rate is temporarily unavailable. For example, in the absence of LIBOR publication, the fallback mechanism would default to the most recently available rate. Reliance on fallback provisions subsequent to cessation of the rate would in perpetuity convert the floating rate into a fixed rate, which was not originally intended by parties.

The other kind of fallback provisions that a few contracts incorporate can be invoked on market disruptions, allowing the parties to negotiation for a substitute rate for given period of time. Upon failure of the parties to decide on substitute rate, the interest rate shall be linked to the lender's cost of funds. This gives raise to number of legal interpretations and challenges by the aggrieved party. This is because the borrower is ripped off the safeguards arising out of objective rate and is now at the hands of the lender.

To avoid this outcome, legacy contracts must be identified, individually re-negotiated, and amended. To facilitate this process, the APLMA has released template clauses which do not replace LIBOR but *enable* amendments when the benchmark rate is replaced.[viii] Although many contracts are being and will be amended, a large number of contracts might be left unamended. This may be because of difficulty in identifying legacy contracts, locating or negotiating with parties for consent, and holdouts. Timely amendments cannot be expected across contracts, given the scale of the task and relatively short amount of time.

In absence of appropriate actions, the legal effect and status of these legacy contracts will be questioned as it would permanently change the nature of the instrument. This would automatically proliferate litigation as participants would seek judicial redressal due to legal uncertainty. This, in turn, will lead to an onslaught of cases involving large volumes of transactions, disrupting the market substantially and burdening the state's resources. With the ongoing transition, India must strive towards ensuring as minimal disruption of transactional activities as possible. This issue could be addressed through legislative interference.

To adequately deal with the aforementioned issues, multiple jurisdictions have already brought forth legislative fixes to provide for an all-encompassing solution. The U.K[ix], European Union (E.U.) [x] and the State of New York[xi] (N.Y.) have adopted measures to impose recommended benchmark replacement by way of legislation in specific contracts. However, India is lagging as compared to some of the other countries in taking adequate legislative steps. The Government of India had issued a notification to consider COVID-19 as a force majeure event in order to avoid disruption of contracts and reduce potential litigations.[xii] Similarly, it could also provide a detailed default mechanism through operation of law with respect to the contracts which could not be amended.

For India, the approaches taken by N.Y. and E.U. in the kinds of contracts covered under their legislative scope would be more advisable as compared to the UK's proposal. The FCA of the U.K. has indicated rather ambiguous criteria for application of legislation, limiting it to a narrow pool of '*tough legacy contracts*'. [xiii] In fact, the definition of 'tough legacy contracts' also remains controversial and yet to be clarified by FCA's upcoming consultation. The N.Y. and E.U. solutions would be more suitable to adopt as they have a broader ambit to include all contracts which lack or have unsuitable fallback provisions.[xiv] These unsuitable fallbacks may be provisions that prescribe LIBOR-based rates, impermanent replacements, or any benchmark that does not reflect market/economic reality or require third-party consent but have been denied. It must be further noted that the principles of freedom to contract must be maintained by allowing parties to mutually opt-out of mandatory imposition when they are able to negotiate and alter their contracts successfully.

All three precedents have prescribed varied applications based on currency. E.U. allows for all LIBOR rates of any currency while N.Y. limits its legislation to USD LIBOR only and the U.K. is expected to include GBP, JPY and USD as of yet.[xv] Following the trend of widening the scope for a smoother transition, it would be wise to have wider jurisdiction over LIBOR and LIBOR-based rates in any currency used in India. It is also important for the proposed legislation to cover all contracts governed by Indian law. To protect the Indian market participants from inadequate safeguards in other governing jurisdictions, the E.U. model can be followed. E.U provides for a wider jurisdictional reach by allowing any contract (despite being governed by laws of another jurisdiction) to fall within the ambit of its provisions. This can be adopted as long as both the contracting parties are based in India and the jurisdiction of the governing law has not provided measures for an adequate switch from LIBOR.

Lastly, there is also a need to import the safe harbor provisions from these legislations. Safe harbor clauses would help reduce prospective litigations concerning contracts that are automatically transitioned by the operation of law. Predominantly, the safe harbor clause in the legislation must explicitly protect parties against claims arising from using automatic transition of the rate as a ground for litigation. It is vital to ensure that the performance of contracts is not obstructed due to claims of force majeure, breach of contract, or frustration.

The FCA's announcement[xvi] that IBA shall continue to publish a few specific LIBOR tenors rates till the end of 2023 comes as a sigh of relief to India. Yet, given the enormity of the endeavour, there is still a need for active steps to be taken not merely in recognizing the appropriate replacement rate but also to fill the gap in the transition towards the new benchmark rate. The introduction of legislative solutions to the quandary is the need of the hour to minimize disruption.

BIBILOGRAPHY

LEGISLATIONS AND NOTIFICATIONS

- *FCA Announcement on future cessation and loss of representatives of the LIBOR Benchmarks*, FINANCIAL CONDUCT AUTHORITY (Mar. 05, 2021).
- *FCA Statement on Planned Amendments to the Benchmarks Regulation*, FINANCIAL CONDUCT AUTHORITY (Jun. 23, 2020).

- *Regulation of the European Parliament And Of The Council amending Regulation (EU) 2016/1011 and amending Regulation (EU) No 648/2012*, EUROPEAN PARLIAMENT (Jan. 22, 2021).
- Article 18-C, Senate Bill S297B/Assembly Bill 164B, State of New York (Jan. 06, 2021).
- Office Memorandum: Force Majeure Clause (FMC), Government Of India (Feb.19, 2020)
- Proposed amendments to the Benchmark's Regulation, FINANCIAL CONDUCT AUTHORITY (Jun. 23, 2020)
- Announcements on the End of LIBOR, FINANCIAL CONDUCT AUTHORITY (Mar. 05, 2021).

REPORTS

- *LIBOR: The Rise and Fall*, RESERVE BANK OF INDIA (Nov. 11, 2020)
- FCA Consults on New Benchmarks Powers, FINANCIAL CONDUCT AUTHORITY (Nov. 18, 2020)

ARTICLES REFERRED

- Shayan Ghosh, *Lenders test transactions on LIBOR successor SOFR*, LIVE MINT (Jan. 27, 2021)
- Nand Gopal Anand, Ankit Sinha, Harshit Dusad and Garima Parakh, *Transitioning from LIBOR-The Road Ahead for the Indian Banking Sector*, INTERNATIONAL BAR ASSOCIATION

MISCELLANEOUS

- Andrew Bailey, Chief Executive, FCA, Speech at Bloomberg, The Future of LIBOR (Jul. 27, 2017)

ENDNOTES

[i] *LIBOR: The Rise and Fall,* RESERVE BANK OF INDIA (Nov. 11, 2020).
[ii] *Id.*
[iii] Andrew Bailey, Chief Executive, FCA, Speech at Bloomberg, The Future of LIBOR (Jul. 27, 2017).
[iv] *FCA Announcement on future cessation and loss of representatives of the LIBOR Benchmarks*, FINANCIAL CONDUCT AUTHORITY (Mar. 05, 2021).
[v] *Id* at 1.
[vi] Shayan Ghosh, *Lenders test transactions on LIBOR successor SOFR*, LIVE MINT (Jan. 27, 2021, 5:28 AM), https://www.livemint.com/industry/banking/lenders-test-transactions-on-libor-successor-sofr-11611682447501.html.
[vii] *Id* at 1.
[viii] Nand Gopal Anand, Ankit Sinha, Harshit Dusad and Garima Parakh, *Transitioning from LIBOR-The Road Ahead for the Indian Banking Sector*, INTERNATIONAL BAR ASSOCIATION, https://www.ibanet.org/article/18dbbbe4-0da3-4092-ba53-cf1feb08cfc8.
[ix] *FCA Statement on Planned Amendments to the Benchmarks Regulation,* FINANCIAL CONDUCT AUTHORITY (Jun. 23, 2020).
[x] *Regulation Of The European Parliament And Of The Council amending Regulation (EU) 2016/1011 as regards the exemption of certain third-country spot foreign exchange benchmarks and the designation of replacements for certain benchmarks in cessation, and amending Regulation (EU) No 648/2012*, EUROPEAN PARLIAMENT (Jan. 22, 2021).
[xi] Article 18-C, Senate Bill S297B/Assembly Bill 164B, State of New York (Jan. 06, 2021).
[xii] Office Memorandum: Force Majeure Clause (FMC), Government Of India (Feb.19, 2020), https://doe.gov.in/sites/default/files/Force%20Majeure%20Clause%20-FMC.pdf.
[xiii] Proposed amendments to the Benchmark's Regulation, FINANCIAL CONDUCT AUTHORITY (Jun. 23, 2020).
[xiv] *Id* at 10.
[xv] FCA Consults on New Benchmarks Powers, FINANCIAL CONDUCT AUTHORITY (Nov. 18, 2020).
[xvi] Announcements on the End of LIBOR, FINANCIAL CONDUCT AUTHORITY (Mar. 05, 2021).