

'Dead' or 'zombie' LIBOR: consequences for agreements governed by Swiss law

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Nicolas Ollivier
Lalive, Geneva
nollivier@lalive.law (mailto:nollivier@lalive.law)

Grégoire Geissbühler
Lalive, Geneva
ggeissbuehler@lalive.law (mailto:ggeissbuehler@lalive.law)

'And on the pedestal, these words appear:

My name is LIBOR, Rate of Rates;

Look on my Works, ye Mighty, and despair!

Nothing beside remains. Round the decay

Of that colossal Wreck, boundless and bare

The lone and level sands stretch far away.'

(heavily inspired from P B Shelley)

Introduction

The discontinuation of LIBOR (London Interbank Offered Rate) was, at one time, unthinkable. However, following a rate-rigging scandal, increased regulation and a speech by the Chairman of the Financial Conduct Authority (FCA)^[1] highlighting the absence of an underlying market for LIBOR, it became clear that the banking world was changing. Alternative reference rates must be found by the end of 2021, when the panel banks will stop supporting LIBOR (see the Swiss Financial Market Supervisory Authority's communication on this topic^[2] and another speech of the Chairman of the FCA^[3]).

While the quest for a suitable replacement is well under way, many contracts include a reference to the LIBOR, some of which will persist long after its demise. From a strict contractual law point of view, the parties are still bound by the inclusion of LIBOR, which cannot be replaced by another rate unless the parties agree to it. Of course, most parties will renegotiate and find a suitable replacement, but in some cases, the renegotiation could prove problematic (eg, if the parties are already in conflict).

We will analyse two situations in this contribution: (1) a complete disappearance of LIBOR; and (2) the partial discontinuation of LIBOR, where only some banks continue to publish a benchmark rate but without any institutional support or endorsement.^[4]

Complete discontinuation ('dead' LIBOR)

If LIBOR is fully discontinued (ie, LIBOR rates are no longer published by any bank) and the parties fail to agree to a replacement solution, they will face uncertainty in the pursuit of the relationship. This could be interpreted as a lacuna (gap) in the contract (Article 18 of the Swiss Code of Obligations (SCO)), which will then have to be filled by the judge.

Two types of agreements must be distinguished: the agreements in which the characteristic performance obligation is intrinsically linked to LIBOR itself (such as in interest rate swaps and floating rate bond); and the discontinuation of LIBOR resulting in the loss of an essential term of the agreement. In turn, the agreement will be discontinued even if its duration should have been extended beyond the date of discontinuation of the LIBOR as Article 18 SCO does not allow the judge to fill gaps relating to essential terms. For other agreements, where the characteristic performance obligation is not essentially linked to LIBOR, such as a loan and a mortgage referencing to a LIBOR rate, Article 18 of the SCO will apply and Swiss courts will strive to fill the gap. A termination of the agreement after discontinuation of LIBOR would be disproportionate under Swiss law.

The lacuna-filling aims at determining the solution that would have been chosen by parties negotiating in good faith if they had been aware of the lacuna. It is possible to consider supplementary rules from the SCO or the usual practice of the economic sector in the determination of the most appropriate lacuna-filling provision.

The supplementary rule on interests is found in Article 73 of the SCO. It provides for a general interest rate at five per cent per annum. This rate has not been modified since the end of the 19th century and the adoption of the first version of the SCO. In our view, this rate is inappropriate for two reasons: (1) LIBOR is a fluctuating rate published daily across five currencies (CHF, EUR, GBP, JPY and USD) which relies on the state of the economy (via the interbank offered rate), whereas the SCO rate is fixed and detached from economic considerations; and (2) as of mid-December 2019, the LIBOR CHF-overnight rate was at 0.77 per cent, 577 basis points under the SCO rate. A change of the SCO rate would be considerable in the obligations of the parties and cannot be deemed appropriate.

We believe the best way to replace LIBOR in such contracts would be to use a benchmark based on Overnight Indexed Swap (OIS) rates.^[5] A replacement for the LIBOR CHF – overnight could be SARON (Swiss Average Rate Overnight – ISIN CH0049613687), which is administered by SIX Group AG (SIX).^[6] Its rates are close to the LIBOR CHF-overnight rate (–0.71 per cent mid-December 2019 versus –0.77 per cent, a mere six basis point difference). The use of the SARON is appropriate in the case of lacuna-filling, as one could expect parties negotiating in good faith to have chosen a similar rate for their contract, had they been aware of the discontinuation of LIBOR.

Should the contract rely on a more complex method (LIBOR + x basis points, an aggregate of different rates, etc), the SARON can simply be substituted in the calculation. If the chosen LIBOR rate had a different maturity than 'overnight', SIX also provides for benchmarks with longer terms to maturity, up to 12 months. For example, a reference to LIBOR CHF-three-months rate could be replaced by the SAR3M (Swiss Average Rate three months). Finally, if the currency is not CHF but Swiss law is still applicable, other OIS rates are available (eg, the Secured Overnight Financing Rate for USD).

At the discontinuation date of LIBOR, alternative rates will be available in CHF. Some Swiss banks are adapting their products, preparing for the post-LIBOR era. In November 2019 a major bank in Switzerland launched the first real estate financing based on SARON.^[7] Should some parties fail to agree on new terms for existing agreements, Swiss courts should be able to fill the lacuna and allow the agreements to continue, provided that the characteristic performance obligation is not too intrinsically linked to LIBOR itself.

Partial discontinuation ('zombie' LIBOR)

J P Morgan Chase & Co's strategists warned that markets underestimated the risk that a 'zombie' version of LIBOR will survive. As of the end of 2021, banks will no longer have to submit the data used to calculate LIBOR but there will be no ban on submissions. It could be possible, therefore, that a small panel of banks continue to feed the benchmark leaving it in a state between death and life.^[8] Indeed, the Intercontinental Exchange published a so-called Reduced Submissions Policy, which states that LIBOR will be published provided that five or more submissions have been received for a particular currency.^[9]

Should LIBOR be thus partially discontinued, it would still exist, but only in the state of a weak reflection of its former self. If only a few banks (out of the present 16) continue to publish the rates, the resulting LIBOR would be much more subject to higher volatility. Furthermore, any error or manipulation by a specific number of banks would have a higher impact on the benchmark.

LIBOR is calculated using a so-called truncated mean, where the top and bottom 25 per cent rates are discarded before calculating the average rate, thus eliminating outliers and possible errors. For each bank leaving the LIBOR fixation system, the resulting rate will either be calculated on fewer rates, or the margin of error will increase. In both cases, the quality of LIBOR will decrease.

For example, the first table is based on values randomly distributed around -0.70 ± 0.20 for 16 banks (A-P; 'standard' LIBOR) and six banks (A-F; 'zombie' LIBOR) – the top and bottom 25 per cent rates are shown in black and are not counted in the result. The truncated mean of the standard LIBOR is much closer to the mathematical mean of the distribution (1.8 versus 16.1 basis points). The second table is based on the hypothesis that two participating banks (A and B) communicated rates far outside the general consensus. The standard LIBOR remains unaffected, but the zombie LIBOR drops considerably (28.8 basis points).

Bank	LIBOR	Z-LIBOR		Bank	LIBOR	Z-LIBOR
A	-0.896	-0.896		A	-1.500	-1.500
B	-0.891	-0.891		B	-1.400	-1.400
C	-0.827	-0.827		C	-0.827	-0.827
D	-0.554	-0.554		D	-0.554	-0.554
E	-0.888	-0.888		E	-0.888	-0.888
F	-0.836	-0.836		F	-0.836	-0.836
G	-0.709			G	-0.709	
H	-0.642			H	-0.642	

I	-0.684			I	-0.684	
J	-0.622			J	-0.622	
K	-0.852			K	-0.852	
L	-0.657			L	-0.657	
M	-0.547			M	-0.547	
N	-0.766			N	-0.766	
O	-0.855			O	-0.855	
P	-0.517			P	-0.517	
Result	-0.718	-0.861		Result	-0.718	-0.988

As already explained, the intent of the parties is decisive in the interpretation of their agreement. If the agreement of the parties provides for a definition of the LIBOR that includes and accepts the use of a zombie LIBOR, their agreement shall prevail.

Absent any such specific definition of LIBOR, one can assume that in most cases, the parties chose LIBOR because it was the default standard interest rate. A zombie LIBOR would not offer the same guarantees. Therefore, we consider that the LIBOR upon which the parties agreed exists no more, which can in turn be construed as a lacuna.

The legal reasoning and the lacuna-filling process will then be the same as with a total discontinuation of LIBOR. This is a logical conclusion: the total disappearance of a benchmark or an alteration so important that it is no longer of use to the parties having the same economic consequence and thus treated the same way from a legal standpoint.

Conclusion

The discontinuation of LIBOR is an important event but should not affect disproportionately the economic actors and the agreements entered into by the parties. It would be incoherent if the efforts to find a suitable replacement to LIBOR were undermined by a too-strict interpretation of the agreements, leading to early termination before the end of the contractual duration.

Fortunately, a way out of LIBOR exists for agreements governed by Swiss law, even if the parties do not agree to renegotiate the terms of their agreement. Swiss courts can rely on the economic solutions created to replace LIBOR as a means to find a suitable alternative and preserve the continuation of the agreements.

Swiss law is renowned for its flexible and pragmatic approach and the present challenge offers a good illustration. LIBOR may die or turn into a zombie, but the agreement will endure if LIBOR was not at its heart.

Notes

[1] www.fca.org.uk/news/speeches/the-future-of-libor
(<http://www.fca.org.uk/news/speeches/the-future-of-libor>).

[2] www.finma.ch/en/news/2018/12/20181217-aktuell-libor-aufsichtsmittteilung
(<http://www.finma.ch/en/news/2018/12/20181217-aktuell-libor-aufsichtsmittteilung>).

[3] www.fca.org.uk/news/speeches/libor-preparing-end
(<http://www.fca.org.uk/news/speeches/libor-preparing-end>).

[4] The participating banks are currently chosen by the ICE Benchmark Administration with the assistance of the Foreign Exchange and Money Markets Committee: www.global-rates.com/interest-rates/libor/libor-information.aspx (<http://www.global-rates.com/interest-rates/libor/libor-information.aspx>).

[5] See the PwC report on this topic: www.pwc.ch/en/publications/2017/pwc-discontinuation%20of%20libor_final.pdf (http://www.pwc.ch/en/publications/2017/pwc-discontinuation%20of%20libor_final.pdf).

[6] www.six-group.com/exchanges/indices/data_centre/swiss_reference_rates/saron_en.html
(http://www.six-group.com/exchanges/indices/data_centre/swiss_reference_rates/saron_en.html), www.six-group.com/exchanges/indices/data_centre/swiss_reference_rates/reference_rates_en.html
(http://www.six-group.com/exchanges/indices/data_centre/swiss_reference_rates/reference_rates_en.html).

[7] www.agefi.com/home/entreprises/detail/edition/online/article/ubs-lance-en-suisse-le-premier-financement-immobilier-reposant-sur-le-taux-de-reference-saron-calcule-par-la-bns-492472.html
(<http://www.agefi.com/home/entreprises/detail/edition/online/article/ubs-lance-en-suisse-le-premier-financement-immobilier-reposant-sur-le-taux-de-reference-saron-calcule-par-la-bns-492472.html>).

[8] Bloomberg, Alex Harris, 'Zombie Libor' Threatens Market's Complacent View, JPMorgan Says, www.bloomberg.com/news/articles/2019-09-09/zombie-libor-risks-are-being-underappreciated-jpmorgan-says (<http://www.bloomberg.com/news/articles/2019-09-09/zombie-libor-risks-are-being-underappreciated-jpmorgan-says>), consulted on 16 December 2019.

[9] www.theice.com/publicdocs/ICE_LIBOR_Reduced_Submissions_Policy.pdf
(http://www.theice.com/publicdocs/ICE_LIBOR_Reduced_Submissions_Policy.pdf).

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