Legal Fallback Language

Status and Recommendation Document

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2 Introduction

The publication of IBORs (Interbank Offered Rate) commonly used throughout the world will be gradually ceased after 2021 and the reform will have broad effects on banks, bank customers and service providers. It is foreseen that more than $400 trillion worth of IBOR contracts (loan and derivative) exist throughout the world and almost none of these contracts were prepared by taking into consideration the full termination of IBOR rates or with any provision related to a fallback suitable for changes bearing significant financial consequences unforeseeable by the parties. Contracts with maturity later than December 31, 2021 in particular are in uncertainty because of this deficiency and the fact that the calculations in contracts will change significantly will result in complex problems that the parties or courts will have to resolve. Therefore, it is important for contracts to include suitable fallback language that regulate the cessation of the interest rate. As legacy contracts mostly do not regulate the interest rate to be applied in the event of permanent cessation of IBOR rates, such contracts will need to be amended through negotiations. However, as negotiating and amending each contract separately will lead to major difficulties, it is important to have a legal fallback language covering a rate regulation to which non-amendable contracts will be subject. Many jurisdictions have draft legislations prepared to address such concerns and facilitate the transition.

This document also takes into consideration foreign works and plans to develop a roadmap for potential legal fallback language works in our countries.

3 Summary

This document discusses legal fallback languages that are of critical importance for duly conducting the IBOR transition.

An interest rate practicable for every contract should be available during the transition process. In order to achieve this, contracts, products and transactions with post-2021 maturity should primarily be identified and an action plan should be prepared to implement an alternative interest rate suitable for them. This action plan should be able to distinguish “prioritized contracts” and prioritize the time and resources of the bank according to such contracts, in other words, a security network should be available for contracts not included in the “prioritized contracts”. Draft legislations from the United States of America, the European Union and the United Kingdom were examined to create such structure and also provide the necessary legal support during the transition from TRLIBOR to TLREF.

4 The Definition of and the Requirement for Legal Fallback

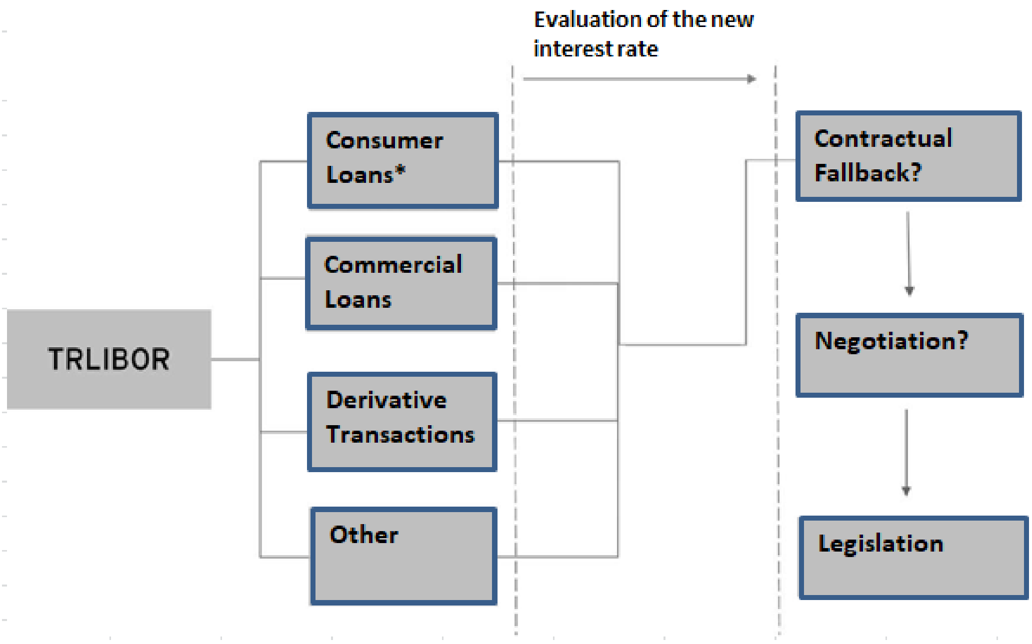
Fallback rate refers to a secondary rate to be applied if the interest rate decided to be applied on a contract, product or transaction becomes impracticable. The fallback language of a contract, product or transaction is the article that regulates when and how such rate will be applied. Legacy contracts using TRLIBOR rates do not regulate the interest rate to be applied in the event of permanent cessation of the TRLIBOR rate or may contain provisions difficult to apply in practice or assessments made with ambiguous expressions.

The priority for such contracts, products and transactions is to determine the rate most suitable to the original will of the parties through negotiations and to add a new fallback language to the contract, product or transaction. However, banks - the largest actors of the transition - considering contractual fallback and negotiation methods for all contracts will result in a significant loss of time and resources.

On the other hand, in some contracts, products or transactions, it may not be possible to reach the counterparties or, due to the number of such documents, it may be practically impossible to hold negotiations and reach an agreement with the counterparties of each contract, product or transaction until the target date of the TRLIBOR transition. At this point, there many contracts, products or transactions face the danger of being deprived of a valid interest rate.

Legal fallback is a concept discussed and included in draft legislations in many countries to create a security network against such danger.

With the security network created by the legal fallback rate, banks will have the opportunity to allocate the time and other resources for the TRLIBOR transition negotiations to the most important contracts, products and transactions. Certain opinions were requested from banks to form a basis and the questions in this context are provided in the annex “6.2 Opinion Request”.



The table was prepared to show the contract types to be affected from the IBOR transition globally and is currently not applied to TRLIBOR consumer loans pursuant to market practices.

5 Foreign Legal Fallback Language Draft Regulations

The European Union, the United States of America and the United Kingdom were taken into consideration in this document as sample draft legislations.

5.1 United States of America

The draft regulation examined from the United States of America is a regulation prepared for the New York State, aiming to amend the Uniform Commercial Code and although the Uniform Commercial Code is not a federal law, it was enacted by fifty (50) states.[ii]

The proposed bill aims to ensure legal certainty to reduce the potentially expensive and time-consuming legal process regarding issues that may arise if the New York law is chosen as the governing law. In this context, the aim is to resolve the following issues:

- Preventing a contract party from refusing to fulfill its contractual obligations or declaring to terminate the contract based on the cessation of the publication of LIBOR (London Inter-bank Offered Rate) or the implementation of the fallback language recommended by the law (benchmark replacement);

- Identifying that the recommended fallback language (benchmark replacement) is a commercially reasonable replacement and equivalent of LIBOR; and

- Provide a safe haven to ensure that lawsuits are not filed against the use of the recommended benchmark replacement.

The aim of the proposed legislation is to achieved the aforementioned purposes by making it mandatory to use the recommended fallback in contracts with no fallback language or contracts using LIBOR as the fallback. If a fallback language includes discretionary power, it is aimed to encourage to use the replacement rate recommended with the “safe haven” specified in the proposed legislation. However, the proposed legislation will not affect legacy contracts containing a fallback language using a replacement rate other than LIBOR.

The proposed legislation was partially prepared based on the New York State legislation enacted in 1998 when some currencies were replaced with the Euro. In one of its meetings, ARRC stated that legislations should also be made in states other than New York and even a federal law could be considered.[iii] It was therefore emphasized that although various states may have different laws, they will not be mutually exclusive and the most important issue is to consider legacy contracts. In the same meeting it was also considered that separate legal regulations could be made for contracts subject to different jurisdictions. This regulation consists of four articles entitled “Definitions”, “Effects of LIBOR Cessation on Contracts”, “Contract Continuity and Safe Haven” and “Integrity of the Regulation”.

In the “Definitions” article, LIBOR is defined as the US Dollar LIBOR rate and “LIBOR cessation”, in other words the trigger event” is defined as the occurrence of any one of the following:

(i) LIBOR administrator announces that it has/will permanently or indefinitely ceased/cease to publish the rate and the rate will not be continued by another institution,

(ii) The institution with administrative mandate over the LIBOR administrator, the American Federal Reserve System, an official with liquidation power over the LIBOR administrator, an authority with decision power over the LIBOR administrator or a court or institution with similar decision or liquidation power, announces that it has/will permanently or indefinitely ceased/cease to publish the rate and the rate will not be continued by another institution,

(iii) The supervisory authority (FCA) to which the LIBOR administrator reports, makes a public announcement or shares information that the LIBOR is not representative for contracts, notes or instruments determined by the Federal Reserve Board, the New York Federal Reserve Bank or the Alternative Reference Rates Committee (ARRC).

Pursuant to these incidents, the dates when LIBOR is to be replaced were defined as follows:

(i) In the first and second cases of cessation, the replacement rate will enter into force on the latter of the date of the announcement or the date when publication of the rate is ceased.

(ii) In the third case of cessation, as long as there is no fallback language foreseeing a later date in the concerned contract, note or instrument, the replacement rate will enter into force on date of the public release or when the information is shared.

Another important definition in the legislation is “recommended replacement rate”. Accordingly, the recommended replacement rate is the rate to be determined with the implementation of spread adjustment and other compatible changes recommended by the Federal Reserve Board, the New York Federal Reserve Bank or the Alternative Reference Rates Committee (ARRC) on the interest rate again recommended by these institutions.

According to the article entitled “Effects of LIBOR Cessation on Contracts”, following the cessation of LIBOR, the recommended replacement rate will enter into force for the following contracts on the date when LIBOR will be replaced:

(i) Contracts not using the LIBOR rate and not containing fallback language,

(ii) Contracts in which the fallback language uses the LIBOR rate.

According to the article entitled “Contract continuity and safe haven”, the replacement rate will be considered commercially reasonable and the parties will not raise any contract violation claims due to the application of this rate.

According to the article entitled “Integrity of the Regulation”, if any article or part of the bill is deemed null or canceled by a judicial authority with jurisdiction, the remainder of the regulation will not be affected by such annulment or cancellation.

The regulation was submitted to the senate in the parliament on October 28, 2020 and forwarded to the committee.[iv]

5.2 European Union

The works carried out in the European Union seek to amend the Benchmark Regulation ((EU) 2016/1011, BMR) currently in force. The draft prepared in these works not only address the cessation of the IBOR rates, but also aim to develop a roadmap for all rates for which publication can cease.

This regulation plans to give certain powers to the European Commission about determining legal fallback.

The regulation requires the occurrence of one of the following as the time (trigger event) of the cessation of any interest rate:

(i) The regulatory authority to which the institution announcing the rate reports, announces that the benchmark nature of the interest rate is irrecoverably disrupted with the exercise of the powers specified in article 23 of the regulation,

(ii) LIBOR administrator announces that it has/will permanently or indefinitely ceased/cease to publish the rate and the rate will not be continued by another institution,

(iii) The authority with administrative power over the LIBOR administrator or an official with liquidation power over the LIBOR administrator announces that it has/will permanently or indefinitely ceased/cease to publish the rate and the rate will not be continued by another institution.

The regulation plans to authorize the European Commission to determine the rate to be applied in such case. The rate to be determined will apply to the contracts of banks, credit agencies or other financial institutions described with the expression “supervised entity”.

The replacement rate to be determined will be mandatory for the following contracts:

(i) Contracts not containing any fallback language,

(ii) Contracts using interests rates whose cessation could cause a disruption in the functioning of the financial market in the European Union and containing fallback language only for the temporary non-publication of such rate,

(iii) Contracts using the interest rates identified in the second item as the fallback rate.

This mandatory requirement will not prevent the parties from reaching an agreement on a different fallback or a replacement article through bilateral negotiations.

Furthermore, there are cases where the legislation can be applied as a preference. Contracts that provide the parties the option to choose fallback and contracts to which “supervised” entities are not a party, will have the option to use the replacement rate to be determined under the regulation.

The European Parliament and the Council reached an agreement on the regulation according to the announcement dated November 30, 2020.[vi]

5.3 United Kingdom

The regulation in the United Kingdom aims to amend the BMR that was transferred into domestic law during the European Union membership. The regulation is called the “Financial Services Bill” and involves many issues. The articles concerning the IBOR transition give powers to the FCA (Financial Conduct Authority) to evaluate whether a benchmark is unrepresentative or its representativeness is at risk.

The regulation added the paragraphs 21A, 22A, 22B, 23A, 23B, 23C and 23D to article 21 of the BMR to facilitate the IBOR transition process.

With the additions, the FCA gains the power to evaluate whether a rate measures the economic reality of a market and economy it is supposed to represent. And this measurement will be made according to the definitions of “benchmark unrepresentative” or “representativeness at risk” described in the other articles of the regulation. These measurements will be made based on whether the concerned benchmark represents the underlying market or economic reality it is intended to measure.

If the FCA determines that a benchmark has become unrepresentative or its representativeness is at risk, it is authorized under this regulation to prohibit “supervised entities”, in other words banks, credit agencies and other financial institutions from using these benchmarks.

In addition to these decisions, the FCA was also authorized to set replacement rates. However, it is also possible for FCA to once again grant representativeness to the concerned benchmark by changing the calculation methodology of the concerned benchmark or through other measures.

The regulation was submitted to the parliament and was being discussed in the House of Lords at the date this report was being prepared.[vii]

6 Annexes

6.1 Abbreviations

BMR	Benchmark Regulation (EU) 2016/1011
FCA	Financial Conduct Authority
IBOR	Interbank Offered Rate
LIBOR	London Interbank Offered Rate

6.2 References

[i] Andreas Schrimpf, Vladyslav Sushko, "Beyond LIBOR: a primer on the new reference rates," BIS Three-Month Assessments, March 2019.
[ii] https://www.law.cornell.edu/wex/table_ucc
[iii] https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2020/October-21-ARRC-Meeting-Minutes.pdf
[iv] https://www.nysenate.gov/legislation/bills/2019/s9070
[v] For the list of supervised entities published on January 1, 2020, ref.https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.listofsupervisedentities202002.en.pdf
[vi] https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_20_2270
[vii] https://services.parliament.uk/bills/2019-21/financialservices.html

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