LexisPSL Banking & Finance: LIBOR transition newsletter—September 2021

Welcome to the LexisPSL Banking & Finance LIBOR transition newsletter for September 2021, where we look at the latest developments in relation to LIBOR transition across the globe over the last month.

Featured developments

FCA consultation suggests synthetic LIBOR will be available for all legacy contracts except cleared derivatives

What has happened?

The Financial Conduct Authority (FCA) has published a consultation on the use of LIBOR under Articles 23C and 21A of the UK Benchmark Regulation (UK BMR). It proposes to:

- permit legacy use, ie use in existing contracts, of 1 month, 3 month and 6 month Sterling and Yen LIBOR from 1 January 2022 in all contracts except cleared derivatives, as these have adequate fallback provisions
- prohibit new use of overnight, 1 month, 3 month, 6 month and 12 month US dollar LIBOR, with limited exceptions

What are the practical implications?

1 month, 3 month, and 6 month Sterling and Yen LIBOR settings are going to continue to be published following 31 December 2021 under a new methodology, Term SONIA/TONA plus the fixed ISDA adjustment spread (known as 'synthetic LIBOR').

If the FCA exercises its powers as proposed, this would effectively remove the urgency to amend most contracts referencing Sterling and Yen LIBOR prior to the end of the year. The expectation was for a narrower permission so this will come as welcome news to the market.

In terms of USD LIBOR, it was widely anticipated that the FCA would prohibit new use, but the consultation provides confirmation that alternatives to USD LIBOR, such as SOFR compounded in arrears, Term SOFR or SOFR averages should now be used in new contracts.

For information on alternatives to USD LIBOR, see Practice Note: Interest provisions in risk free rate based loan agreements.

UK introduces bill to give LIBOR phase-out legal clarity

What has happened?

The UK government has introduced the Critical Benchmarks (References and Administrators' Liability) (the Bill). This aims to reduce uncertainty and litigation in relation to the wind-down of LIBOR. If passed, the Bill would, in relation to LIBOR:

- clarify that references to LIBOR in contracts include LIBOR published as synthetic LIBOR under Article 23D of the UK BMR
- prevent any fallbacks on cessation of LIBOR from being triggered by the designation of LIBOR as an Article 23A benchmark and its continued publication as synthetic LIBOR, and
- grant IBA, as the administrator of LIBOR, immunity from legal action where it takes actions as a result of requirements imposed by the FCA

What are the practical implications?

The aim of the Bill is to ensure that parties to tough legacy contracts are able to apply synthetic LIBOR to their contracts with confidence, without the risk of claims for breach of contract or frustration. For those UK law tough legacy contracts which reference Sterling or Yen LIBOR, ie those currencies to be published as synthetic LIBOR, it should help clarify the contractual position when LIBOR becomes 'unrepresentative' at the end of the year.

It is not entirely clear when existing fallbacks will apply and when they will be overridden, however, with the Bill giving a power for the Treasury to pass secondary legislation regarding the operation of these provisions. The Bill must go through several readings and changes may be made before it is passed as an Act, however, so we will hopefully see further clarity on this in due course.

On 13 October 2021, the House of Lords is scheduled to debate the second reading of the Bill.

For more detailed information, see Practice Note: Legislative solutions to tough legacy contracts.

ICE Benchmark Administration launches RFR indexes

What has happened?

The Intercontinental Exchange (ICE) Benchmark Administration has launched its risk free rates (RFR) indexes for US Dollar (SOFR), Euro (€STR) and Japanese Yen (TONA), following the launch of ICE SONIA Indexes for GBP Sterling in April 2021.

What are the practical implications?

The SONIA Indexes were developed to support the UK lending market and provide a simple method for parties to calculate SONIA compound interest between any two index dates and agree on their associated interest accruals. They support use of SONIA floors and multiple lookback approaches. The publication of the additional RFR indexes will mean that using compounded RFRs in loan documentation becomes more straightforward for other currencies too.

Other developments

Sterling

FCA confirm continued publication of 1, 3 and 6 month Sterling and Yen LIBOR

The Financial Conduct Authority (FCA) has confirmed that, to avoid disruption to legacy contracts that reference the one-, three- and six-month Sterling and Japanese Yen LIBOR settings, it will require the LIBOR benchmark administrator to publish these settings under a 'synthetic' methodology, based on term risk-free rates, for the duration of 2022. These six LIBOR settings will be available only for use legacy contracts and are not for use in new business.

ISDA generally supportive of FCA's proposals on LIBOR Transition and DTO

The International Swaps and Derivatives Association (ISDA) released its response to the FCA's consultation on LIBOR transition and the derivatives trading obligation (DTO) (CP21/22). The response included a general support for the FCA's proposals and asked the FCA to consider phasing in any new products that are to be included within the scope of the DTO. ISDA stated this would 'help to alleviate the pressures on firms currently working hard to effect LIBOR transition by the end of 2021'.

FCA representative speaks on preparedness for LIBOR transition

Toby Williams from the Benchmarks Policy team within the Markets and Wholesale Policy Division at the FCA has spoken on preparedness for LIBOR transition at the Association for Financial Markets in Europe (AFME) and Information Management Network (IMN) Global ABS conference. He encouraged firms to act now and discussed what the FCA is doing to support an orderly year-end.

US dollar

LSTA publishes Term SOFR concept document in light of ARRC recommendations

The Loan Syndications and Trading Association (LSTA) has published its Secured Overnight Financing Rate (Term SOFR) concept document, the latest addition to its SOFR Document Library. The document is designed to familiarise market participants with using Term SOFR.

IOSCO says credit sensitive rates must comply with the Principles on Financial Benchmarks

The International Organization of Securities Commissions (IOSCO) has issued a statement stressing the importance of continued transition to robust alternative financial benchmarks, ie risk-free rates, to mitigate potential risks arising from the cessation of LIBOR, including USD LIBOR. In light of some alternatives being suggested, notably credit sensitive rates, IOSCO calls for greater attention to Principles 6 and 7 of its Principles on Financial Benchmarks, concerning the 'relative size of the underlying market in relation to the volume of trading' and 'data sufficiency in a benchmark's design to accurately and reliably represent the underlying market' respectively.

For more information on Term SOFR and credit sensitive rates, see Practice Note: Interest provisions in risk free rate based loan agreements.

Swiss Francs (CHF)

The Swiss Financial Market Supervisory Authority (FINMA) publish guidance on transition away from LIBOR

FINMA have published more Guidance on LIBOR transition, emphasizing the importance of urgent action on syndicated loans still referencing CHF LIBOR.

Euro

ISDA publishes response to Commission on EONIA

ISDA has released its response to the European Commission's consultation on the Draft Implementing Regulation designating the replacement rate for Euro Overnight Index Average (EONIA). The response discussed the limited scope of the power and a need to avoid a presumption of contractual frustration. ISDA emphasised the importance of early adoption of the Regulation given the time left until the cessation of EONIA and further suggested amendments to the Regulation.

EUR RFR Working Group writes to Commission on EONIA cessation

The European Securities and Markets Authority (ESMA) has published a letter from the chair of the EUR Risk Free Rates Working Group to the European Commission saying the draft Implementing Act designating EONIA as a critical benchmark in cessation is an important component of a 'clear and comprehensive' solution for cash and derivative products, and thanking the Commission for its support with regards to the transition from EONIA to the Euro Short Term Rate (€STR). The Working Group recommends that the Implementing Act highlights the importance of continued active transition to €STR for all contracts and financial instruments currently referencing EONIA, and suggests some refinements relating to the scope of the statutory replacement rate and date of application of the designation.

For information on the EU legislation, see Practice Note: Legislative solutions to tough legacy contracts.

What's coming up?

This section sets out some key upcoming developments to look out for:

Date	Currency	What's happening?
In progress	Sterling	Critical Benchmarks (References and Administrators' Liability) Bill – this Bill is in progress; the next stage is the second reading in the House of Lords
20 October 2021	Sterling/Yen/USD	Deadline for responses to the FCA's consultation paper CP21/29, on its proposed decisions on the use of LIBOR (Articles 23C and 21A Benchmark Regulation)
Q4	Sterling/Yen/USD	FCA announces its final decision on use of LIBOR
17 December 2021	Sterling	LCH and CME cleared GBP LIBOR swap conversion date
End-Q4	All	1,3, 6 month Sterling and Yen LIBOR cease to be representative but continue to be published as synthetic LIBOR, available for legacy use except for cleared derivatives. 1 month, 3 month, 6 month and 12 month USD LIBOR continues to be published and 'representative', but most 'new use' is prohibited. All other currencies and settings cease publication

For detailed information on developments for each LIBOR currency, see LIBOR developments tracker.

Featured Q&A

Every month we feature a LIBOR-transition related question that has been asked by one of our customers. This month, the question is:

What will happen to loan agreements that can't be amended by the end of the year?

LIBOR is ceasing at the end of 2021 for most currencies and tenors. The exceptions are:

- 1, 3, 6 and 12 month US dollar LIBOR, which is continuing to be published until end-June 2023, though use in new contracts is being prohibited or discouraged by regulators, and
- certain Sterling and Yen LIBOR tenors which will be published as 'synthetic LIBOR'

The regulators are encouraging the market to amend contracts wherever possible to provide certainty and avoid a last-minute panic, but some contracts are likely to be impossible to amend, or, because of the volume of contracts, simply not amended in time.

The UK, EU and US have all come up with legislative 'fixes' to try to (temporarily at least) solve this problem. There are still areas that need to be finalized, though the position is clearer than it was. What will happen will depend on the currency of the loan(s), the governing law of the loan agreement and the parties involved, as well as what is finally decided on the various outstanding points.

What is likely to be the position for loans governed by UK law?

For Sterling and Yen loans governed by UK law, the UK legislative fix under the Financial Services Act 2021 (which amends the UK Benchmarks Regulation) is likely to assist. In summary, for the duration of 2022 at least, the effect of this will be:

- nothing needs to be done by the parties to the loan agreement
- the reference rate under the loan agreement will continue to be 'LIBOR'
- LIBOR will constitute Term SONIA (as published by IBA) for Sterling, or Term TONA (as published by Quick Benchmarks Inc) for Yen, together with the fixed spread adjustment published for the purposes of the ISDA IBOR Fallbacks Supplement and Protocol

Can synthetic LIBOR be used for all loans?

In summary, the answer to this is yes, any loan will be able to use synthetic LIBOR. The UK BMR 2021 is drafted such that the 'use' of synthetic LIBOR by supervised entities will only be permitted in certain tough legacy contracts. However, the consultation published by the FCA on 29 September suggests that all contracts except for cleared derivatives will be able to use it.

In any event, however, the FCA's powers under the legislation to control the use of LIBOR apply to Benchmark Regulation contracts only, ie not commercial loans (though the FCA have made clear that supervised entities should be doing everything they can to amend all contracts, including loan agreements, prior to the end of the year).

Synthetic LIBOR is very much a temporary fix – synthetic Japanese Yen LIBOR will only be published for a 12 month period, while the publication of synthetic Sterling LIBOR will be reviewed after 12 months.

US Dollar LIBOR will still be published until end-June 2023, so while it should not be used for new contracts, there is no end 2021 cliff edge for legacy loan agreements.

Other LIBOR currencies (euro and Swiss francs) will not be published after end-2021 in any form, so the fallbacks for these contracts will need to be reviewed to see what the contractual position will be at that point. The statutory replacement rate planned for CHF LIBOR (see below) appears to apply to contracts governed by the laws of an EU state only so will not assist in UK law loan agreements.

What about loan agreements governed by other laws?

Where a loan agreement references Yen or Sterling but is not governed by UK law, synthetic Sterling and Yen LIBOR should be available, depending on the exact wording in the loan agreement. Note that the Critical Benchmarks (References and Administrators' Liability) Bill will only apply to UK law loan agreements, leaving an increased possibility of dispute and challenge for loan agreements not governed by UK law.

Loan agreements governed by non-UK law, as with those governed by UK law, will continue to be able to use USD LIBOR for legacy loans past end-2021.

For EU governed contracts referencing Swiss Franc LIBOR, the European Commission is planning to use its powers under the EU Benchmarks Regulation to designate a statutory replacement rate for certain settings of Swiss Franc LIBOR for EU law governed contracts. The proposal is to use compounded SARON using the 'last reset' methodology to provide visibility, plus a fixed spread adjustment based on the historical median spread between Swiss franc LIBOR and relevant SARON compounded over a five-year lookback period up to 5 March, 2021.

For detailed information, see Practice Note: Legislative solutions to tough legacy contracts.

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