SLAUGHTER AND MAY

Transforming Interest Rate Benchmarks

September 2021

Transition to synthetic LIBOR by statute

The UK Parliament is typically reluctant to interfere with freedom of contract unless absolutely necessary. However, the mountain of contracts referencing a LIBOR rate that will not be amended prior to the rate's cessation in its current form, has been determined sufficiently material to warrant statutory intervention.

*The Critical Benchmarks (References and Administrators' Liability) Bill (the **Bill**), introduced to Parliament on 8 September will, if passed, add to the limited number of instances under English law where the interpretation and effect of a contractual provision is determined by statute. The Bill provides that references to a LIBOR rate in any contract or arrangement (whether financial or non-financial) will be deemed to refer to the equivalent synthetic LIBOR rate, where such rates are available.*

This Briefing outlines the scope of application of synthetic LIBOR (based on current information) and the impact of the Bill on references to LIBOR in legacy contracts that are not actively transitioned to alternative rates ahead of the relevant deadline.

What is "synthetic LIBOR"?

The UK Benchmarks Regulation (**BMR**) was amended earlier this year to empower the Financial Conduct Authority (**FCA**) to mandate the production of so-called "synthetic LIBOR" after LIBOR ceases to be published in its current form.

The process requires the FCA to "designate" a critical benchmark (such as LIBOR) under A23A of the BMR as no longer representative of the reality it seeks to measure. If that happens, the FCA can take steps to compel the continuing publication of the benchmark for up to 10 years (reviewed every 12 months), based on a revised methodology. In the context of LIBOR, the rate calculated in accordance with this revised methodology has become known as synthetic LIBOR.

Will all LIBOR rates be replaced with synthetic LIBOR?

No. On 5 March 2021, the FCA announced the dates on which each of the 35 current LIBOR settings will either cease, or become unrepresentative (summarised in the table in the Appendix). Synthetic LIBOR is being considered only for those GBP, JPY and (subject to future confirmation) USD settings which have been placed in the "unrepresentative" category. No synthetic LIBOR rates will be available for CHF and Euro.

The FCA has already consulted on synthetic LIBOR proposals for the 1, 3 and 6 month GBP LIBOR settings and, for an interim period only to end-2022, the 1, 3 and 6 month JPY LIBOR settings. Final confirmation of which synthetic LIBOR rates will be available for these currencies and how they will be composed, is anticipated in the coming weeks.

Given the extended timetable for the wind-down of USD LIBOR, the FCA has not yet begun to consult in relation to the USD currency/tenor settings that will become unrepresentative at the end of June 2023. For now, it has indicated only its intention to monitor developments.

How will synthetic LIBOR be composed?

Synthetic LIBOR will be built from the risk-free rates in the currencies for which synthetic LIBOR is being considered, specifically, the forward looking term rates derived from those risk-free rates (**Term RFRs**). Term RFRs derived from SONIA (the Sterling Overnight Index Average, for GBP), TONAR (the Tokyo Overnight Average Rate, for JPY) and SOFR (the Secured Overnight Financing Rate, for USD) are already available to the market on-screen.

The FCA has indicated that synthetic LIBOR for a particular currency/tenor setting will be the combination of the appropriate Term RFR plus the fixed credit adjustment spread published by Bloomberg that applies as part of the ISDA fallbacks for the relevant currency/tenor setting.

Again, this is to be finally confirmed by the FCA once the consultation process is complete.

Is the use of synthetic LIBOR restricted?

The BMR restricts the use of critical benchmarks such as LIBOR by FCA supervised entities in, and in connection with, certain financial contracts and instruments. In relation to financial contracts and instruments within the BMR sphere, FCA supervised entities will be able to "use" synthetic LIBOR only to the extent permitted to do so by the FCA under Article 23C of the BMR. Having previously consulted on permitting the continued use of a benchmark in legacy contracts, the FCA will shortly begin a further consultation on the circumstances in which it proposes such use will be permitted, which will be confirmed in a notice in due course. For FCA-supervised entities this means that there will be no certainty as to how they may be able to use synthetic LIBOR pending the conclusion of the consultation process, leaving little time (at least in relation to GBP LIBOR and JPY LIBOR) to take action in reliance on the final FCA decision.

The BMR restricts the use of LIBOR by supervised entities only in the context of certain financial contracts and instruments, which are defined in detail in the BMR to include for example, bonds, derivatives and consumer loans, but notably, not syndicated or bilateral business loans. The FCA's notice permitting the use of synthetic LIBOR will address legacy LIBOR contracts within the scope of the BMR regime only. Accordingly, there will be certain financial contracts such as business loans that fall outside the scope of the BMR, for which the use of synthetic LIBOR is unrestricted.

Whether a contract or instrument is governed by restrictions in the BMR will be important for the purposes of determining whether synthetic LIBOR can be applied by regulated entities to legacy LIBOR products. However, it is important to note that FCA supervised firms are also under strict instructions from regulators to cease new LIBOR business of all types by specified deadlines, which either coincide or pre-date the publication of any synthetic LIBOR rates. For the financial sector therefore, synthetic LIBOR will be of use in relation to certain legacy contracts only.

The use of synthetic LIBOR in non-financial contracts is not restricted by the BMR. This applies to legacy contracts and, in theory, new contracts, although in practice, contracting parties might be expected to prefer alternative rates with more certainty as to their longevity. While the FCA can continue to compel the production of synthetic LIBOR for up to 10 years, it is required by the BMR to review that decision every 12 months.

Why is the Bill necessary?

The FCA's decision to pursue synthetic LIBOR for the most used currency/tenor settings is welcome, given the volume of legacy contracts to be transitioned and the short time left to do so. However, there was widespread concern expressed in response to HM Treasury's consultation on supporting the wind-down of critical benchmarks, that the proposal to produce synthetic LIBOR would not, of itself, be sufficient to avoid disruption to LIBOR contracts that are not actively transitioned by the end of 2021 (or the end of June 2023, in the case of USD LIBOR references).

The application of synthetic LIBOR, absent legislation, would be a matter of contractual interpretation (and may turn, for example, on how LIBOR is described in the contract in question, whether that contract includes any fallback mechanisms, and how synthetic LIBOR is published – as many LIBOR contracts refer to the specific screen pages where LIBOR is to be found). If the parties contracted to use LIBOR, does that reference include synthetic LIBOR (a rate which the parties might not plausibly been able to have had in contemplation when they entered into the contract)? The potential for "winners and losers" among parties to contracts purportedly moving to synthetic LIBOR gives rise to the potential for disputes and disruption as parties seek legal advice to determine whether the rate should apply.

What does the Bill do?

The Bill seeks to minimise the possibility of disputes and disruption by providing legal certainty that references to LIBOR however expressed, will be interpreted as references to synthetic LIBOR, where such rate is available. The terms of the Bill specify that such references will be deemed to have referred to synthetic LIBOR since inception, a provision intended to head off arguments that the parties' bargain has changed to such an extent that the contract is materially breached, or frustrated.

Note that while the provisions of the Bill amend the BMR, its provisions are not restricted to contracts and arrangements governed by the BMR (and where use of LIBOR is controlled) as discussed above. The Bill is thus part of the growing body of financial regulation with reaches beyond regulated entities and of which non-financial corporates must keep abreast.

In contrast to the legislative approach being taken in the US (which has a very broad "safe harbour" from claims related to the transition from LIBOR to the rates mandated by law), the Bill does not include any specific provision protecting parties using synthetic LIBOR from the risk of litigation. Instead, it simply confirms that the deeming provision neither creates any new liabilities nor extinguishes any existing causes of action. In this respect the Bill is closer to the EU legislative solution (see further below) which also does not contain a broad safe harbour. The Government's decision to stop short of offering such protection can be explained by a desire to tread cautiously when intervening in contracts, given the necessarily broad-brush nature of the deeming provision.

The Bill also contains provisions limiting the liability of the administrator of a benchmark in connection with the exercise of the FCA's powers under the BMR.

How does the Bill affect existing contractual fallbacks?

During the consultation preceding the Bill, concerns were expressed that a statutory provision to the effect that "LIBOR means synthetic LIBOR" could have the effect of overriding contractual fallbacks that are designed to provide for the application of a benchmark other than LIBOR.

The Bill purports to deal with this by firstly by making clear that parties can contract out of the "LIBOR means synthetic LIBOR" provision. It goes on to protect contractual fallbacks, that is, express provisions for the contract or arrangement to be varied or operate by reference to something other than the benchmark in question (ie LIBOR), or to terminate on a particular date or in particular circumstances. This protection for fallbacks, however, is limited in order to avoid preserving fallbacks in LIBOR contracts which are not sufficiently robust (ie one of the reasons why legacy contracts need to be transitioned). The provisions dealing with fallbacks are quite complex as a result, and may require some analysis in practice.

Is the "tough legacy" concept still relevant?

Synthetic LIBOR is intended to deal with so-called "tough legacy" LIBOR contracts, which simply cannot be transitioned to alternative rates ahead of the required deadlines. The challenge of defining what is "tough legacy" in the context of the wide range of contracts referencing LIBOR, has at first sight, resulted in a less restrictive approach than some initially expected. The Bill applies to references to LIBOR in any "contract or arrangement". The restrictions on the use of synthetic LIBOR in legacy LIBOR contracts bite only on financial contracts and instruments governed by the BMR (and where final clarification is awaited from the FCA, as discussed above).

The Bill does, however, contemplate that restrictions on the use of synthetic LIBOR may be required in future. The Bill confers power on HM Treasury to exclude the application of the "LIBOR means synthetic LIBOR" provision to specified benchmark(s) or to contracts or arrangements of a specified description. HM Treasury is also empowered to make regulations which would adjust the provisions protecting fallbacks discussed above.

While the most obvious use of these secondary legislative powers might be to echo any restrictions the FCA places on the use of synthetic LIBOR in in-scope BMR products, the Bill leaves open the possibility that the pool of contracts and arrangements affected by the Bill could be drawn more tightly in the future.

Does the Bill apply to contracts governed by foreign laws?

The explanatory notes to the Bill confirm that the provisions apply to any contract or arrangement governed by the laws of England and Wales, Scotland or Northern Ireland. While the provisions of the Bill do not expressly limit its application to contracts and arrangements governed by the laws of such legal systems, it is only in such contexts that there is certainty the Bill's provisions will operate as expected.

Contracts governed by the laws of countries which have legislated separately for LIBOR transition, will certainly be expected to cede to the local regime (under local conflict of laws principles):

- In New York, legislation to replace USD LIBOR references was passed earlier this year. Federal legislation is also on the cards, in which case, contracts referencing USD governed by the laws of any US state will be managed via the local regime.

- In the EU, the EU Benchmarks Regulation was amended earlier this year, with the effect that the Commission is empowered to replace LIBOR references in contracts governed by the law of a member state. The Commission's powers are also expressed to extend to contracts governed by the laws of any other country where all parties are established in the EU and the other country has not put in place its own legislative solution.

As will be apparent from the brief summary above, the US, EU and UK legislative solutions to the tough legacy problem may overlap in scope and it is possible that in some limited situations may arise where there is a theoretical conflict of laws question. For example, contracts under New York law referencing a LIBOR setting in a currency that is not USD are outside the scope of the US legislation and a question therefore arises as to whether the New York law rules of contractual interpretation apply or potentially a New York court may consider the EU or UK legislative solution. Similarly, a contract governed by English law, with EU-established parties referencing CHF LIBOR would not be addressed by the UK's synthetic LIBOR regime – an English court would therefore need to decide whether to apply the usual English law rules of contractual interpretation or whether to consider the EU regime.

The interaction of the various legislative solutions (both in terms of scope and the designation of replacement rates for LIBOR) is still to be finalised, but no doubt there will be queries and potentially areas of uncertainty even after the process is concluded, which may take some time to resolve.

What is the impact of the Bill in practice?

While the introduction of the Bill brings the UK's legislative fix for legacy LIBOR contracts into sharper focus, the extent to which the law will affect LIBOR in contracts and agreements remains to be finally confirmed. The Bill must complete its passage through Parliament, the FCA is yet to announce finally how it will exercise its BMR powers and the detail of the legislative and regulatory intervention in this area in the US and in the EU, remains work in progress.

Accordingly, the authorities continue to reiterate that synthetic LIBOR is not a substitute for active transition of existing contracts to alternative rates over which the parties have control. This is a particularly important consideration for long-dated and perpetual contracts and arrangements referencing LIBOR, which will out-live the expected term of synthetic LIBOR as well as more complex arrangements where changing from LIBOR to synthetic LIBOR may have knock-on consequences that are not addressed by the FCA's proposals.

The statutory safety-net in the Bill that preserves the operation of LIBOR references in contracts and arrangements which simply cannot be transitioned in time, or indeed, have been overlooked, is nonetheless, a welcome step forward. While some might perceive the Bill (and the concept of synthetic LIBOR) as deficient in that first, the scope is not comprehensive enough to "save" all legacy contracts, and secondly, it does not rule out entirely the possibility of speculative disputes and litigation, it seems likely that if passed, it will prevent short-term disruption in many situations where legacy contracts have not been amended in time. The volume and variety of uses of LIBOR requires policymakers to strike a balance; perfection should not be the enemy of the good.

Appendix
LIBOR CESSATION/PRE-CESSATION DATES

	Overnight /Spot Next	1 wk	1mth	2mth	3mth	6mth	12mth
Sterling	Ces 31.12.21	Ces 31.12.21	NR 31.12.21 Synth to ?	Ces 31.12.21	NR 31.12.21 Synth to ?	NR 31.12.21 Synth to ?	Ces 31.12.21
Dollar	Ces30.06.23	Ces 31.12.21	NR30.06.23 Synth to ?	Ces 31.12.21	NR 30.06.23 Synth to ?	NR 30.06.23 Synth to ?	Ces 30.06.23
Euro	Ces 31.12.21	Ces 31.12.21	Ces 31.12.21	Ces 31.12.21	Crs 31.12.21	Ces 31.12.21	Ces 31.12.21
CHF	Ces 31.12.21	Ces 31.12.21	Ces 31.12.21	Ces 31.12.21	Ces 31.12.21	Ces 31.12.21	Ces 31.12.21
JPY	Ces 31.12.21	Ces 31.12.21	NR 31.12.21 Synth to 31.12.22?	Ces 31.12.21	NR31.12.21 Synth to 31.12.22?	NR 31.12.21 Synth to 31.12.22?	Ces 31.12.21

Key

Ces *- publication of LIBOR rate ceases*

NR *- LIBOR rate is non-representative*

Synth *- FCA considering publication of a synthetic LIBOR rate*

Contacts

Philip Snell
T +44 (0) 20 7090 3105
M +44 (0) 7776 240 275
E philip.snell@slaughterandmay.com

Matthew Tobin
T + (0) 20 7090 3442
M +44 (0) 7789 980 325
E matthew.tobin@slaughterandmay.com

Jan Putnis
T +44 (0) 20 7090 3211
M +44 (0) 7887 540 490
E jan.putnis@slaughterandmay.com

Robert Byk
T +44 (0) 20 7090 3435
M +44 (0) 7795 613 787
E robert.byk@slaughterandmay.com

Richard Jones
T +44 (0) 20 7090 4733
M +44 (0) 7736 045271
E richard.jones@slaughterandmay.com

Oliver Wicker
T +44 (0) 20 7090 3995
M +44 (0) 7717 505 155
E oliver.wicker@slaughterandmay.com

Kathrine Meloni
T +44 (0) 20 7090 3491
M +44 (0) 7717 691 987
E kathrine.meloni@slaughterandmay.com

Eric Phillips
T +44 (0) 20 7090 3055
M +44 (0) 7786 436 639
E eric.phillips@slaughterandmay.com

September 2021