Feature

KEY POINTS

- Restrictions on use of sterling and yen Synthetic LIBOR is expected to be limited.
- Legislation should allow for references to LIBOR in English law contracts to be interpreted as references to synthetic LIBOR.
- The UK legislative approach differs from that of the EU and US.

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Contractual continuity for "tough legacy" contracts

With time ticking until the end of 2021 when at least certain settings of LIBOR will cease, the UK authorities are finalising their plans for "tough" legacy through the means of legislation and powers granted to the FCA. In this article, we examine such legislation and powers with a comparative eye to alternative solutions in the US and the EU.

WHAT IS A "TOUGH LEGACY" CONTRACT?

Whilst there is no specific definition, it is generally taken to mean a contract which cannot be amended (or, in certain cases, cannot easily be amended – such as any requirement for approval for amendments from a majority of bondholders). This means that after the end of 2021 (or whenever the specified LIBOR setting ceases or becomes unrepresentative) those contracts will likely continue to reference LIBOR or fallback to a rate which was never intended to be a long-term fallback.

SYNTHETIC LIBOR

In order to ensure contractual continuity for "tough legacy" contracts, amendments to the UK Benchmarks Regulation (UKBMR) through the Financial Services Bill 2021 gave the UK FCA the power to declare a critical benchmark as unrepresentative and to demand modification of the calculation methodologies of such a benchmark. The power extends to any critical benchmark but was clearly drafted with LIBOR in mind – and the FCA has duly announced that it will compel the continued publication of certain LIBOR settings with a changed methodology (Synthetic LIBOR) after 31 December 2021. The FCA has subsequently consulted on and confirmed the methodology for the calculation of Synthetic LIBOR for sterling and yen, determining that it will require LIBOR's administrator to continue publication of LIBOR on the basis of:

- forward-looking term versions of the relevant risk-free rate (the ICE Term SONIA Reference Rates for sterling and the Tokyo Term Risk Free Reference Rates for yen) plus;
- the respective ISDA fixed spread adjustment.

These rates will only be published for one-, three- and six-month sterling and yen LIBOR rates and it is clear they are not anticipated to be published indefinitely. Publication will be revisited annually for sterling and is not, in any event, expected to continue for more than ten years. For yen, Synthetic LIBOR will only be published for one year. The FCA has yet to confirm as to whether it will publish synthetic LIBOR for US Dollars and further consultations in this respect will be expected in due course.

WHO WILL BE ABLE TO USE SYNTHETIC LIBOR?

Following consultation, on 16 November the UK FCA issued a draft Notice (due to be issued in final form on 1 January 2022) which would permit market participants to use Synthetic LIBOR for legacy purposes in all products with the exception of cleared derivatives (which should have appropriate fallbacks in accordance with clearing house rules). Although the proposals only extend to entities and contracts which are within the scope of the UKBMR, the reality is that, for legacy use and depending on the terms of particular contracts, other entities and contracts will be able to reference Synthetic LIBOR in any event as there is nothing restricting them from doing so (for example, syndicated loan agreements).

It is likely that the FCA's broad proposals will garner market support from both parties who have an interest in contracts or entities which are within the scope of the UK Benchmarks Regulation and those who do not: it is not in the interests of harmony and legal and practical certainty to have different rules for different products.

CONTRACTUAL CONTINUITY

Whilst confirmation that Synthetic LIBOR will be available for use in appropriate circumstances is helpful, parties to contracts will need to consider their terms and whether contractual continuity for references to LIBOR can be assumed. It is likely that for many contracts this would be the case, particularly if Synthetic LIBOR shares features with LIBOR such as publication on the same screen. However, this is not without doubt.

To address this, and in light of the powers given to the FCA to allow for a Synthetic LIBOR, the Treasury introduced the Critical Benchmarks (References and Administrators' Liability) Bill (Bill). At the time of writing, the Bill had completed its passage through the House of Lords and House of Commons under an expedited timetable, with some lively debate but without any drafting amendments. Only Royal Assent is still pending. In essence, the Bill provides that references to LIBOR in relevant English law contracts or "arrangements" will be interpreted as references to Synthetic LIBOR. Moreover, in an attempt to prevent claims of breach or frustration, the Bill provides that this will be the case even where the contract pre-dates this continuity legislation and the FCA's designation of the benchmark and subsequent modification to create Synthetic LIBOR. It further states that such contracts or arrangements are to be treated as having always provided for the benchmark reference to mean the rate as so modified. As with the FCA's powers, the Bill will have broader application and will not be limited to LIBOR benchmarks. However, LIBOR is receiving most focus at the moment.

The Bill attempts to be wide ranging in its application and, despite the intention of amending the UKBMR, is not limited to

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contracts or entities within the scope of such regulation. The Bill's provisions are intended to apply to any contract or arrangement made under the laws of England and Wales, Scotland or Northern Ireland (subject to the FCA's final determination on permitted use following the consultation referred to above). This means that, for example, non-supervised entities and products outside the scope of the UKBMR such as syndicated loans will be able to rely on its provisions.

Whilst the Bill aims to catch all types of references in contracts or arrangements to FCA designated benchmarks in sweeping terms, contracts will need to be assessed to review whether or not they are impacted, not least in the context of any fallbacks. The intention is that contracts which already address the transition away from LIBOR with appropriate fallbacks should not be affected: the Bill carves out contracts or arrangements which have specifically contemplated FCA designation of LIBOR as a critical benchmark within the scope of its powers to ensure its orderly wind-down (including its designation of certain settings of LIBOR as "non-representative"). Accordingly, the fallbacks within products with, for example, a "non-representative" trigger should operate as intended by the parties. However, the Bill does make it clear that designation and modification of a critical benchmark does not activate "cessation" fallback triggers in contracts. How the provisions will affect any particular contract will depend on careful analysis of its terms in conjunction with examination of related products to assess whether there is any mismatch of terms.

SAFE HARBOUR

It is worth noting that the Bill does not contemplate general "safe harbour" provisions which would protect parties who switch to the use of Synthetic LIBOR from litigation related to such switch and use. This had been the subject of much discussion in the context of the consultations which preceded the Bill. Ultimately, though, the Treasury appears to have decided that the Bill and permission to use Synthetic LIBOR, combined with a sub-clause which states that the contract is to be treated as having always provided for the reference to the benchmark to be interpreted as the synthetic benchmark, once introduced, will suffice. During the passage of the Bill, the government stated that, in its view, for contracts that continue to refer to LIBOR, these provisions in the Bill will comprehensively address the risk that parties might successfully dispute the use of Synthetic LIBOR to calculate payments after the end of the year. The approach on the "safe harbour" contrasts with the approach in other jurisdictions (see below). There is, however, a limited "safe harbour" which provides protections for the administrator of the relevant benchmark only. It grants the administrator immunity from claims for damages when acting pursuant to the FCA's direction to calculate LIBOR using a revised methodology by inserting a new provision into the UKBMR. Separately, the Bill provides that its provisions will neither extinguish causes of action pre-existing before the FCA's designation nor create a new cause of action which did not previously exist.

US AND EU APPROACH

Legislation has been passed in New York and in the EU (via amendments to the EU Benchmarks Regulation) to address the cessation of LIBOR. The legislative approach is somewhat different to the UK position as the effect is that a benchmark replacement will be applied to contracts by operation of law for contracts that are in scope of the relevant legislation.

In the US, the intention will be that the replacement will be determined by the ARRC for USD LIBOR in the US (ie SOFR plus an adjustment spread). The legislation only applies to contracts or instruments which are governed by New York law and which reference USD LIBOR. There is a safe harbour for liability, parties may opt out of the legislation and the provisions only apply where the contract or instrument has inadequate or no fallback provisions. A similar federal law (which could pre-empt the New York law legislation) is currently being developed.

In the EU, the EU Commission may designate alternative benchmarks to critical benchmarks. The legislation will only apply where the governing law of a contract or instrument is that of an EU member state or where all parties are EU entities and the relevant governing law does not contain provision for orderly transition away from the critical benchmark and where there is no fallback or suitable fallback in the contract or instrument. The parties may contractually opt out of the effects of the legislation. As yet, the EU Commission has not designated an alternative benchmark, but it is interesting to note that, on 15 November, the Euro RFR Working Group wrote to the European Commission proposing that the European Commission should aim to mirror the UK approach by designating Synthetic LIBOR as a replacement rate under the EU BMR for Sterling and Yen LIBOR.

WHY A DIFFERENT LEGISLATIVE APPROACH?

Fundamentally, LIBOR as a benchmark is used world-wide, not just in English law contracts. Therefore, the approach of creating a Synthetic LIBOR and allowing it to be used for legacy transition purposes is intended to minimise global financial stability risks and disruption to financial systems from the wind-down of LIBOR. This means that, subject to the legislative and other legal frameworks in other jurisdictions, global users of legacy LIBOR may continue to reference the rate. From an English law perspective, the Bill is consistent with this approach.

TRANSITION AWAY FROM THE USE OF LIBOR

The FCA has made it clear that the publication of Synthetic LIBOR is really just a bridging solution. It might seem that the process to provide for Synthetic LIBOR and contractual continuity under the Bill is coming at a late stage, but the clear message is that publication of Synthetic LIBOR will be time limited and is not an alternative to active transition away from the use of LIBOR. ■

Further Reading:

- Amending legacy contracts (2021) 9 JIBFL 650.
- USD LIBOR succession legislation at home and abroad (2021) 8 JIBFL 559.
- LexisPSL: LIBOR transition – legislative solutions to tough legacy contracts.