EVERSHEDS SUTHERLAND

An International jigsaw
LIBOR Transition

Following the announcement in March 2020 of the cessation dates for LIBOR (please see our article **FCA announcement triggers LIBOR** endgame published on March 9, 2021), preparations by market participants, governments and regulators have continued as the benchmark approaches the first sunset date on 31 December 2021.

We have set out below some key points to be aware of as the deadline approaches. Whilst considerable efforts have been and continue to be made by market participants to transition away from LIBOR, it is recognized that a considerable body of "tough legacy" financial contracts will remain in 2022 and, in the United States, into the second half of 2023. Given the risk to continuity of financial services and market integrity, if a large body of contracts ceases to operate effectively at the deadlines for discontinuation of applicable LIBOR settings, consultations continue in the key jurisdictions on the legislative and regulatory solutions addressing LIBOR cessation.

Market participants around the world await clarification in Q4 2021 over the extent to which the global legislative landscape will take shape to support and/or mitigate the effects of the LIBOR wind down.

LIBOR cessation

As indicated in our previous updates, it was announced in March that there are two stages to the LIBOR sunset: publication of all sterling, euro, Swiss franc and Japanese yen LIBOR settings along with one-week and two-month US dollar LIBOR settings will cease immediately after 31 December 2021; whereas overnight, one-month, three-month, six-month and 12-month US dollar LIBOR settings will cease immediately after 30 June 2023 This split reflects the volume of positions in the respective settings.

Ongoing transition process

Regulators and industry bodies in the key jurisdictions continue to urge market participants to replace existing LIBOR provisions with alternate rates as quickly as possible or ensure contracts include appropriate fallbacks.[1] For example, the FCA's timeline is well advanced in the UK and, notwithstanding the later deadline for cessation of certain LIBOR settings in the United States, US regulators have been taking action to discourage banks in the United States from entering into new LIBOR-based transactions after December 31, 2021 (for further details please see below).

In Europe and the US, the preferred LIBOR replacements are "risk-free rates" ("**RFRs**") based on historical data over a period – SONIA for Sterling, SOFR for the US dollar and SARON for the Swiss Franc. The rates are "risk free" in the sense that they seek to remove the risk of rate manipulation of the type seen in the LIBOR scandal in 2012 and to provide a better reflection of true market rates given the decrease in the interbank-lending that forms the basis of LIBOR since the financial crisis. Regulated institutions have been set milestones in their jurisdictions to complete the process so far as possible in advance of the end of 2021 and failure to engage appropriately in the transition process comes with the risk of regulatory enforcement.

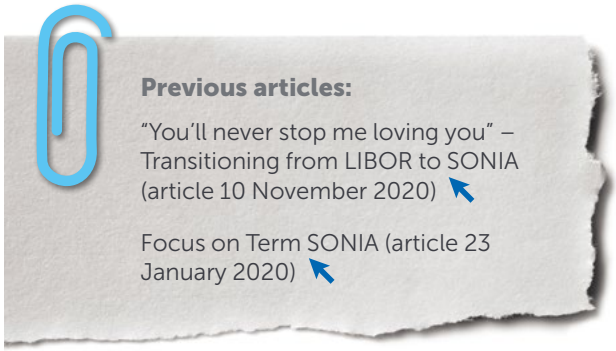
As will have become apparent to many market participants, the amendment process is not always a straightforward one:

- RFR drafting and conventions continue to evolve as more transactions are completed
- if multiple jurisdictions are involved (for example, a loan facility with a large group of borrowers and guarantors incorporated in different jurisdictions), the amendment process could be time intensive (and potentially costly) if all companies are required to sign up to the amendments
- operationally, borrowers may be reluctant to replace the relative certainty of a forward-looking LIBOR rate for their interest payments with a backward-looking RFR
- where lender groups are large/diverse (such as on a syndicated deal), it can be challenging and time consuming reaching a consensus position on the RFR drafting
- bondholders or borrowers may not be contactable/responsive
- trustees in capital market structures may be unwilling to take amendment action unless appropriately indemnified or protected
- while derivatives typically benefit from the ISDA framework that has been developed to facilitate the transition (see our previous article, Lighting the Way Forward), the application of that framework must still be agreed between counterparties

It is therefore recognized that there could be a large volume of legacy contracts that have not been amended to change to an appropriate alternate interest benchmark rate or include a fallback mechanism before the relevant sunset date.

It is important to note that although there can be challenges, progress is being made:

- template documentation and market conventions for transitioning from LIBOR to RFRs have come a long way in the past 12 months
- the change from LIBOR to an RFR, although operationally different, should be economically neutral with the use of credit adjustment spreads to adjust the RFR so that it is equivalent to LIBOR
- following the example of the SONIA First initiative in the UK, the US Commodity Futures Trading Commission (CFTC) (acting through its Market Risk Advisory Committee ("**MRAC**")) adopted the SOFR First initiative, which recommended that interdealer brokers replace their trading of US dollar LIBOR linear swaps with trading of SOFR linear swaps
- a look-forward term SONIA is now available for use in respect of sterling and a look-forward term rate based upon SOFR is now available for use in respect of the US dollar. Although both are expected to have limited use cases, the availability of these rates will help reduce the number of tough legacy contracts in those areas where a forward-looking rate is essential



Further details are provided below on recent regulatory developments in the US to underpin the transition from certain settings of US dollar LIBOR, which will continue beyond the first sunset date on 31 December 2021 until 30 June 2023.

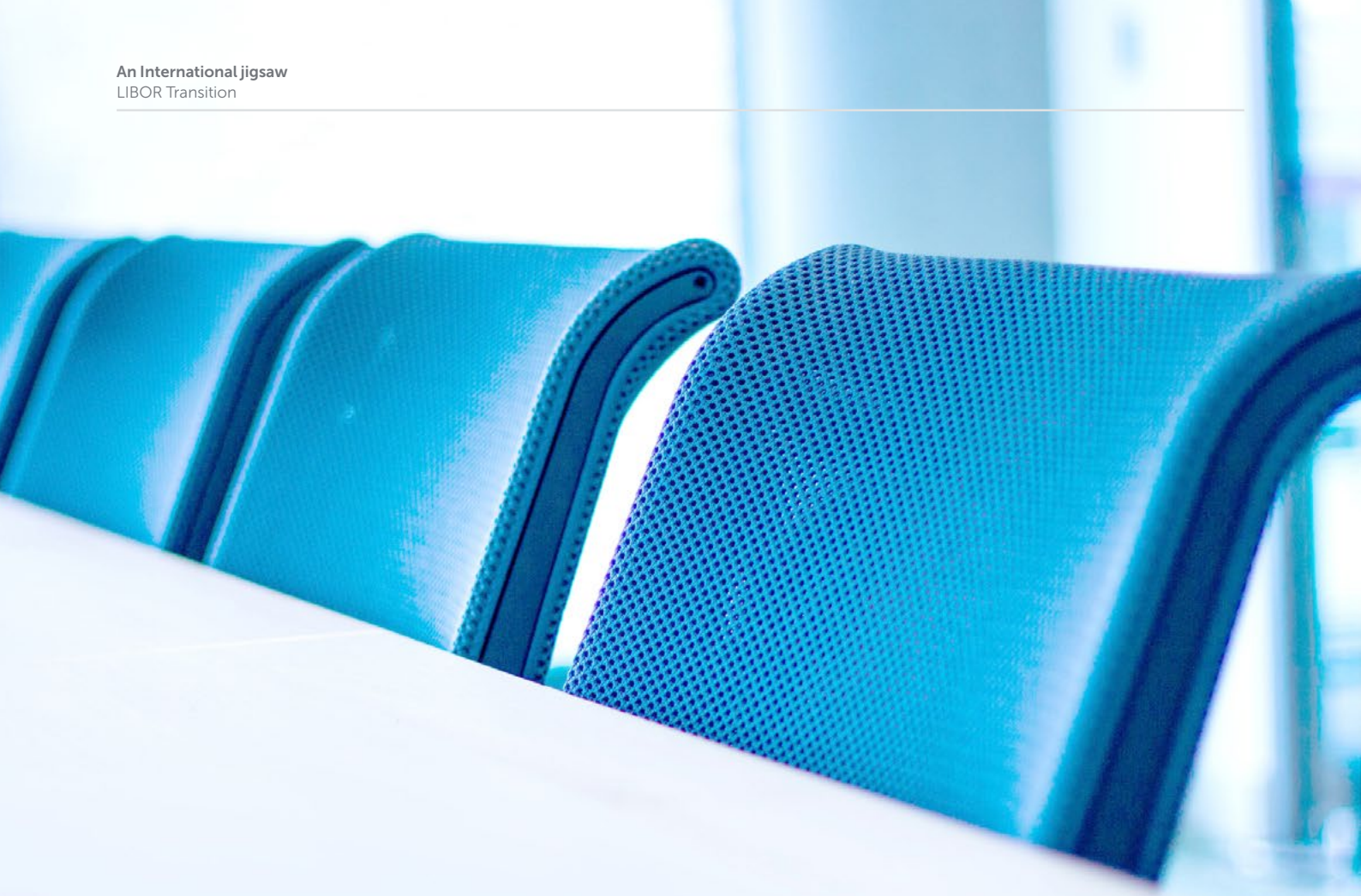
1. A fallback is a contractual mechanism that provides for an alternate reference/benchmark rate to apply at the point of cessation (or, in some instances, at an agreed-upon point prior to cessation) of the relevant LIBOR rate.

US transition: US regulatory developments

In light of the proliferation of alternatives to LIBOR and the slower than expected transition away from LIBOR, regulators, the Alternate Reference Rates Committee (the "**ARRC**") and market participants have more aggressively taken steps to speed up this transition. The ARRC is an industry working group convened by the Federal Reserve Board and the New York Fed to lead the LIBOR transition, which, among other work, has developed industry-specific fallback language that may be used by market participants to address the cessation of US dollar LIBOR. On 30 November 2020, the US prudential regulators issued a statement encouraging banks to stop new US dollar LIBOR issuances by the end of 2021. In addition to the recent public positions taken by members of the Financial Stability Oversight Council (FSOC), including from the US prudential regulators and the Securities and Exchange Commission and the CFTC, the CFTC (through the MRAC), the ARRC and the ICE Benchmark Administration have also made statements and taken action to move the markets to transition away from LIBOR using SOFR.

On 13 July 2021, the MRAC adopted a market best practice known as "**SOFR First**". SOFR First is designed to help market participants decrease reliance on US dollar LIBOR in light of statements from the Financial Stability Board and the International Organization of Securities Commissions on the LIBOR transition which reinforce US prudential regulators' guidance that banks should cease entering new contracts that reference US dollar LIBOR post 31 December 2021. SOFR First recommends a phased approach to be completed by 31 December 2021. The first phase, completed on 26 July 2021, implemented the MRAC recommendation that interdealer brokers would replace their trading of LIBOR linear swaps with trading of SOFR linear swaps.

In light of the successful implementation of this first phase of SOFR First, the ARRC formally announced that a forward-looking term rate based on SOFR published by the CME Group ("**Term SOFR**") is an appropriate fallback to US dollar LIBOR to be used for certain types of transactions. The CME Group is currently publishing one-month, three-month and six-month tenors of Term SOFR. The ARRC recommended a use case for Term SOFR limited to business loans, securitizations of assets referencing Term SOFR and end-user facing derivatives intended to hedge cash products that reference the SOFR Term Rate. The successful implementation of SOFR First and the ARRC's support of Term SOFR are expected to increase the volume of new transactions quoted at SOFR and the adoption of fallback language for legacy contracts, supporting the implementation of the transition away from LIBOR. The ARRC continues to recommend overnight SOFR and SOFR averages for replacement of LIBOR in all use cases, including use cases for which the ARRC has not recommended Term SOFR or for which an appropriate tenor of Term SOFR is not available.



Litigation risk

In the absence of effective legislation mandating a fallback rate, LIBOR-linked contractual mechanisms in such legacy contracts will cease to function effectively from the cessation dates, carrying the risk of disputes and litigation. Parties will find themselves at risk of legal claims regarding the approach to rate setting and/or possible termination under legal concepts such as frustration and force majeure, or their equivalents in the relevant jurisdictions. The commercial motivation to avoid these risks is reinforced by the regulatory risk for financial institutions of failing to take appropriate action.

However, such concerns need to be balanced against the risk of disputes arising from the transition process itself where counterparties are dissatisfied with their replacement rates, which will not necessarily have equal economic effects for contracting parties, leading to possible claims for mis-selling and misrepresentation.

As indicated below, parties also need to be aware that relying on "tough legacy" legislation where transition is not possible (see below) in the various jurisdictions will not necessarily address all existing legacy contracts in those jurisdictions or may not lead to the results desired by the parties. Furthermore, in some jurisdictions, particularly in the US, parties that elect to rely on legislative measures instead of amending legacy contracts run the risk of court challenge to the legislation.

Previous articles:

Libor – the countdown continues (9 March 2020)

Q & A: Will the death of LIBOR be the birth of a new wave of litigation? (18 July 2019)

Legislative and regulatory measures for tough legacy contracts

Consultations about possible legislative and regulatory solutions to mitigate the risks for tough legacy contracts are at different stages of evolution around the world.

It will be important for the success of the LIBOR reform project that these measures close possible gaps and mismatches as they take shape in Q4 of 2021. We have included a (non-exhaustive) update on the global landscape below, which illustrates some of the possible issues based on current proposals in the UK, US and EU.

UK

The Financial Services Act 2021 amended the UK Benchmarks Regulation ("**UK BMR**") – the on-shored iteration of the EU Benchmarks Regulation ("**EU BMR**") following the UK's exit from the EU - to give the FCA powers to facilitate the orderly wind-down of LIBOR. The FCA has been consulting on the use of its powers: (i) to allow use of various LIBOR settings for tough legacy contracts following cessation;[2] (ii) to compel the continued publication of "synthetic" LIBOR settings for sterling and Japanese yen for tough legacy contracts after 31 December 2021;[3] and (iii) to restrict the new use of US dollar LIBOR after the end of 31 December 2021 (consistent with the approach of regulators in the US).[4] In addition, the Critical Benchmarks (References and Administrators' Liability) Bill, which specifically addresses contractual continuity in the contest of synthetic LIBOR, was introduced to parliament in September 2021.

The FCA has confirmed that synthetic rates will be published for one-month, three-month and six-month sterling and Japanese yen LIBOR. As the existing contractual mechanisms contained in legacy contracts are designed for forward-looking LIBOR rates, they will typically not accommodate a (backward-looking) RFR. As such, the new synthetic rates will take the form of forward-looking versions of the RFRs - Term SONIA and TORF (Tokyo Risk Free Rate) published by ICE Benchmark Administration and QUICK Benchmarks Inc. respectively - plus a spread adjustment to replicate, so far as possible, the economic effect of LIBOR (which unlike the RFRs included an assessment of bank credit and liquidity conditions). In line with market sentiment, the FCA has confirmed that the spread adjustment will follow the approach developed by ISDA for derivative contracts in their LIBOR Fallbacks Supplement and Protocol.

In terms of the permitted use by "tough legacy" contracts of the sterling and yen synthetic rates, the FCA issued a consultation on 29 September 2021 (with responses due by 20 October 2021)[5] proposing that synthetic use should be available for all contracts except cleared derivatives (which are expected to have been transitioned successfully by the relevant clearing houses by the end of 2021). If enacted, this is a welcome development and will provide some relief to parties who have not been in a position to amend their contracts.

However, it is to be noted that no synthetic LIBOR will be published for many of the LIBOR settings - the remaining yen and sterling rates, euro, Swiss franc and those US dollar LIBOR settings not continuing into 2022. Where the synthetic rates will be published, the FCA has made clear that ongoing legacy use will be kept under review in 2022 and restrictions may be imposed if market participants fail to make sufficient progress with their transition efforts. Further, the publication of synthetic yen LIBOR settings will cease after 12 months (ie at the end of 2022) and sterling LIBOR will be subject to ongoing review and may only be published for a maximum of ten years. So, the FCA's tough legacy safety net will not cover all scenarios.

Finally, the FCA's proposed rules on legacy use apply to UK "supervised entities" under the on-shored UK BMR, by contrast to the US and EU measures (outlined below), which apply to contracts governed by the laws of the relevant jurisdictions. This divergence in approach leads to a potential mismatch in the measures that apply in cross-border scenarios.

2 Consultation Papers CP21/15 and CP 21/29
3 Consultation Paper CP21/19
4 Consultation Paper CP21/15 and CP 21/29
5 Consultation Paper CP 21/29

US

On 6 April 2021, the New York Governor signed into law the New York State Legislature's Senate Bill 297B/Assembly Bill 164B (the "**New York LIBOR Legislation**"). The New York LIBOR Legislation amends the New York General Obligations Law by adding a new Article 18-c and mirrors a legislative proposal drafted by the ARRC. The New York LIBOR Legislation applies to US dollar LIBOR-based contracts, securities, and instruments governed by New York law that (i) do not have any US dollar LIBOR fallback provisions in place, (ii) have US dollar LIBOR fallback provisions that result in replacement rates that are in some way based on US dollar LIBOR, or (iii) have US dollar LIBOR fallback provisions that allow or require one of the parties or a third party to select a replacement rate for US dollar LIBOR. The New York LIBOR Legislation (a) provides in respect of (i) and (ii) above, upon the occurrence of a "LIBOR Discontinuance Event" and the related "LIBOR Replacement Date" (each as defined in the New York LIBOR Legislation), that the then-current US dollar LIBOR-based benchmark, by operation of law, be replaced by a "Recommended Benchmark Replacement" (as defined in the New York LIBOR Legislation) based on SOFR or, (b) in respect of (iii), encourages the replacement of LIBOR with the "Recommended Benchmark Replacement" by providing a safe harbor from certain legal challenges under New York law. It should be noted that the New York LIBOR Legislation will not pre-empt existing contractual fallbacks that utilize a fallback benchmark other than US dollar LIBOR (such as the prime rate). We have previously published an article on developments in New York on 5 May 2021 (please see **Legislating for LIBOR's cessation**). Other states may follow suit with their own legislation, such as Alabama's LIBOR Discontinuance and Replacement Act of 2021.[6]

At present, there is no specific federal law akin to the New York LIBOR Legislation addressing the US dollar LIBOR transition. However, United States Congress began working on a draft version of federal legislation in October 2020 that would provide a statutory substitute benchmark rate for contracts that use US dollar LIBOR as a benchmark and that do not have any sufficient fallback clauses in place. The current version of the legislation, the Adjustable Interest Rate (LIBOR) Act 2021, was formally introduced in the House of Representatives on 22 July 2021. The bill has been assigned to the House Financial Services, Ways and Means, and Education and Labor Committees. On 29 July 2021, the House Financial Services Committee voted to positively report the bill out of committee and send it to the full House. Consideration of the bill by the full House has not yet taken place. While similar to the New York LIBOR Legislation, including inclusion of a safe harbor for use of recommended LIBOR fallbacks that are based on SOFR, there are differences in the current draft of the federal legislation, including, perhaps most significantly, that the draft bill specifically provides for the pre-emption of state law, which would include the New York LIBOR Legislation. At this time, it is uncertain as to whether, when and in what form such federal legislation would be adopted.

While the state and federal legislative actions are intended to be helpful in addressing legacy contracts, these legislative actions are not currently expected to address all potential issues relating to legacy contracts. It is in light of this situation that US regulators have taken a number of recent actions, such as those described above, to induce parties to adopt new reference rates and to take action to amend legacy contracts.

6 Ala. Code § 5-28-1 et. seq.

European Union

In the EU, the EU BMR has been amended to allow the European Commission to specify a replacement rate (plus a credit spread adjustment) for a benchmark that is discontinued. That replacement rate would be applied to existing contracts referencing that benchmark. This power applies in the following scenarios:

1. **Benchmarks**: (i) critical benchmarks under the EU BMR (following the end of the implementation period for the UK's exit from the EU, LIBOR is no longer a critical benchmark); and (ii) non-critical benchmarks and third country benchmarks if cessation or wind-down would significantly disrupt the functioning of financial markets in the EU or, in the case of third country benchmarks, pose a systemic risk to the financial system in the EU. This could therefore capture LIBOR.

2. **Contracts – Governing Law**: (i) contracts governed by the law of an EU member state; and (ii) contracts subject to the law of a third country where the parties to that contract are all established in the EU and the law of that third country do not provide for the orderly wind-down of a benchmark.

3. **Contracts – Fallbacks**: (i) contracts with no fallback provisions; or (ii) contracts with no suitable fallback provisions - either: (a) the fallback does not provide for a permanent replacement; (b) the application of the fallback requires consent from third parties, which has been denied; or (c) the fallback is to a rate that no longer reflects the underlying market or economic reality that the benchmark is intended to measure and its application could have an adverse impact on financial stability.

There is an ongoing consultation by the EU Commission on the designation of a statutory replacement for Swiss franc LIBOR. There are no current proposals for a replacement of EU LIBOR. We wait to see how further EU measures will interact with the FCA's proposed synthetic LIBOR rates, UK legislation and the US rules. There are cross-border scenarios that are not currently clear and the market will watch for developments in the last quarter of this year.

Conclusion

The LIBOR transition is entering its final phase in the UK and EU, with preparations continuing apace in the US in respect of those US dollar LIBOR settings that will continue to be published until 30 June 2023.

When the music stops for the remainder on 1 January 2022, some LIBOR settings will be covered by the "tough legacy" safety measures that are being put in place in key jurisdictions and others not. Further, as indicated above, there remain questions about the way in which the measures in different jurisdictions will interact. As such, where agreements have not been transitioned, there is a real risk of uncertainty and litigation unless contracts contain workable fallbacks.

In terms of the tough legacy measures, market participants will watch closely as the global legislative jigsaw takes shape in Q4 2021. To quote Joanna Perkins, the Chief Executive of the Financial Markets Law Committee, "The challenge for regulators will be one of careful coordination".[7]

7 Letter-on-FS-Bill.pdf (fmlc.org)

How can Eversheds Sutherland assist?

Eversheds Sutherland's offices around the world have the experience and a range of tools which can help quickly identify and then manage the LIBOR transition risks. Please get in touch if you would like to discuss any of the issues raised in this article.

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