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In The Know

Leveraged Finance Newsletter

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LIBOR is dead. Long live *synthetic* LIBOR!

Synthetic LIBOR offers a temporary reprieve for unremediated legacy contracts but not without risk

On Friday, 30 June 2023, the last ever rates based on the London Interbank Offered Rates (LIBORs) will be published. This momentous day will be the culmination of a long journey for the financial markets, as market participants move into the future with alternative risk-free rates. However, work remains, in some jurisdictions more than others, to address legacy transactions and to understand what rate a USD LIBOR contract may switch to following this date.

Further efforts will also be needed to transition away from interbank offered rates (IBORs) in some non-LIBOR currencies and to comply with the latest regulatory guidance on the use of robust contractual fallbacks to avoid the need for a rerun of the LIBOR transition process.

In this edition, we examine the current state of play and what actions financial institutions, asset managers, insurers and corporates should take.

Key takeaways

- As of 1 July 2023, LIBORs, as a measure of the interest rates on which key banks are willing to lend money in the short-term interbank market, will no longer be published.
- Synthetic versions of one-, three- and six-month USD LIBORs will be available until 30 September 2024. These will be published by ICE Benchmark Administration Limited in the same place and at the same times as the original USD LIBORs but will be constituted from different data, i.e., CME Group's Term SOFR rates together with fixed credit spread adjustments.
- A number of mechanisms can provide a temporary reprieve or technical solution for unremediated contracts; namely synthetic USD LIBOR, the US Adjustable Interest Rate (LIBOR) Act ("**US LIBOR Act**") and the ISDA IBOR Fallbacks Protocol. Nonetheless, all market participants with unremediated legacy contracts should do the following:
  - Assess what interest rates will apply to those contracts after 30 June 2023 (e.g., a contractual fallback rate, a statutorily imposed replacement rate or synthetic LIBOR)
  - Actively continue to progress amendments to the interest rate terms of legacy contracts wherever possible
- For USD loans, Term SOFR (as opposed to Compounded in Arrears SOFR or Daily Simple SOFR) is proving the most popular replacement rate. Some regulators, and the Financial Stability Board, are apprehensive about the widespread use of Term SOFR and would prefer more transactions to be overnight SOFR-based wherever achievable. We expect them to continue to monitor the adoption of Term SOFR and, if necessary, issue further guidance on its use.
- There are no current plans for EURIBOR to cease, but European regulators have recently reiterated their guidance for parties to ensure that their EURIBOR-based contracts include robust fallbacks should EURIBOR become unavailable. Parties should consider including a rate switch mechanism in new euro loan contracts to effect an automatic conversion from EURIBOR to €STR (the euro risk-free rate) upon the cessation of EURIBOR or EURIBOR ceasing to be representative of lending costs.
- With forward-looking term rates based on €STR now available for use in transactions, these rates, which are operationally (if not economically) similar to EURIBOR, may encourage transition in euro-denominated products.
- Work on IBOR transition will continue for some time as other currencies progress toward the use of risk-free rates.

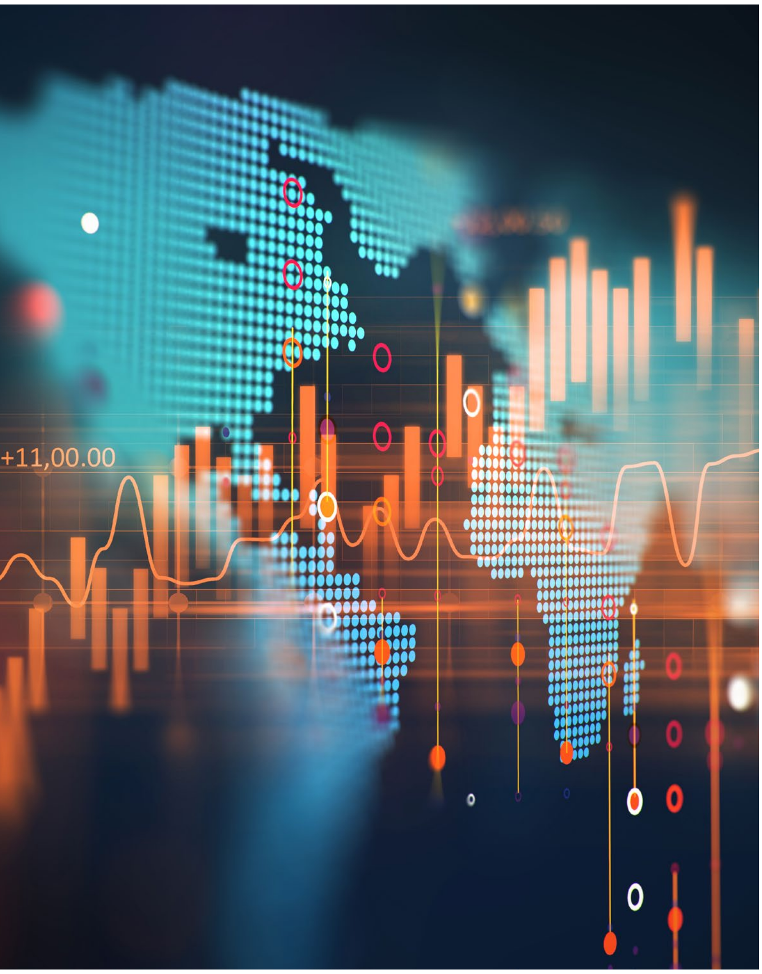
US dollars — transition progress

The day some never believed would come has finally arrived. Friday, 30 June 2023 marks the last publication date for any LIBOR — at least in its current form.

Over the last few years, the finance world has been weaning itself off the use of LIBORs as an interest rate basis for financial products. As we have previously written about (see "Welcome to the World of Risk-Free Rates" and "Ready or not, here it comes — LIBOR transitions' endgame in the loan markets"), this seismic change has progressed at sometimes varying paces with pauses and punctuation marks along the way.

Perhaps the most significant moment came on 5 March 2021 when the UK's Financial Conduct Authority (FCA) set out the final timetable for LIBOR's demise (FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks). At that time, it was recognized that, of the five LIBOR currencies, US dollar LIBORs were the most widely used and systemically important of those rates and more time should be given for an orderly transition for US dollar LIBORs than for the other LIBOR currencies (pound sterling, Swiss franc, Japanese yen and euro).

While 31 December 2021 marked the end of all non-US dollar LIBORs (although in the case of certain pound sterling and Japanese yen tenors, synthetic versions remained available for a longer period), the one-, three- and six-month tenors of USD LIBOR were allowed to continue until 30 June 2023. This has contributed to the slower pace of LIBOR transition for US dollar-denominated contracts than that of other LIBOR currencies. However, a combination of regulatory initiatives, legislation, industry working group efforts, education, the forming of market consensus, increasing liquidity in SOFR trading and hard work from market participants have ensured that great strides have been made in the last 12 months.



The areas of greatest concern revolve around legacy contracts that continue to reference USD LIBOR.

- In the US, the most recent readout from the Alternative Reference Rates Committee's (ARRC) 25 May 2023 meeting noted that "respondents [in the most recent sentiment survey of ARRC members] continued to characterize the LIBOR transition overall as progressing smoothly or generally smoothly in 2023." However, it is anticipated that a significant stock of USD LIBOR exposures will remain outstanding which do not benefit from suitable fallback provisions.
- In Japan, the results of a survey on the use of LIBOR undertaken by the Financial Services Agency and Bank of Japan at the end of December 2022 (and published on 24 March 2023) found that "almost 60 percent of financial institutions either have no existing contract or have completed an active transition [of contract referencing USD LIBOR]" and that "financial institutions with legacy contracts responded that they did not have major obstacles to transition arrangements at this point."
- In the EU, the minutes of a meeting of the Working Group on Euro Risk-Free Rates held on 3 April 2023 covered the results of a USD LIBOR survey of the members of the working group and noted "a material decline of the total number of tough legacy contracts and of the total exposures corresponding to such tough legacy contracts, both for derivatives and cash products," but that "[s]imilar to the previous survey [in July 2022], bilateral and syndicated loans are the asset class with the largest tough legacy exposure, followed by derivatives and bonds."
- The situation is less advanced in some other jurisdictions. The Financial Stability Board's (FSB) Progress Report on LIBOR and Other Benchmark Transition Issues (published on 16 December 2022) noted strong progress in many jurisdictions and that the vast majority

of post-30 June 2023 USD LIBOR exposures would be in derivatives. However, the 24 non-FSB members surveyed (including Bahrain, Chile, Ghana and Malaysia) estimated that around USD 0.483 trillion of US dollar assets, USD 0.033 trillion of liabilities and USD 0.971 trillion of derivatives exposures would remain after 30 June 2023 and highlighted issues such as "most contracts are pending renegotiation," "uncertainty about the remaining proportion of exposures" and the identification of "several issues around system readiness." Further progress will have been made since that report but, nonetheless, more work remains.

LIBOR transition has, to some degree, been slowed by the general macroeconomic conditions. In particular, inflationary pressures that have led some central banks to increase interest rates over the last 12 months or so, have reduced some natural opportunities for amending legacy contracts as corporates may have been reluctant to refinance into higher rates. Bank credit tightening may also have had an effect on amending legacy terms. These factors have also complicated the debate around appropriate credit spread adjustments, which are intended to ensure there is no (or minimal) transfer of economic value as a result of the transition; the ISDA fixed credit spread adjustments were set by reference to the mean difference between each tenor of USD LIBOR and SOFR (compounded over the same period as the relevant tenor) over the five years preceding 5 March 2021. In the two-plus years since that calculation date, the spot spread has varied and informed debtor/creditor negotiations. An increase in distressed credits also complicates transition discussions.

US dollars — after 30 June 2023

For contracts that remain unremediated, what happens after 30 June 2023? It depends on the type of contract, any relevant contractual fallbacks and such contract's governing law. Described below are the possibilities.

- **Contractual fallback language**: Some contracts have fallback language that will implement a switch to a new benchmark interest rate. For example, English-law loan agreements may include a rate switch mechanism that automatically flips the interest rate basis from USD LIBOR to CME Term SOFR or Compounded in Arrears SOFR. Parties to a non-cleared derivative contract (e.g., an ISDA Master Agreement) may have adhered to the ISDA IBOR Fallbacks Protocol that automatically effects a change from USD LIBOR to SOFR plus a fixed credit spread adjustment after 30 June 2023. However, some contracts have no contractual fallback. For these contracts, if the loan agreement is governed by the law of a US state, the US LIBOR Act may apply, as described below.
- **Synthetic USD LIBOR**: Synthetic USD LIBOR is another possibility. The FCA confirmed that it will exercise its powers to compel ICE Benchmark Administration Limited to publish one-, three- and six-month tenors of "synthetic" USD LIBOR until 30 September 2024. The methodology for these synthetic rates will use the relevant CME Term SOFR rate plus the respective ISDA fixed credit spread adjustment.

  The UK Critical Benchmarks (References and Administrators' Liability) Act 2021 clarifies that a reference in a contract or other arrangement to LIBOR should, for all purposes, be treated as a reference to the relevant synthetic LIBOR. This aims to ensure contractual continuity, although its efficacy for non-UK law contracts will be a matter for the relevant jurisdiction in question.

  Although representations were made to the FCA to retain flexibility to further extend the end date for synthetic USD LIBOR, it declined to do so. However, it did leave some "wiggle room" and have guided that:

  > ... our current assessment that end-September 2024 provides sufficient time for cessation to be orderly is based on the

> information available to us … We consider the evidence base for our assessment to be robust. Therefore, unless unforeseen and material events were to occur which significantly change the information and circumstances on which our assessment was based, we expect … to follow the timeline we have indicated.

- **Designated replacement rates**: For agreements governed by the law of New York or another US state, the US LIBOR Act may apply. The US LIBOR Act empowered the board of governors of the Federal Reserve System to select a replacement rate for any US-law governed contract that uses USD LIBOR as a benchmark, if such contract: (i) contains only fallback provisions based on USD LIBOR (e.g., a historic LIBOR) or on a poll of quoted rates; (ii) does not contain any fallback provisions; or (iii) contains fallback provisions that do not specify a specific replacement rate or a determining person. The statutory replacement rates selected for corporate loans are the relevant tenor of CME Term SOFR, which corresponds to the applicable USD LIBOR tenor plus the applicable ISDA fixed credit spread adjustment. It was intentional that the US and UK solutions for legacy contracts produce the same result.

Market participants should note that USD LIBOR loans that will bear interest by reference to synthetic USD LIBOR or the US LIBOR Act designated replacement rates may result in an imperfect hedge after 30 June 2023. The standard fallback rates for USD LIBOR hedging contracts, as set out in the ISDA IBOR Fallbacks Protocol and the rules of central counterparty clearing houses, are based on Compounded in Arrears SOFR plus the applicable ISDA fixed credit spread adjustment. As noted above, loans that will bear interest by reference to synthetic USD LIBOR or the US LIBOR Act designated replacement rates will bear interest at CME Term SOFR plus the applicable ISDA fixed credit spread adjustment. Thus, for hedged loans, active transition in order to ensure that the relevant hedging and loan benchmarks are in alignment is preferable.

As legacy contracts naturally come to the end of their terms, the stock of legacy USD LIBOR exposures will continue to reduce. However, the push for active transition should continue so parties can ensure that a sustainable and clear replacement rate is in place.

In the US, the ARRC limitations on Term SOFR hedging continue to be strict. As a general matter, counterparties may only enter into a Term SOFR swap in order to hedge an existing position in a Term SOFR cash product or to use Term SOFR in connection with a fallback from a legacy USD LIBOR exposure.

Vice chair Michael S. Barr of the US Financial Stability Oversight Council stated:

> A world in which Term SOFR is used across all or most cash products is not a plausible one. Such a world would not be consistent with sustaining a robust market for

> overnight SOFR derivatives, the foundation for Term SOFR rates. Therefore, the use of Term SOFR must remain limited in line with the recommendations of the FSOC and Financial Stability Board.

Many parties have chosen to transition their loans to a Term SOFR basis. It is clear that regulators wish to keep Term SOFR use to a minimum to avoid the risk that overnight SOFR may become less robust as a result of increased Term SOFR trading.

The ARRC limitations had led to less liquidity in the Term SOFR hedging market, and increased expense compared to hedging overnight SOFR.

Euros

Whilst there are no current plans for EURIBOR to cease publication or be declared unrepresentative of the market it measures, market participants should note a number of recent developments. EURIBOR is a daily reference rate based on the average rate at which Eurozone banks lend to each other on an unsecured basis in the interbank market, based on quotes from a panel of banks. As such, EURIBOR is not a risk-free rate and potentially has the same issues as LIBOR.

First, two administrators — Refinitv and the European Money Markets Institute (EMMI) — are now publishing forward-looking term rates that are based on €STR (the euro short-term rate) in various tenors. EMMI's offering has been publishing live rates since 14 November 2022 and can be used in transactions, while Refinitiv's version is currently only available on a beta basis. It is hoped that the availability of these rates will encourage wider usage of €STR in the loan markets.

Second, the Working Group on Euro Risk-Free Rates ("**Euro RFR WG**") has recently updated its terms of reference. Part of the updated remit of the Euro RFR WG is to "foster the use of €STR in a diverse range of financial products."

To date, the use of €STR, whether in its pure overnight form or as a forward-looking term rate, appears to be very limited and the majority of euro loans that we see do not provide "hardwired" provisions dealing with any possible cessation or non-representativeness of EURIBOR. The Euro RFR WG originally issued recommendations in May 2021 detailing suitable potential fallbacks to be included in documentation to cater for this. However, the response from market participants to date has been underwhelming. In an attempt to drive change, the Euro RFR WG recently issued further guidance to reiterate these fallbacks and noted that "[c]ost of funds and replacement of screen rate language are not workable permanent fallbacks and do not provide scalable options in the case of a possible permanent discontinuation of EURIBOR" and that:

> … whilst EURIBOR is not scheduled to be discontinued, this does not negate the need for market participants to include robust fallback language in their contracts. Robust fallbacks are a requirement of the EU Benchmarks Regulation (BMR) …

The experience of LIBOR transition has shown that the combination of clear cessation dates and robust regulatory/supervisory "guidance" has been the catalyst for accelerating change. If European regulators start to police compliance with the Euro RFR WG recommendations more strictly, many more euro loans should start to include "rate-switch" mechanisms that provide for an automatic switch from EURIBOR to Compounded in Arrears €STR or a forward-looking term €STR (EMMI's Efterm ® or Refinitiv's Refinitiv Term €STR).

A clear cessation date for EURIBOR would kick-start adoption of €STR for new loans. In the meantime, a number of push and pull factors may, nonetheless, encourage loan market participants to move away from EURIBOR. The ingredients that have contributed to making a success of LIBOR transition (e.g., IT systems updates, recommended market conventions, template documentation and the availability of forward-looking term rates) can be equally applied to any EURIBOR transition. There are few barriers, other than the parties' desires, to switching to €STR-based lending. On the other hand, we see continued efforts to improve the robustness of EURIBOR, including reforms to reduce reliance on expert determination, which signal its continued relevance for loan markets.

Other currencies

Many other countries remain committed to reform regarding replacement of the relevant IBOR for their currencies.

In South Africa, the Johannesburg Interbank Average Rate (JIBAR) is due to be retired, with the South African Rand Overnight Index Average (ZARONIA) identified as a successor near risk-free rate. ZARONIA has been published since 2 November 2022 and its performance is currently being observed by market participants. This observation period is due to end on 30 October 2023, with the expectation that trading in ZARONIA-based derivative products can commence soon afterward. While the exact timing is, as yet, unclear, the South African Reserve Bank has stated that it would prefer a relatively short JIBAR transition period.

In Canada, a two-stage transition plan is underway to move from the Canadian Dollar Offered Rate (CDOR) to the Canadian Overnight Repo Rate Average. After 30 June 2023, the Bank of Canada's guidance is that no new CDOR derivatives or securities will be permitted. After 28 June 2024, publication of all remaining CDORs will cease.

In Poland, the Warsaw Interbank Offered Rate is due to be replaced by the Warsaw Interbank Bid Rate by the end of 2024.

We are closely following these transitions and will publish client alerts on InsightPlus as developments occur.

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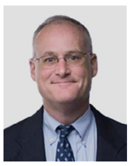

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