Synthetic USD LIBOR

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As market participants prepare to submit comments on the recent proposal of the UK's Financial Conduct Authority (the "FCA") (available here) to require the temporary publication of a "synthetic" 1-, 3- and 6-month USD LIBOR, some have voiced concern that such a compelled publication of a synthetic USD LIBOR could precipitate a wave of litigation over whether certain U.S. law-governed contracts will be able to fall back to contractually agreed alternative rates in June 2023.

Although the Federal Reserve Board's recent regulations implementing the LIBOR Act (available here) (the "FRB regulations") aim to address these concerns, they acknowledge that many LIBOR legacy contracts (*i.e.*, those that identify a specific benchmark replacement) fall outside the scope of the Act and its regulatory authority.

Background

On November 23, 2022, the FCA announced a proposal to require ICE Benchmark Administration ("IBA"), the administrator for LIBOR[1], to continue to publish the 1-, 3- and 6-month settings of US dollar LIBOR[2] under a non-representative, "synthetic" methodology until end-September 2024.

The FCA proposal on US dollar LIBOR follows prior mandates to IBA to continue to publish, on a synthetic basis:

- 1-, 3- and 6- month yen LIBOR to the end of 2022;
- 1- and 6- month sterling LIBOR until the end of March 2023; and
- 3-month sterling LIBOR until the end of March 2024.

FCA's recent proposal aims to smooth the market transition away from LIBOR and seeks feedback on whether to:

- require publication of USD LIBOR for 1-, 3- and 6-month settings beyond the end-June 2023 deadline until the end of September 2024, using a synthetic methodology based on the sum of the CME's Term SOFR Reference Rate plus the relevant ISDA spread adjustment; and

- permit use of these synthetic USD LIBOR settings in all legacy contracts except for cleared derivatives (consistent with prior synthetic LIBOR rates).[3]

Compelled publication of synthetic USD LIBOR would be intended for use only in legacy (not newly entered) contracts and would be accompanied by an FCA announcement that the synthetic rates are not "representative" of the markets that the original LIBOR setting were intended to measure. The FCA also stressed that synthetic USD LIBOR settings would be "only a bridge to appropriate alternative risk-free rates, not a permanent solution", and thus market participants should prioritize active transition and focus on converting their legacy contracts to risk-free rates as soon as possible.

Potential Impact on Certain U.S. Law Contracts

In its November proposal, the FCA cited a substantial number of non-U.S. cash market contracts that would benefit from a 15-month extension. The 15-month extension is intended to address this set of international "tough legacy" contracts not covered by the existing US legislative fix in the LIBOR Act, while balancing the interests of market participants whose contractual fallbacks will be delayed by publication of a synthetic USD LIBOR.

However, some are warning of collateral consequences for US law governed contracts that either identify a specific benchmark replacement or determining person or opt out of the LIBOR Act, and thus are not covered by the US legislative fallback to the SOFR replacement rate. Specifically, for any such contracts containing fallbacks that are not expressly triggered unless USD LIBOR becomes "unavailable", the continued publication of a synthetic USD LIBOR that, although non-representative, arguably remains "available" may raise questions as to whether the LIBOR Act's safe harbor for such excluded contracts applies.

In the adopting release accompanying the FRB regulations, the FRB seeks to resolve this ambiguity with respect to a subset of contracts that (a) authorize a party or person to select a benchmark replacement when USD LIBOR becomes unavailable (without identifying a specific benchmark) and (b) do not expressly authorize such selection when USD LIBOR ceases to be representative. Specifically, the FRB regulations clarify that, notwithstanding the lack of an express non-representativeness trigger, such contracts will fall back to the SOFR replacement rate if the determining person does not select another benchmark replacement by the LIBOR replacement date (i.e., June 30, 2023).

The FRB declined, however, to extend this interpretation to contracts that identify a specific benchmark replacement (but lack a non-representativeness trigger), as the FRB has concluded such contracts are outside the scope of the LIBOR Act.

Although publication of synthetic USD LIBOR should not affect loan agreements with fallbacks based on LSTA-recommended language (as such fallbacks apply if USD LIBOR becomes non-representative), it may raise issues for a set of legacy contracts that specify a benchmark replacement but lack such a non-representativeness trigger.

Comments on the FCA proposal are due by January 6, 2023 and a final announcement is expected by the end of the first quarter or early in the second quarter of 2023.

FOOTNOTES

[1] The FCA is the regulatory supervisor for IBA.

[2] The announcement has no effect on the publication of other remaining USD LIBOR settings (i.e., overnight and 12-month), which will cease permanently after June 30, 2023.

[3] The expectation is that, for derivatives used to hedge cash products (e.g., bonds), synthetic USD LIBOR would be permitted for such hedges if it is permitted in such cash products.

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