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Transforming Interest Rate Benchmarks

(L)IBOR transition: headlines and deadlines

The LIBOR transition process is in its final stages:

- The final five USD LIBOR settings will cease on 30 June 2023.
- Synthetic 3-month GBP LIBOR (the last remaining synthetic GBP LIBOR rate) will cease on 31 March 2024.
- Synthetic USD LIBOR rates for 1, 3 and 6-month tenors will be published until 30 September 2024.
- Regulators are emphasising that the focus should remain on active transition; synthetic LIBOR rates are a temporary bridging tool for “tough” legacy contracts only.
- To be certain a synthetic LIBOR rate applies to a particular contract, legal analysis is likely to be required.
- In the case of tough legacy contracts not governed by English law, local legal analysis is likely to be required; for example, LIBOR-referencing contracts governed by New York/US law may be subject to the provisions of the US Adjustable Interest Rate (LIBOR) Act.
- Synthetic LIBOR rates cannot be used for cleared derivatives.

Developments in relation to other domestic IBOR rates are gathering momentum - in particular:

- A cessation date has now been announced for CDOR (28 June 2024).
- Interest in €STR is increasing; in light of new guidance from the Working Group on Euro Risk-Free Rates, there is renewed focus on €STR-based fallbacks for EURIBOR in loans and bonds.

This briefing contains a reminder of some key headlines and deadlines, covering the approach to LIBOR transition in English law loans, bonds and derivatives, and some of the more recent communications from regulators.

USD LIBOR transition

For those with continuing USD LIBOR exposures, the clock is ticking. The FCA's announcement that 1, 3 and 6-month synthetic rates will be available for a short period is welcome given the sheer volume of outstanding USD LIBOR exposures. The FCA and other regulators have, however, made clear that market participants should remain focussed on actively transitioning legacy USD LIBOR-referencing products before end-June 2023 where feasible.

Loans – SOFR rate options

Those transitioning loans from USD LIBOR in the London market in most cases must make a choice between Term SOFR and SOFR compounded in arrears[1]. The LMA has produced drafting for both rate options. Both are valid choices. The decision is influenced by a range of factors. These include which rate is operationally easiest or feasible, (in some cases) whether lenders are licenced to use Term SOFR and (in hedged deals) whether hedging is available on terms that are commercially acceptable.

The Alternative Reference Rate Committee's recent update to its Term SOFR Scope of Use Best Practice Recommendations, to permit dealers to enter into Term SOFR-SOFR basis swaps with non-dealer market participants, is aimed at easing the build-up of one-way Term SOFR risk at dealers and thus supporting the availability of Term SOFR hedges. Term SOFR hedging appears to be more expensive given that compounded in arrears SOFR is the standard in the derivatives market. This is expected to continue and will be an important factor in the choice of SOFR rate for treasurers looking to hedge SOFR loans.

The availability of LMA drafting for multi-currency facilities incorporating Term SOFR has made documenting a Term SOFR loan alongside compounded in arrears rates for other ex-LIBOR currencies much simpler. The LMA's facilities referencing Term SOFR (available to members from the LMA website) were updated from exposure drafts to LMA recommended forms on 25 May 2023.

The most appropriate long-term fallbacks for Term SOFR remain a topic for discussion. Options include compounded in arrears SOFR, or (if Term SOFR has been used to avoid using compounded in arrears rates) a central bank rate

[1] There was no similar debate in the context of GBP LIBOR because, although a term rate is available for SONIA, the UK regulators have consistently ruled out its use in corporate loans.

(which has a parallel in the customary fallbacks for compounded in arrears risk-free rates). Both of these options are included in the LMA's Term SOFR drafting.

For further information on LIBOR transition in the loan market and the LMA's drafting, treasurers are referred to the ACT's most recent Borrower's Guide to the LMA's Investment Grade Agreements.

Bonds – USD LIBOR transition work continues

The replacement rate for USD LIBOR in the bond market is compounded in arrears SOFR. Term SOFR is not generally being used as a reference rate for new issuance.

Although the transition away from USD LIBOR on legacy bonds is steadily progressing, the size of the legacy USD LIBOR bond market remains considerable. Active transition in the bond markets involves a bond-by-bond consent solicitation process, which can be a time-consuming and costly exercise for issuers. USD LIBOR bonds, in particular, have a more geographically diverse investor base, which can make active transition even more challenging.

The FCA's decision to permit the use of synthetic USD LIBOR for legacy USD LIBOR bonds is helpful for the bond markets as it will provide an additional window for legacy bonds to be actively transitioned or to allow such bonds to mature. Whether synthetic LIBOR applies to bonds not governed by English law (for example New York law bonds) will involve an analysis of any applicable local regime for tough legacy contracts.

Even with the extended window to September 2024, issuers with outstanding USD LIBOR bonds are encouraged to start putting in place their transition plans without delay. Legacy LIBOR bond terms may not envisage permanent LIBOR cessation and may therefore, without any further action, ultimately fall back to a fixed rate, which is not likely to have been the intention of the parties.

Derivatives – fallbacks and basis risk

The main options for transitioning legacy USD LIBOR derivatives remain unchanged - (i) adhere to the ISDA 2020 IBOR Fallbacks Protocol (the **Protocol**), which enables adhering parties to incorporate robust fallback provisions into their contracts so that, provided both parties have adhered, a market agreed fallback rate will apply automatically after the 30 June USD LIBOR end-date, or (ii) bilaterally agree a fallback rate, either by incorporating the terms of the Protocol or agreeing alternative fallbacks.

The most appropriate and viable option will depend in part on the number of agreements which need to be transitioned, and in part on the replacement rate being used in any underlying cash product.

Treasurers will want to ensure that the fallback rates in the derivative match as closely as possible with the replacement rate in the cash product to avoid any basis risk. Even where both products are transitioning to compounded in arrears SOFR, there is some potential for a mismatch given the different calculation methodologies and conventions used in the different markets.

Given the limited time available to transition away from USD LIBOR, if the degree of basis risk is unacceptable, the parties may choose to adopt the fallback terms of the Protocol and then later bilaterally negotiate changes to their contracts to achieve greater consistency between the replacement rates and thus reduce basis risk.

The issue of mismatch and basis risk will also be relevant to securitisations where, in addition to operational and procedural considerations, there will be a focus on minimising mismatches between any floating rate notes, interest rate swaps, and the rates applicable to the underlying securitised assets.

Other news - CDOR and EURIBOR

A number of jurisdictions around the world are transitioning domestic IBORs to risk-free rates, following the path trodden by the LIBOR currency jurisdictions. Users should keep developments in relation to all domestic currency benchmarks under review.

Considerable progress has been made in Canada. CDOR, the Canadian Dollar Offered Rate, will cease in June 2024 and is being replaced by CORRA, the Canadian Overnight Repo Rate Average. CORRA compounded in arrears is starting to be used; in February 2023, the LMA published a compounded CORRA schedule to provide loan market participants with a suggested form of drafting for use of compounded in arrears CORRA, which largely follows the form of the other currency schedules already contained in the LMA's compounded rate recommended form facilities agreements. A Term CORRA rate is also being developed; the use cases include loans and trade finance.

Although there are still no plans to discontinue EURIBOR, the Working Group on Euro Risk-Free Rates remains focussed on the need to implement robust fallback provisions in EURIBOR-referencing products to address any future discontinuation. To this end, it has recently published further guidance on fallbacks for corporate lending products, in which, given a lack of adoption to date in the loan market, it reiterates its May 2021 recommendations on EURIBOR fallback rates and triggers, and provides additional clarity on applicable conventions.

In light of this additional guidance aimed specifically at the loan market, borrowers can expect EURIBOR fallbacks to feature in future discussions on new and refinanced EURIBOR-referencing loans. The LMA's facility templates include drafting for compounded in arrears €STR which can be used in fallback provisions; Term €STR provisions are anticipated shortly.

Slaughter and May are continuing to closely monitor developments in relation to transition from LIBOR, EURIBOR and other major benchmarks across all of the major financial products. For further information, please contact your usual adviser at Slaughter and May or any of the lawyers listed below

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