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UK FCA ANNOUNCEMENT ON CESSATION AND LOSS OF REPRESENTATIVENESS OF LIBOR BENCHMARKS: WHAT NEXT FOR DERIVATIVES?

On 5 March 2021 the UK Financial Conduct Authority (the "**FCA**") published an announcement on the future cessation and loss of representativeness of LIBOR benchmarks (the "**FCA LIBOR Announcement**"). This announcement constitutes an "Index Cessation Event" for the purposes of the ISDA IBOR Fallbacks Supplement and the ISDA 2020 IBOR Fallbacks Protocol. The publication of this announcement also triggers the fixing of the spread adjustment for each LIBOR setting under the terms of the Bloomberg IBOR Fallbacks Rate Adjustment Rulebook. The market now has a clear timetable for the cessation of LIBOR benchmarks and, for derivatives transactions that include an index cessation event trigger, confirmation of the dates from which the adjusted risk-free rate fallbacks for transactions referencing these LIBOR rates will apply as well as the quantum of the spread adjustment to be applied to these adjusted fallback rates.

Key issues

- FCA has announced the timing for the cessation or loss of representativeness of LIBOR
- FCA LIBOR Announcement covers all 35 settings for sterling, euro, Swiss franc, Japanese yen and US dollar LIBOR
- FCA LIBOR Announcement is an "Index Cessation Event" for the purposes of the ISDA IBOR Fallbacks Supplement and the ISDA 2020 IBOR Fallbacks Protocol
- The spread adjustment for each of the 35 LIBOR settings is now fixed at the date of the FCA LIBOR Announcement
- For derivatives transactions that incorporate the terms of the ISDA IBOR Fallbacks Supplement the fallback rates will apply following the date on which the relevant LIBOR setting permanently ceases or becomes non-representative
- For outstanding derivatives which continue to reference euro, sterling, Swiss franc and Japanese yen LIBOR this will be after 31 December 2021 for all settings
- For US dollar LIBOR settings this will be after 30 June 2023
- SOR and THBFX will also be impacted by the FCA LIBOR Announcement
- For certain LIBOR settings, there is the potential for publication of a non-representative synthetic LIBOR rate

THE FCA LIBOR ANNOUNCEMENT

The FCA LIBOR Announcement confirmed that publication of:

(i) all seven euro LIBOR settings, all seven Swiss franc LIBOR settings, overnight, one-week, 2-month and 12-month sterling LIBOR, spot next, one-week, 2-month and 12-month Japanese yen LIBOR and one-week and 2-month US dollar LIBOR will permanently cease immediately after 31 December 2021; and

(ii) the overnight and 12-month US dollar LIBOR settings will permanently cease immediately after 30 June 2023.

For the remaining LIBOR rates and settings, the FCA announced that:

(i) the 1-month, 3-month and 6-month Japanese yen LIBOR settings and the 1-month, 3-month and 6-month sterling LIBOR settings will cease to be provided or, subject to consultation by the FCA, will be provided but will be determined by reference to an alternative methodology immediately after 31 December 2021; and

(ii) the 1-month, 3-month and 6-month US dollar LIBOR settings will cease to be provided or, subject to consultation by the FCA, will be provided but will be determined on an alternative basis immediately after June 30, 2023.

The FCA confirmed that if such settings are determined by reference to an alternative methodology, they will no longer be representative of the underlying market and economic reality they are intended to measure and that representativeness will not be restored.

US dollar LIBOR is a component in the calculation of the Singapore Overnight Rate ("**SOR**") and the Thai Baht Interest Rate Fixing ("**THBFIX**"). The calculation of SOR and THBFIX, and therefore the calculation of any amounts or rate options under derivatives transactions which reference these rates, will also be impacted by the FCA LIBOR Announcement.

US FINANCIAL REGULATORS' GUIDANCE REGARDING USE OF US DOLLAR LIBOR

Notwithstanding the extended availability of US dollar LIBOR, market participants should be mindful of regulatory, litigation and reputational risks related to using US dollar LIBOR for new contracts. In a joint statement, available here, US financial regulators caution that new contracts that use US dollar LIBOR as a reference rate after 31 December 2021 would create safety and soundness risks. They encourage banks to cease entering into new contracts that use US dollar LIBOR as a reference rate as soon as practicable and in any event by 31 December 2021. The Alternative Reference Rates Committee developed its recommended timelines for stopping new use of US dollar LIBOR, available here, on the basis of what was considered to be practicable with all recommended timelines ahead of end-2021, in line with the guidance provided by US financial regulators. To the extent that a new contract refers to any tenor of LIBOR, parties will want to consider including robust fallback language that provides a clearly defined alternative reference rate that will apply after discontinuation of the relevant tenor of LIBOR.

THE ISDA 2020 IBOR FALLBACKS PROTOCOL AND IBOR FALLBACKS SUPPLEMENT

Under the ISDA 2020 IBOR Fallbacks Protocol (the "**IBOR Fallbacks Protocol**") and Supplement Number 70 to the 2006 ISDA Definitions, (the "**IBOR Fallbacks Supplement**") the FCA LIBOR Announcement constitutes an index cessation event for all 35 LIBOR settings on the basis that all LIBOR settings will either permanently cease to be published or become non-representative from the dates specified in the FCA LIBOR Announcement.

In terms of the related index cessation effective date, which is when the adjusted risk-free rate (RFR) fallbacks (the "**Adjusted RFR Fallback**") will apply, for outstanding derivatives which continue to reference euro, sterling, Swiss franc and Japanese yen LIBOR for all settings this will be 1 January 2022.

With respect to US dollar LIBOR, one-week and 2-month US dollar LIBOR, these settings will not be published after 31 December 2021, but the Adjusted RFR Fallback will not immediately take effect. Instead, the rate for the one-week and 2-month US dollar LIBOR settings will be calculated using linear interpolation between the next shorter and next longer settings which continue to be published. The index cessation effective date for all US dollar LIBOR settings will be 1 July 2023, as the remaining US dollar LIBOR settings will cease to be published or will have become non-representative on 30 June 2023. Thereafter linear interpolation of any US dollar LIBOR settings will no longer be possible.

For SOR and THBFX the index cessation effective date in respect of the US dollar LIBOR component of such rates will be 1 July 2023. Therefore the applicable fallback rates for SOR and THBFX will apply with effect from the first date occurring on or after 1 July 2023 on which SOR or THBFIX is required for any determination.

In each case, the index cessation effective date could change if, for example, the FCA were to make a later announcement that certain LIBOR settings will cease to be provided or become non-representative from a different date to those specified in the FCA LIBOR Announcement.

SPREAD ADJUSTMENT

The spread adjustment constituent of an adjusted risk-free rate fallback is included because LIBOR benchmarks incorporate a credit risk premium, while rates which are risk free or nearly risk free do not. The fallback rate for each LIBOR benchmark setting is based on the relevant RFR fallback compounded in arrears over the corresponding LIBOR setting plus the applicable spread adjustment. The spread has been calculated using a historical median approach over a five-year lookback period from the date of the FCA LIBOR Announcement.

Bloomberg Index Services Limited (“**BISL**”) is responsible for calculating and publishing the spread adjustment and has confirmed that under the Bloomberg IBOR Fallback Rate Adjustments Rule Book, the FCA LIBOR Announcement has triggered the fixing of the spread adjustments. Consequently, the spread adjustment for all 35 LIBOR settings is now fixed and will not be subject to further change.

2018 ISDA BENCHMARKS SUPPLEMENT

Where parties have entered into the 2018 ISDA Benchmarks Supplement and the ISDA Fallbacks Supplement also applies to their derivatives transactions (whether by way of adherence to the ISDA Fallbacks Protocol or bilateral agreement), the occurrence of an index cessation event will lead to the application of the Adjusted RFR Fallback as a “Priority Fallback” under the provisions of the 2006 ISDA Definitions Benchmarks Annex to the 2018 ISDA Benchmarks Supplement.

"TOUGH LEGACY" CONTRACTS AND SYNTHETIC LIBOR

The sterling Risk Free Rate Working Group (the "**RFRWG**") in its work on transition to SONIA has acknowledged that there are likely to be contracts which have no realistic prospect of being amended to transition away from LIBOR. Such 'tough legacy’ contracts may reference sterling LIBOR as well as the other LIBOR currencies. US financial regulators are similarly concerned about tough legacy contracts that reference US dollar LIBOR. They have welcomed the extension of the cessation date for commonly-used tenors of US dollar LIBOR to 30 June 2023 as it allows time for a significant number of such legacy contracts to mature.

Under the proposed Financial Services Bill currently making its way through the UK Parliament, the FCA will be granted new powers to designate a critical benchmark as unrepresentative or at risk of becoming unrepresentative. If the FCA does so designate a benchmark, UK regulated firms will be prohibited from using that benchmark (except where the FCA has published a notice permitting legacy use of the benchmark). The FCA will also have the power to impose changes to the calculation methodology of that designated benchmark, allowing it to continue to be published on the basis of that amended calculation methodology (in the case of LIBOR, this is referred to as "**synthetic LIBOR**").

The scope of any permitted legacy use of a designated benchmark (i.e., which contracts will be deemed to be "tough legacy" contracts) and the availability of any "safe harbours" relating to the use of a designated benchmark that continues to be published in an amended form remain subject to further regulatory and legislative developments.

In the FCA LIBOR Announcement, the FCA stated that it intends to consult on using the proposed new powers under the proposed Financial Services Bill to require IBA to continue publishing 1-month, 3-month and 6-month sterling LIBOR on a synthetic basis for a further period after the end of 2021, and 1-month, 3-month and 6-month Japanese yen LIBOR on a synthetic basis for an additional year after 31 December 2021.The FCA will also consider whether to require IBA to continue publishing 1-month, 3-month and 6-month US dollar LIBOR on a synthetic basis for a further period after 30 June 2023.

However the FCA also confirmed that these settings would no longer be representative of their underlying market after 31 December 2021 (for the six sterling and Japanese yen LIBOR settings) and 30 June 2023 (for the three US dollar LIBOR settings) and also confirmed that representativeness will not be restored.

The FCA also confirmed in the FCA LIBOR Announcement that it will not use its powers to compel IBA to continue to publish any of the other 26 LIBOR settings.

The European Commission also has new powers under the amended EU Benchmarks Regulation, enabling it to designate one or more replacements for a benchmark where the competent authority for the administrator has announced that the benchmark no longer reflects the underlying market or economic reality or where the administrator or another authority announces that the benchmark will cease to be provided. If the Commission designates an alternative rate, this will automatically replace all references to the benchmark in contracts and financial instruments which have no fallback provision or no suitable fallback provision.

This automatic replacement will apply to contracts or financial instruments governed by the law of an EU member state, or to contracts governed by the law of a non-EU member state where all parties are established in the EU (and where the law of the relevant non-EU member state does not provide for the orderly wind-down of the benchmark).

The Commission has not announced whether or not it intends to exercise its power to designate an alternative rate for LIBOR, and it remains unclear how any such exercise of this power would interact with the proposed powers of the FCA under the Financial Services Bill.

CONCLUSION

With the FCA LIBOR Announcement market participants now have clarity on a number of key issues: the timetable for the permanent cessation or non-representativeness of all 35 LIBOR settings; when the adjusted risk-free rate fallbacks for transactions referencing these LIBOR rates will apply; and confirmation of the quantum of the spread adjustment to be applied to the risk-free fallback rates.

The FCA continues to urge market participants actively to transition their legacy instruments away from LIBOR and this announcement helps provide a clear focus and further impetus for such transition efforts.

Moreover, whilst the FCA has confirmed that it will consult on whether to require IBA to continue to publish certain LIBOR settings on a synthetic basis, it has underlined that this is intended only to assist with the problem of genuine tough legacy contracts, where it is not practicable to convert such contracts before the loss of representativeness of LIBOR. The use of synthetic LIBOR by UK regulated firms will not be permitted for new transactions, while its continued use by regulated firms in legacy transactions will be subject to permission from the FCA under its proposed new powers.

For derivatives transactions that are not subject to the IBOR Fallbacks Protocol or do not incorporate the IBOR Fallbacks Supplement, the FCA LIBOR Announcement highlights the need to take the necessary steps within the time available to ensure that obligations under those transactions can continue to be performed after the cessation or loss of representativeness of LIBOR. This requirement to address transition and conversion to the stronger and more liquid adjusted risk-free rates will apply to derivatives transactions generally, including in respect of more complex linked derivatives transactions that hedge exposures within the securities and loan markets.

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