BANK OF SCOTLAND

IBOR TRANSITION NEWSLETTER

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COMMERCIAL BANKING

THE END IS IN SIGHT

Welcome to our Newsletter. This is our twenty-first edition providing an update on the transition away from the London Interbank Offered Rate (LIBOR) and other Interbank Offered Rates (IBORs). This will be our penultimate newsletter. After a brief pause, we will publish our final newsletter in December. There are a number of important topics this month, which include:

- **IT ISN'T TOO LATE…BUT TIME IS RUNNING OUT**
- **UK 'SAFE HARBOUR' INTRODUCED**
- **EONIA IN FOCUS**
- **STATEMENT ON CREDIT SENSTIVE RATES**
- **FAQS ON TERM SOFR**
- **A CLOSER LOOK: FAQs ABOUT TOUGH LEGACY**

Please contact your Relationship Team if you have any questions or queries on the contents.

IT ISN'T TOO LATE…BUT TIME IS RUNNING OUT

Sterling market participants have been devoting considerable time and effort in recent months to achieve the active transition of outstanding legacy GBP LIBOR contracts expiring after the end of 2021 before the end-September 2021 milestone set out by the Working Group on Sterling Risk-Free Reference Rates (BOE WG). By setting the milestone ahead of the cessation date, industry and regulators aimed to avoid the risks of any "transition bottlenecks" at the end of the year with the added benefit of providing headroom to focus on some of the more complex contracts that may require closer attention to transition before year end.

For the legacy contracts that have yet to transition, the passing of the milestone serves as a reminder of increasing risks associated with failing to prepare for LIBOR cessation. Active transition remains the clearest way to mitigate these risks, and there is still a window, albeit ever narrowing, to do so.

Failing that, contracts will need to have robust fallbacks in place that will operate in the event of LIBOR cessation. There are considerable risks involved in holding out for an 'easy' outcome that relies on a yet unspecified 'tough legacy' or legislative solution, not least the possibility of not qualifying for what will only be a temporary fix. Should any tough legacy approach, not apply, it may be too late in the day to amend these legacy contracts.

UK 'SAFE HARBOUR' INTRODUCED

On 8 September 2021 HM Treasury introduced draft "safe harbour" rules to the House of Lords. These aim to protect users and administrators of rates that have been designated "unrepresentative" by the Financial Conduct Authority (FCA) but which will continue to be used on a synthetic basis under the UK's tough legacy regime. These draft rules are set out in the Critical Benchmarks (Reference and Administrators' Liability) Bill, which is another important step towards solidifying the UK's approach to 'tough legacy'. HM Treasury also provided a supporting assessment which outlines how the bill, once passed, will provide a legal base in UK law for contracts to substitute LIBOR with synthetic LIBOR.

The bill does not provide a legal carte blanche for all contracts to continue referencing LIBOR calculated using a synthetic LIBOR after cessation. Instead qualification will be at the discretion of the FCA in line with its powers under the UK Benchmark Market Regulations (UK BMR). The answer to which contracts will qualify will not be forthcoming from the FCA until later in Q4 2021.

The bill was introduced following confirmation in May 2021 that the UK Government would bring forward further legislation in response to feedback to the HMT consultation on supporting the wind down of critical benchmarks.

EONIA IN FOCUS

Recent efforts in the Eurozone have been focused on the Euro Overnight Index Average (EONIA) cessation scheduled for 3 January 2022 and a European Commission (EC) consultation on EONIA statutory replacement draft Implementing Act (IA) to the EU Benchmark Regulations (EU BMR).

In response to the consultation, the International Swaps and Derivative Association (ISDA), discussed the limited scope of regulatory power to designate a statutory replacement and the need to avoid a presumption of contractual frustration for contracts without fallbacks. ISDA also stressed the importance of adopting the IA in a timely manner.

The Working Group on Euro Risk-Free rates (EU RFR WG) also responded and recommended that the IA highlights the importance of continued active transition to the Euro Short Term Rate (€STR) for all contracts and financial instruments currently referencing EONIA to ensure the market successfully transitions away from EONIA. The response also suggests some refinements relating to the scope of statutory replacement rates and date of application of the designation. The consultation closed at the end of August 2021 and the EC aims to adopt the IA by the end of September/beginning of October 2021 allowing sufficient time for the designated rate to replace contractual references to EONIA in the EU on 3 January 2022.

STATEMENT ON CREDIT SENSITIVE RATES

Credit sensitive rates, which aim to reflect borrowing costs as an alternative to near credit risk-free rates such as Secured Overnight Financing Rate (SOFR) have been the subject of much discussion recently, with most of the official sector warning of potential risks arising from their use. On 8 September 2021, the International Organisation of Securities Commissions (IOSCO) issued a Statement on Credit Sensitive Rates asking the administrators of such rates to ensure they take due account of the IOSCO Principles for Financial Benchmarks particularly when assessing whether the benchmarks are based on active markets, with high volumes of transactions, representing the underlying interest they intend to measure and are resilient during times of stress.

The IOSCO statement was welcomed by the official sector; John C Williams, President of the Federal Reserve Bank of New York and Co-Chair of the Financial Stability Board's Official Sector Steering Group, commented "Compliance with all the IOSCO Principles – consistently over time – is essential to a successful and lasting transition from LIBOR".

FAQS ON TERM SOFR

On 27 August 2021 the Alternative Reference Rates Committee (ARRC), published a series of Frequently Asked Questions (FAQs) to support the conventions and use cases on how best to employ the SOFR Term Rate to transition away from USD LIBOR, which were published on 21 July 2021. The conventions and use cases apply to CME Group's forward-looking SOFR Term Rates, which were formally recommended by the ARRC on 29 July 2021.

A CLOSER LOOK: FAQS ABOUT 'TOUGH LEGACY'

We have compiled some FAQs about UK 'Tough Legacy' and synthetic LIBOR that may prove useful to readers. As stated earlier, there are considerable risks involved in holding out for an 'easy' outcome that relies on a yet unspecified 'tough legacy' or legislative solution, not least the possibility of not qualifying for what will only be a temporary fix.

1) **When will I know if any of my contracts qualify for 'Tough Legacy' treatment and can use a synthetic LIBOR?**

   The FCA will confirm the types of contracts or "use cases" that will qualify during Q4 2021. It is important to be clear that only the 1-month, 3-month and 6-month GBP LIBOR settings will continue to be available on a synthetic basis. The Overnight, 1-week, 2-month and 12-month GBP LIBOR settings will permanently cease to exist after 31 December 2021.

2) Will a synthetic LIBOR be available for contracts in non-GBP currencies?

The FCA is also considering making settings for 1-month, 3-month, and 6-month Japanese yen LIBOR available. US LIBOR settings for overnight and 1-month, 3-month, 6-month and 12-month will cease immediately after 30 June 2023 and for 1-week and 2-month USD LIBOR after 31 December 2021. The FCA has indicated that it will consider a synthetic methodology for the, 1-month, 3-month, and 6-month USD LIBOR settings after their cessation.

3) When will I know precisely how synthetic LIBOR will be calculated?

The final decision from the FCA on its synthetic LIBOR methodology is due to be released once the FCA has considered responses to their consultation issued in late June 2021 on how it proposes to use its powers to require synthetic LIBOR to be calculated for GBP LIBOR and JPY LIBOR, For more information on the consultation, please see the A Closer Look section of our July 2021 newsletter.

4) Is synthetic LIBOR considered a permanent solution to transition?

No, in terms of how long synthetic LIBOR will last, the FCA has said that it will be for “as short a time as possible”; and under its powers, it is required to review its policy every two years. Moreover, the FCA can only compel ICE Benchmark Administration (IBA) to publish on a non-representative (synthetic) basis for a maximum period of 12 months at a time and they will therefore need to review their decision accordingly. For JPY LIBOR, the FCA has advised that it intends to compel publication for one year only until the end-2022.

5) Does the proposed UK ‘Safe Harbour’ legislation mean that I don’t have to do anything?

No, the intention of the proposed legislation is to clarify, for existing contracts under UK law, the replacement of LIBOR with synthetic LIBOR, should the FCA consider that these contracts qualify as a valid use case for ‘Tough Legacy’ treatment.

6) Does UK ‘Tough Legacy’ apply only to contracts written in UK law?

Yes, the FCA legal framework applies only to those contracts written in UK law. EU and US jurisdictions are developing their own approaches and other jurisdictions may, or may not, choose to apply the FCA approach to the concept of ‘Tough Legacy’.

Cris Kinrade
IBOR Transition Programme
Bank of Scotland Commercial Banking

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