BANK OF SCOTLAND

IBOR TRANSITION NEWSLETTER

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COMMERCIAL BANKING

DON'T DELAY

Welcome to our Newsletter. This is our nineteenth edition providing an update on the transition away from the London Interbank Offered Rate (LIBOR) and other Interbank Offered Rates (IBORs). There are a number of important topics this month, which include:

- **SEPTEMBER STERLING DEADLINE LOOMS**
- **FSB REPORT & GLOBAL COORDINATION**
- **ISDA SUMS IT UP**
- **EURO ACTIVITY**
- **A CLOSER LOOK: SYNTHETIC LIBOR**

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

SEPTEMBER STERLING DEADLINE LOOMS

Both the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA) expect market participants to "complete active conversion of all legacy GBP LIBOR contracts expiring after end-2021, where viable and, if not viable ensure robust fallbacks are adopted where possible"… by the end of September 2021. This supports the Working Group on Sterling Risk-Free Reference Rates (BoE WG) milestone.

In other words, UK regulator expectations around transition are well in advance of GBP LIBOR's cessation at the end of this year and for good reason. Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA was clear in a July 2021 speech, that meeting the milestone "will help avoid risks of getting caught in a pre-Christmas rush – where we could see a squeeze in IT, legal or other resources, or would simply have too little time to adjust to unexpected hurdles."

In a July 2021 publication the BoE WG, outlined several benefits of actively transitioning LIBOR-linked contracts by the end-September milestone. These included avoiding issues arising from: 1) resource constraints; 2) potential withdrawal of market liquidity in GBP LIBOR; and 3) internal governance required for active transition.

Firms contemplating relying upon fallbacks at cessation need to be certain they are truly robust, both in terms of smoothly switching to a new rate, and operational preparedness. Likewise, they should understand the costs of relying on fallbacks versus active transition. An April 2021 statement from the BoE WG sets out some further considerations to take into account when choosing whether to rely on fallbacks in derivatives markets rather than to actively transition.

Looking ahead, how to address 'tough legacy' contracts and the potential availability of 'synthetic' GBP and JPY LIBOR for use, alongside developments for USD LIBOR, are likely to be the key emerging "hot" topics in coming months. There is still much uncertainty not just about how synthetic LIBOR will work, but also permitted use cases and for how long this rate can be used. Not surprisingly the FCA has encouraged market participants not to delay their plans by waiting for a potential 'synthetic' solution.

Last month, this newsletter took a broad look at the 'Tough Legacy' landscape (*click here to read*) as it stood at the time. In this newsletter, the *A Closer Look* section focuses on synthetic LIBOR and the latest consultations.

Meanwhile, the additional complexities involved with juggling exposures in GBP LIBOR and other benchmarks due to cease at the end of 2021, with others that aren't due to cease until the middle of 2023, only adds weight to the argument that borrowers, lenders and advisors should be engaging well ahead of the end of September 2021. Multicurrency exposures are not seen by regulators as an impediment to achieving the end of September 2021 milestone.

FSB REPORT & GLOBAL COORDINATION

The Financial Stability Board's (FSB) Progress Report to the G20 on LIBOR transition issues, published on 6 July 2021 illustrates that the need to accelerate transition activity is a truly global issue and not localised to the UK and sterling markets. The core message is that there should be no remaining doubts as to the urgency of the need to transition away from LIBOR by the end of 2021 and encourages authorities to set globally consistent expectations and milestones that firms will rapidly cease any new use of LIBOR, regardless of where those trades are booked or in which currency they are denominated.

Nothing over the past month exemplifies global coordination and consistency better than the Bank of England (BoE) and FCA joint announcement on 16 June 2021 supporting the US regulator led 'SOFR First' initiative, a programme aimed at switching derivative trading conventions away from LIBOR and on to Secured Overnight Financing Rate (SOFR) from 26 July 2021. This followed the formal launch of the initiative on 8 June 2021. The Commodity Futures Trading Commission (CFTC) formally adopted the initiative on 13 July 2021, extending its application to cross currency swaps, non-linear derivatives, and exchange traded derivatives.

In similar vein, on 1 July 2021 the National Working Group on Swiss Franc Reference Rates (CHF WG) agreed details of a similar initiative for 'Swiss Average Rate Overnight' (SARON). From 1 September 2021 at the latest, all market participants (investors and issuers) are to switch to using the SARON swap curve as the only pricing reference, and from 1 July 2021 only SARON-based derivatives can be used for new transactions, excluding transactions that reduce or hedge LIBOR exposures. The CHF WG also expressed support for 21 September 2021, approved by the CFTC, as a likely start date to switch conventions of cross-currency swaps in all five LIBOR currencies to RFRs.

There have been other, less obvious areas of international coordination, for example the work to dissuade market participants from adopting 'credit-sensitive' rates, which are considered by global regulators as being inferior to risk-free rates. Edwin Schooling Latter, urged just such caution in his 5 July 2021 speech and noted that "any regulated UK market participants looking to use these so-called 'credit sensitive' rates in UK-based business should consider the risks carefully, and raise with their FCA supervisors before doing so." The US Securities and Exchange Commission (SEC) expressed similar sentiments on 11 June 2021, and the Federal Housing Finance Agency (FHFA) also provided supervisory guidance on 1 July 2021. These statements were welcomed by the US Alternative Reference Rates Committee (ARRC).

Meanwhile, although a number of key US dollar settings are continuing until end-June 2023, this is only to support the rundown of legacy contracts and US regulators continue to sign post the requirement to end all new use of USD LIBOR by the end of 2021. This topic was the focus of the comments from U.S regulators to banks at the Financial Stability Oversight Council of the US Department of the Treasury, which also strongly discouraged the use of 'credit sensitive' rates.

ISDA SUMS IT UP

Scott O'Malia, the International Swaps and Derivatives Association (ISDA) CEO, summed up the current regulatory mood regarding transition in a 15 July 2021 article in two words: "hurry up". However, he also struck an optimistic tone on the achievements to date. He pointed to the fact that more than 14,300 entities across nearly 90 jurisdictions had adhered to the ISDA Protocol, which allows firms to incorporate the fallbacks into existing non-cleared derivatives entered into prior to 25th January 2021, and reminded readers that the protocol remains open for adherence.

O'Malia also mentioned that 11.7% of total cleared over-the-counter and exchange-traded interest rates were linked to risk free rates (RFRs) in June 2021, up from 4.9% in June 2020, a trend that paves the way for the use of alternative rates instead of LIBOR from the start of next year.

EURO ACTIVITY

LIBOR transition has similarly been a key area of focus in the EU over the past month, despite the fact that the Euro Interbank Offered Rate (EURIBOR) is not planned to cease for the foreseeable future. On 24 June 2021 the European Commission, the European Securities and Markets Authority (ESMA), the European Central Bank in its banking supervisory capacity (ECB Banking Supervision) and the European Banking Authority (EBA) issued a joint statement encouraging market participants to use the time remaining until the cessation, or loss of representativeness of LIBOR settings, to substantially reduce their exposure to these rates in particular by no longer using any LIBOR settings as references in new contracts. They also highlighted and echoed the sentiments expressed by the FCA that any synthetic rates or statutory fallback rates should only be used when absolutely necessary to transition contracts, rather than relying on such rates as solutions to LIBOR transition.

Aside from LIBOR transition, focus in the EU has centered on preparations for the discontinuation of the Euro Overnight Index Average (EONIA) in favour of Euro Short-Term Rate (€STR) from 3 January 2022. In that regard, the Chair of the Working Group on Euro Risk-Free Rates (EU RFR WG) sent a letter to the European Commission on 15 July 2021 requesting support with regards to transition via the designation of a statutory replacement rate for EONIA as part of a comprehensive solution for cash and derivative products.

Behind the scenes, there has been some reshuffling at the EU RFR WG and there are likely to be more changes to come. ESMA, in its new capacity as Secretariat of the EU RFR WG announced on 29 June 2021 that James von Moltke has been appointed to Chair the group, taking over from Tanate Phutrakul. This follows the conclusion of the EUR RFR WG's initial mandate in May 2021, which had culminated in a number of recommendations on euro area benchmark transition and reform.

On 12 July 2021, ESMA issued a call for expression of interest for financial firms to join the EU RFR WG. Priority will be given to firms that have diverse business activities and are able to commit time and resources, while also having demonstrated their support for interest rate benchmarks in the past. The deadline for applications is 30 July 2021.

A CLOSER LOOK: SYNTHETIC LIBOR

Last month, this *A Closer Look* section examined the subject of 'Tough Legacy' across a number of jurisdictions and several key dates to look out for in the future (*click here to read*). Since then, in late June 2021 the FCA published a consultation containing its proposal on how it will use its Article 23D (2) Benchmarks Regulation (BMR) powers to require a synthetic LIBOR to be calculated for GBP and JPY LIBOR. The consultation closes on 27 August 2021 with the FCA intending to issue a further consultation on precisely which (tough) legacy contracts will be permitted to use these synthetic LIBOR rates and to confirm their final decisions as soon as practicable in Q4.

The consultation document provides details of what the FCA is proposing. The February 2021 edition of this newsletter (*click here to read*) covered what had been outlined initially in terms of a 'synthetic LIBOR', namely that: 1) the rate could include a fixed spread like the ISDA spread adjustment (5YHM) and 2) that the range of currencies and settings would be limited to the more widely used currencies and tenors.

The consultation reveals that the FCA is contemplating synthetic LIBOR for only the 1-month, 3-month, and 6-month settings of GBP and JPY LIBOR. For the calculation of each setting, the FCA is planning to use the respective matching **term** risk free rate plus the 5YHM spread adjustment already published by ISDA for the referenced currency and tenor. The **term** risk free rate to be used for GBP LIBOR is Term SONIA and for JPY LIBOR, the Tokyo Term Risk Free Rate (TORF). Given most of the key USD LIBOR settings are not due to cease or become non-representative until after end-June 2023, they will be addressed at a later date…if necessary.

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 basis for maximum period of 12 months at a time and they will need to review their decision accordingly. For JPY LIBOR, the FCA has advised that it intends to compel publication only until the end-2022.

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