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LIBOR Transition Update: Synthetic LIBOR Is Here

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Back in March of 2021, we covered a number of developments pertaining to the end of LIBOR that came out of certain announcements made early that month by the Intercontinental Exchange Benchmark Administration (the "IBA"), which is the administrator of LIBOR. In those announcements, the IBA stated that it would cease publication of certain LIBOR settings on certain dates. In those same announcements, the IBA noted that its regulator, the UK Financial Conduct Authority (the "FCA"), could potentially require the IBA to publish certain LIBOR tenors on a synthetic basis.

Recently, as has been long signaled, the FCA announced that it would indeed require IBA to publish an unrepresentative synthetic USD LIBOR for 1-, 3- and 6-month tenors for an additional year, which is expected to be further extended through September 30, 2024. It has come at a time when we continue to be in the thick of LIBOR transition amendments in our fund finance deals, as June 30, 2023 − the last date of publication of representative USD LIBOR − is quickly approaching. Given this dynamic, the FCA announcement has created some confusion in the fund finance market – and in the broader loan markets. Here we explain the dynamics at work and what it means for fund finance deals.

What is Synthetic USD LIBOR and why was it published?

Synthetic LIBOR as a benchmark will be calculated on the basis of CME Term SOFR plus the standard ARRC/ISDA spread adjustments for 1-month, 3-month, and 6-month tenors. This means that synthetic LIBOR is the same rate that is used for deals that have standard ARRC hardwired fallback language, as well as for deals that transition pursuant to the LIBOR Act, which is discussed below.

The FCA's intention in requiring the IBA to publish synthetic LIBOR is to give the parties to certain contracts described below additional time to transition their deal documents, or for these deals to mature according to their terms.

Synthetic LIBOR has been put in place to be used for legacy contracts that have no other means of transitioning. These contracts are largely agreements that are governed by non-U.S. law that reference USD LIBOR and lack any fallback or transition mechanism. As we discuss below, U.S. deals that fit certain criteria would be transitioned pursuant to their terms or, pursuant to the LIBOR Act, rather than using synthetic USD LIBOR.

What does this mean for the fund finance market?

In the fund finance corner of the loan market, synthetic LIBOR is not expected to affect the vast majority of deals for a couple of reasons.

First, most of our deals do not have very long tenors and, as such, the documentation is generally up to date and the deals that have not yet been remediated at least contemplate the end of LIBOR with some version of ARRC-recommended benchmark transition language (there have been several iterations over the years). These deals will specifically say that LIBOR ceasing to be representative (*i.e.*, publication of synthetic LIBOR) would constitute a benchmark transition event. On June 30, 2023, LIBOR will no longer be representative. This means that any deal document that has ARRC or ARRC-like language will transition because there is a trigger in the loan agreement for the instance where LIBOR is not representative.

Second, the result under contracts that do not contain any ARRC or ARRC-like language will depend on the language of the deal documents themselves. LIBOR-based loan agreements that pre-date any ARRC transition language still typically contemplate unavailability of "LIBOR."

Whether publication of synthetic LIBOR means that "LIBOR" is "unavailable" will depend on the specific language in a document. Most formulations of the definition of "LIBOR" include language that could make it challenging, from a contractual perspective, to argue that synthetic LIBOR is an available "LIBOR." In these circumstances, it is important to analyze closely, in coordination with your legal counsel, whether the publication of synthetic LIBOR constitutes a transition event.

What about the LIBOR Act?

The LIBOR Act has been similarly confusing to market participants. On March 15, 2022, the Adjustable Interest Rate (LIBOR) Act was signed into law. This federal law provides a means for transitioning legacy contracts that either lack or have insufficient provisions to address the end of LIBOR. Given that it is a federal law, the LIBOR Act and the regulations promulgated pursuant to the law supersede any state or local laws related to the same subject matter. This helps to create greater certainty and uniformity in the market for the contracts to which it applies.

The deals to which the LIBOR Act most readily apply are deals governed by U.S. law with no fallback language. The law serves to provide a means for these challenging legacy contracts to transition to a replacement benchmark. The law also contains a means by which certain conforming and operational changes related to the replacement benchmark can be made without the need for consent by the parties to the agreement.

What fund finance market participants most need to know here is that because most fund finance deals, even from many years ago, contain fallbacks to non-LIBOR rates (*e.g.*, prime or federal funds), these contracts would be out of scope for the primary transition provisions of the LIBOR Act. Market participants should not rely on the LIBOR Act except under certain, expected to be limited, circumstances.

What else do I need to do?

Keep in mind that even if you have an agreement with hardwired fallback, while June 30, 2023 will be a benchmark transition event under the terms of the deal, you will almost always need a conforming changes amendment. The credit agreement contemplates what the benchmark will be but it lacks, among other things, certain definitions and operative provisions pertaining to the benchmark transition. The amendment for these provisions does not typically require affirmative or negative consent by the borrower or syndicate members, but rather the agent or lender has the authority to send out the changes.

Keep going!

The bottom line is that synthetic LIBOR and the LIBOR Act are not primarily intended for deals like the ones we see in the fund finance market. There is, unfortunately, no magic bullet to this benchmark transition. And June 30th is quickly approaching! So keep those transition amendments going and, if you have any questions about your deal documents, contact your friendly Cadwalader lawyer. We are here to help.