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USD synthetic Libor litigation-prone if wrongly applied

By Alice Tchernookova August 16, 2022

Sources fear that a lack of clarity on the scope of application of a synthetic US dollar rate could lead to potential lawsuits and market confusion

The synthetic US dollar Libor rate, if it is eventually approved and applied, should strictly apply to contracts that are not under the remit of US law to avoid market confusion and legal conflicts, sources have said.

Currently under consideration following a consultation published by the Financial Conduct Authority (FCA), the US dollar synthetic rate would come as a last-resort solution to any US dollar contracts that cannot be transitioned and cannot fall back to any other solution, such as the synthetic sterling Libor rate or the ISDA fallbacks.

"The FCA should expressly preclude application of any synthetic US dollar Libor rate to US law contracts," said James Lovely, expert witness and consultant at FPExpert.com. "This is simply a matter of good sense and comity. Conversely, the US Libor transition legislation and proposed Federal Reserve regulations expressly limit application to US law contracts."

A key concern is that if the US dollar synthetic rate's use is not limited to non-US contracts, it would clash with the Fed's Adjustable Interest Rate (Libor) Act, which offers a legislative fix for US-governed contracts that cannot be transitioned in time for USD Libor's full discontinuation in June next year.

"Any tough legacy US law contract would fall under the federal Libor statute and flip over to SOFR – the economics of it may not be good, but that's what is going to happen," said Bradley Berman, counsel at Mayer Brown. "But if you have a US dollar contract governed by UK law, the federal statute won't apply to it. This is where it will be unclear what to do, and where synthetic US dollar Libor might be a boon."

According to Paul Forrester, a corporate finance and securities lawyer working alongside Berman at Mayer Brown, the extent of these contracts is considerable.

"There's a significant number of tough-to-amend legacy US dollar contracts that are not governed by US law and would not be able to take advantage of the US statute," he said. "That universe is mostly made of cash products that are reliant on a robust synthetic Libor solution that would last long enough to enable them to continue to work. Some capital markets instruments have 30, or even 40-year maturities."

A bigger issue could be non-US-governed loan agreements with a US dollar Libor component that has to be remediated, Forrester continued.

"A lot of European lending is done with a US dollar Libor option for many of the multinational borrowers," he said. "I suspect that some of these agreements have not been remediated. If a synthetic rate doesn't apply to them, that remediation will have to be done manually."

The legacy bond market is another area where the synthetic rate has been pointed out as a necessity.

"Many constant-maturity swap (CMS) floating rate notes (FRNs) based on Libor will face an issue if ICE Benchmark Administration (IBA) stops publishing the rate after June 30," said Berman. "Having a synthetic US dollar Libor would mean that the floating rate leg of a Libor-based CMS can keep being published, which would solve the problem."

Repercussions

Despite its many use cases, the synthetic rate could be counterproductive and do more harm than good if its scope isn't clearly defined by the regulators.

"Much depends on whether the FCA produces a US dollar synthetic Libor and whether that rate, as applied to various types of contracts and transactions, tracks (precisely) what the Fed does in implementing regulations for the transition," said Lovely.

The application of a synthetic rate to US law Libor contracts could cause problems in situations where securities have fallback provisions, but no pre-cessation or non-representativeness trigger, he added.

"If the FCA attempts to rely on synthetic USD Libor to (temporarily) fix the UK's tough legacy problem, there will almost certainly be collateral damage and significant disruptions in the US and other places such as Australia, the EU, Mexico and Singapore," said Jason Jurgens, financial markets partner at Jones Day.

"While some of us are working to address and mitigate the adverse consequences of such a UK policy decision, it's unlikely that any solution – short of further Congressional action – will prevent disruptions to the US financial markets." Friction between the FCA's plan and the US Libor act is almost certain, Jurgens argued, but the degree of that friction will depend on what the FCA, IBA and the Fed decide from here onward.

"Clarifying that US dollar synthetic Libor is not to be used in contracts governed by US law because they are remediated by the federal statute would be the sensible thing to do, but the market could still be subject to significant uncertainty," said Forrester. "In the first instance, it's mainly an issue of market confusion and concern. However, if there are adverse economic impacts, some market participants could choose to sue, and then it becomes a litigation problem."

If its use is permitted, some may also choose the synthetic rate over the Fed's legacy fix to bypass unfavourable consequences on their contracts.

"If you rely on the federal statute, you inherit fixed spreads that are not necessarily a market rate or a spot rate, which changes your economics," Forrester explained. "The possibility of using the synthetic rate for US-governed contracts would raise some tricky interplay questions. We need the Fed to finish writing the rules that implement the statute, and there's significant work to be done there."

If US dollar synthetic Libor is properly circumscribed and its use appropriately calibrated, any legal conflict should be avoided, Forrester assured.

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