Cessation of panel bank US dollar LIBOR: implications for bonds under English law

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Summary

Panel bank US dollar LIBOR is due to cease on 30 June 2023. In the US, provision has been made by the Federal Reserve under the US LIBOR Act for a replacement rate for certain legacy contracts, including bonds, from that date with no time limit. The FCA – as the global regulator of LIBOR – announced on 3 April 2023 that, under the UK Benchmarks Regulation, the methodology for US dollar LIBOR will change on the cessation of panel bank LIBOR to synthetic LIBOR for certain legacy contracts, including bonds, until 30 September 2024. It is proposed that the synthetic US dollar rate should be the same as the replacement rate under the US LIBOR Act for as long as the synthetic rate for US dollar LIBOR continues to be published. Before the cessation of synthetic US dollar LIBOR, the FCA is required to review its decision but, in the absence of unforeseen and material events, expects to follow the direction and timeline indicated. The FCA is continuing to encourage active transition of legacy US dollar LIBOR bonds to SOFR in the meantime.

Background

1 The authorities globally have for some time planned the permanent cessation of LIBOR, on the grounds that LIBOR poses clear risks to global financial stability, as the market for unsecured wholesale term lending between banks is no longer sufficiently active to support such a widely used reference rate. Instead, the authorities have encouraged the market to adopt near risk-free reference rates, where the volume of underlying market transactions is greatest.[1]

2 In all five LIBOR currencies, risk-free rates have been adopted instead of LIBOR in *new* transactions: SOFR in US dollars; SONIA in sterling; €STR in euro; SARON in Swiss francs; and TONA in Japanese yen. In each case, the most robust risk-free rates are overnight rates, which are measured by the volume of overnight transactions and do not depend on any use of expert judgment. In some currencies, the overnight risk-free rates are secured, and in other currencies they are unsecured. Overnight risk-free rates compounded in arrears are referenced in the majority of new floating rate note issues in the bond market. Forward-looking term risk-free rates are also used in financial instruments in some limited cases and are preferred by the authorities to credit-sensitive rates, which they consider carry similar risks to LIBOR.

3 *Legacy* LIBOR transactions are being transitioned to risk-free rates, in cases in which this is feasible, as in the case of OTC derivatives, where the ISDA IBOR Fallbacks Protocol has been widely used, and cleared derivatives, which can be converted *en bloc*. In place of panel bank LIBOR rates, synthetic rates have been used in some LIBOR currencies as a temporary bridge to give more time for legacy transactions to mature and for active transition to be undertaken, in particular in the cash markets.

1. Global coordination has been overseen by the FSB Official Sector Steering Group, which is chaired by John Williams, President of the Federal Reserve Bank of New York, and Nikhil Rathi, Chief Executive of the UK FCA. In each LIBOR jurisdiction, the public sector and the private sector have worked closely together through national risk-free rate working groups. ICMA chairs the RFR Bond Market Sub-Group in the UK, working with the FCA and the Bank of England.

Progress to date on the transition away from LIBOR

4 There has already been considerable progress in achieving the authorities' objective of permanent cessation in all five LIBOR currencies. The FCA – as the global regulator of LIBOR – has determined the following:

- At the end of 2021, panel bank LIBOR ceased permanently in 24 of the 35 LIBOR settings in the five LIBOR currencies, including all euro LIBOR and Swiss franc LIBOR settings, and some sterling, Japanese yen and US dollar LIBOR settings. In April 2022, the Financial Stability Board (FSB) noted that the transition from LIBOR, primarily to overnight risk-free rates, had been smooth without any significant market disruption so far.[2]
- In the case of the remaining three sterling and three Japanese yen settings, the FCA instructed the IBA – as the administrator of LIBOR – to change its methodology at the end of 2021 from panel bank to synthetic LIBOR for legacy transactions. Japanese yen LIBOR ceased permanently at the end of 2022. One and six-month sterling LIBOR ceased permanently at the end of March 2023, and three-month sterling LIBOR is due to cease permanently at the end of March 2024.
- Panel bank US dollar LIBOR has continued to be used for legacy transactions. But panel bank US dollar LIBOR is due to cease at the end of June 2023, and all remaining settings other than one, three and six months are due to cease permanently at that point.

The transition away from LIBOR in US dollars

5 Restrictions have been imposed by the US authorities on the use of US dollar LIBOR in *new* transactions since the end of 2021. In place of US dollar LIBOR, SOFR has been used for new transactions for some time.[4] SOFR is underpinned by a daily average of around US$1 trillion in transaction volume, and is now the predominant US dollar reference rate, with almost all US dollar floating rate notes and all US dollar adjustable-rate agency mortgages being tied to SOFR. Almost all new US dollar loans currently reference SOFR, with nearly 100% of US dollar syndicated lending referencing SOFR in December 2022, compared to 30% in December 2021.[5]

6 In the case of *legacy* contracts, the scale of the transition needed from LIBOR to risk-free rates in US dollars is much greater than in the other LIBOR currencies. The US Alternative Reference Rates Committee (ARRC) estimated in March 2021 that roughly US$223 trillion of legacy US dollar LIBOR exposures were outstanding at the end of 2020, of which exposures of US$74 trillion were estimated to mature after 30 June 2023, when panel bank US dollar LIBOR will cease. Around US$5 trillion of the remaining US dollar LIBOR exposures relate to cash products, including bonds.[6] The FSB has estimated that there are around US$2 trillion in bonds, including securitisations, US$2 trillion in business loans, and US$1 trillion in consumer loans.[7]

7 In the bond market, the main outstanding question has been how legacy transactions will be handled for one, three and six-month US dollar settings after 30 June 2023, when panel bank US dollar LIBOR will cease. In the US, it is generally not feasible

EURIBOR

The transition from EURIBOR to risk-free rates is being handled in a different way from LIBOR. In January 2022, ESMA took over the supervision of the EURIBOR administrator, the European Money Markets Institute (EMMI), under the EU Benchmarks Regulation. EMMI undertakes an annual review of EURIBOR's hybrid methodology with a view to confirming that EURIBOR remains robust, resilient and representative of its underlying market, and identifies any recalibrations of the calculation method required. The latest adjustments were implemented by EMMI and the EURIBOR panel banks on 3 October 2022.

The euro short-term rate (€STR), which is an unsecured rate, is the near risk-free rate for the euro area. It has been published by the ECB for five settings since 15 April 2021. €STR has replaced EONIA, an interbank overnight lending reference rate, which was discontinued on 3 January 2022. While EURIBOR continues to be published without a future cessation date, compounded €STR and forward-looking €STR term rates are being promoted for use as fallback rates in new EURIBOR transactions.[3]

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2. FSB, *Progress Report on LIBOR and Other Benchmarks Transition Issues,* 16 December 2022.

3. FSB, *Progress Report on LIBOR and Other Benchmarks Transition Issues,* 16 December 2022.

4. The secured overnight funding rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralised by US Treasury securities. It is published daily by the Federal Reserve Bank of New York.

5. FSB, *Progress Report on LIBOR and Other Benchmarks Transition Issues,* 16 December 2022.

6. ARRC LIBOR Legal Playbook, 11 July 2022.

7. FSB, *Progress Report on LIBOR and Other Benchmarks Transition Issues,* 16 December 2022.

actively to transition legacy bonds from LIBOR to SOFR, as consent solicitation is the main route for transitioning legacy bonds by agreement, and consent thresholds for agreement by investors are commonly 100% under US law. The US authorities have introduced federal legislation (through the US LIBOR Act) to provide a replacement rate from 30 June 2023 for bonds and other contracts which have not been transitioned, and in many cases cannot be.[8] The replacement rate will continue to run until maturity of the bonds, as the US LIBOR Act is not time-limited.

Synthetic US dollar LIBOR

8 As the US dollar is the most widely used international currency, there are also a large number of US dollar bonds (and other financial contracts) referencing LIBOR governed by English law and by the laws of some other jurisdictions. The process of transitioning bonds under English law from LIBOR to SOFR is less difficult than under US law, as consent thresholds are commonly significantly lower than 100%. But even so, active transition from LIBOR to SOFR is problematic for tough legacy contracts.[9] Active transition needs to take place bond by bond – the bond market cannot use a protocol in the same way as the derivatives market can use the ISDA IBOR Fallbacks Protocol. Active transition in the bond market takes time, involves expense, and success is by no means guaranteed. In some cases, active transition may not be feasible at all.

9 The FCA announced on 3 April 2023 that, when panel bank US dollar LIBOR ceases on 30 June 2023, synthetic US dollar LIBOR will succeed it for all legacy contracts (other than cleared derivatives) in one, three and six-month settings.[10] This should provide continuity of contract for legacy bonds, including those likely to have fallbacks to a fixed rate which will be triggered on permanent cessation of LIBOR (ie the opposite of the floating rate agreed when the bond was issued) for as long as synthetic US dollar LIBOR is published.[11] The synthetic US dollar rate proposed by the FCA is the same as the rate in the US proposed by the Federal Reserve: the relevant CME Term SOFR Reference Rate plus the respective ISDA fixed adjustment spread. International consistency through alignment is particularly important in international markets.

10 The UK approach to winding down US dollar LIBOR is not the same as the US approach, though the result should be the same as long as synthetic US dollar LIBOR continues to be published. The FSB has noted that, while legislative approaches may differ, there has been close coordination between the authorities with the aim of ensuring that these different approaches will complement one another.[12]

- The US approach under the LIBOR Act involves contractual override, as a result of which references to US dollar LIBOR in legacy bond issues outstanding at 30 June 2023 are replaced by references to CME Term SOFR plus the ISDA fixed adjustment spread.
- The UK approach involves keeping LIBOR for legacy bond issues outstanding at 30 June 2023 but changing its methodology from panel bank LIBOR to synthetic LIBOR, which will also consist of CME Term SOFR plus the ISDA fixed adjustment spread.[13]
- So the UK approach should achieve the same result as the US approach for as long as synthetic US dollar LIBOR continues to be published. But whereas there is no time limit under the US LIBOR Act, synthetic US dollar LIBOR is subject to a time limit of a maximum of 10 years under the UK Benchmarks Regulation, with an annual review of whether synthetic US dollar LIBOR continues to be necessary in the meantime.

11 It is also important to note that the UK Benchmarks Regulation has been amended by the Critical Benchmarks Act, which was introduced in 2021 by HM Treasury to provide

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8. The US LIBOR Act was enacted in March 2022 to establish a uniform process for replacing US dollar LIBOR in "tough legacy" contracts governed by US law that do not provide a clearly defined and practicable benchmark replacement: FSB, *Progress Report on LIBOR and Other Benchmarks Transition Issues,* 16 December 2022.

9. Tough legacy contracts are defined by the Federal Reserve System as contracts referencing US dollar LIBOR which will not mature by 30 June 2023, but which lack adequate fallback provisions providing for a clearly defined or practicable replacement benchmark following the cessation of US dollar LIBOR*: Regulation Implementing the LIBOR Act, December 2022.* The FSB defines tough legacy contracts as "contracts that do not contain a workable fallback, and cannot, or cannot easily be amended in time before the transition deadline.": *Progress Report on LIBOR and Other Benchmarks Transition Issues,* 16 December 2022.

10. FCA decision on synthetic US dollar LIBOR, 3 April 2023. New use of synthetic US dollar LIBOR will not be permitted.

11. For LIBOR bonds governed by English law, fallback triggers typically work as follows: "Type 1" bonds fall back to a fixed rate at permanent cessation of LIBOR, which was not envisaged when the bonds were issued with a floating rate; "Type 2" bonds fall back to a floating rate at permanent cessation; and "Type 3" bonds – and ARRC-recommended fallbacks for LIBOR bonds – fall back to a floating rate at pre-cessation, if and when LIBOR is declared or becomes "unrepresentative" of its underlying market. These examples do not describe every case. It is important to note that the operation of Type 1 bond fallbacks is subject to reference bank polling, which will no longer be fit for purpose once LIBOR ceases. Under the US LIBOR Act, the reference bank polling mechanism is disapplied for financial instruments in scope of the legislation.

12. FSB: *Progress Report on LIBOR and Other Benchmarks Transition Issues,* 16 December 2022.

13. FCA decision on synthetic US dollar LIBOR, 3 April 2023.

continuity of contract in law between panel bank LIBOR and synthetic LIBOR. The legislation is currency agnostic: in other words, in the same way as there is continuity of contract between panel bank and synthetic sterling LIBOR under English law, there should also be continuity of contract under English law between panel bank and synthetic US dollar LIBOR.

12 In the case of sterling, the introduction of a synthetic rate for legacy LIBOR transactions in place of panel bank LIBOR has worked well so far. As bonds have to be transitioned bond by bond, the availability of the synthetic rate has given more time for legacy bonds to mature or to be transitioned (eg through consent solicitation) to SONIA, where feasible, though there are still a number of legacy sterling bonds outstanding for three month settings, where the permanent cessation date is the end of March 2024.

13 While active transition of legacy sterling LIBOR bonds has made considerable progress, the transition of legacy US dollar LIBOR bonds under English law is a more challenging task: there are more US dollar LIBOR bonds to transition than sterling, and transition is expected to be more complex, as many US dollar LIBOR bonds are held by investors – including retail investors – internationally, given the US dollar's international role. This is not just a feature of the bond market. The LMA has estimated that there are around 100 jurisdictions affected globally in the loan market.

14 Some legacy bonds – including capital instruments – contain a reference to US dollar LIBOR-based benchmarks, such as the US dollar LIBOR ICE Swap Rate, rather than LIBOR itself. The US dollar LIBOR ICE Swap Rate is due to cease on 30 June 2023: ie the same date as panel bank US dollar LIBOR. The ARRC has noted that legacy bonds referencing the US dollar LIBOR ICE Swap Rate are not covered by the US LIBOR Act and has published a recommended fallback formula for these rates when the US dollar LIBOR ICE Swap Rate ends on 30 June 2023. But the fallback rates can only be implemented if the contractual fallback language allows for that. The ARRC recommends that issuers take active steps to address securities that do not have workable fallback language.[14]

The target date for permanent cessation of synthetic US dollar LIBOR

15 The FCA announced on 3 April 2023 that 30 September 2024 will be the target date for the permanent cessation of synthetic US dollar LIBOR.[15] Setting a realistic target date should encourage active transition in the meantime, and in some cases (eg private placements) this should be relatively straightforward. But cessation on 30 September 2024 gives a relatively short time for transition from LIBOR to SOFR of the large number of legacy US dollar LIBOR bonds outstanding with maturities beyond that date.

16 As a result, the FCA is playing a prominent role in encouraging the active transition of legacy US dollar LIBOR bonds, and supervisors are drawing the need for active transition to the attention of the banks they supervise. Given the global role of the US dollar, it is also important that the authorities promote active transition of legacy US dollar LIBOR contracts globally, especially in jurisdictions where awareness is low. The most appropriate global institution to take the lead is the FSB Official Sector Steering Group, which has overseen the transition from LIBOR to risk-free rates globally since the beginning of the process.

17 In response to official encouragement, bond market participants need to transition legacy US dollar LIBOR bonds wherever they can, in particular because some legacy US dollar LIBOR bonds – particularly those issued before around the beginning of 2018 – are expected to fall back to a fixed rate on permanent cessation of synthetic US dollar LIBOR. That is the opposite of the floating rate originally intended. Permanent cessation will also end alignment with the US, where legacy bonds will continue to reference a floating rate under the US LIBOR Act until maturity.

18 The FCA stated on 3 April that: "We intend that publication of the one, three and six-month synthetic US dollar LIBOR settings will cease on 30 September 2024. We will review our decision, in line with the requirements of the Benchmarks Regulation. However, unless unforeseen and material events were to happen, we expect to follow the direction and timelines we have indicated. We consider providing early notice of this is helpful for market participants. Firms must therefore continue to actively transition contracts that reference US dollar LIBOR."[16]

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14. ARRC LIBOR Legal Playbook, 11 July 2022.

15. FCA decision on synthetic US dollar LIBOR, 3 April 2023.

16. The FCA has also stated: "Under the BMR, we are required to review any compulsion decision before the end of the relevant compulsion period to assess whether an extension is necessary for an orderly wind-down." The FCA considers that "it is possible for cessation to be orderly even if not every contract has transitioned away or been equipped with a workable fallback, provided there is not sufficient scale of un-remediated contracts to post a threat either to market integrity or to an appropriate degree of protection for consumers.": CP 22/21 (3.17), November 2022.