The transition of legacy US dollar LIBOR bonds under English law

by **Paul Richards**

Summary

In preparing for the cessation of panel bank US dollar LIBOR on 30 June 2023, there is a strong case for providing synthetic US dollar LIBOR for legacy US dollar LIBOR bonds outstanding under English law, because there are many more than in sterling, where synthetic LIBOR has already been provided; and because this could ensure international alignment between the UK market and the US market for as long as synthetic US dollar LIBOR continues to be published. The synthetic US dollar LIBOR rate would need to be the same as, or as close as possible to, the rate expected under federal US legislation (ie term SOFR plus a credit adjustment spread). The provision of synthetic US dollar LIBOR under English law would avoid an outcome in which many US dollar LIBOR bonds under English law would fall back to a fixed rate on 30 June 2023 when outstanding US dollar LIBOR bonds under federal US legislation will continue to reference a floating rate. As with sterling, the provision of synthetic US dollar LIBOR under English law should help to minimise the risk of market disruption and litigation.

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.[1] Instead, the authorities have encouraged the market to adopt near risk-free reference rates, where the volume of underlying market transactions is greatest.[2] In all five LIBOR currencies, risk-free rates[3] have been adopted instead of LIBOR in new transactions, including in the bond market. In the case of US dollar LIBOR, restrictions were imposed on its use in new transactions from the end of 2021.[4]

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1. Global coordination has been overseen by the FSB Official Sector Steering Group, 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.

2. See also, Katie Kelly and Charlotte Bellamy, Transition from LIBOR in the Bond Market, ICMA Quarterly Report, Third Quarter 2022; and ICMA's response to the FCA consultation on Winding Down Synthetic Sterling LIBOR and US Dollar LIBOR, 1 August 2022. I am also grateful to both Katie Kelly and Charlotte Bellamy for their comments on an earlier draft of this assessment.

3. 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. Overnight risk-free rates compounded in arrears are referenced in the majority of new floating rate bond issues. Forward-looking term risk-free rates are also used in some financial instruments and are preferred by the authorities to credit-sensitive rates, which they consider run the same risks as LIBOR.

4. See the statement by the Federal Reserve Board and others, November 2020; the statement by IOSCO, June 2021 and the statement by the CFTC, July 2021.

2 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 settings, and some sterling, yen and US dollar settings; and there was a change in methodology in three sterling and three Japanese yen settings from panel bank to synthetic LIBOR for legacy transactions. The remaining three Japanese yen settings are due to cease at the end of 2022. The FCA announced on 29 September 2022 that one and six-month synthetic sterling settings will be retired at the end of March 2023, and is due to announce when to retire the three-month synthetic sterling setting.[5] The remaining five US dollar LIBOR settings – overnight, one month, three months, six months and 12 months – will continue for legacy transactions only until the end of June 2023, unless the FCA decides to compel the IBA, as the administrator for LIBOR, to change the methodology for calculating these settings from a panel bank basis and continue to publish them on a synthetic basis.

3 The scale of the transition 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) has estimated[6] that roughly $223 trillion of legacy US dollar LIBOR exposures were outstanding at the end of 2020, of which exposures of $74 trillion were estimated to mature after 30 June 2023, when panel bank US dollar LIBOR will cease. Over 90% of the $74 trillion relates to derivative products, which are either centrally cleared and covered by CCP rulebooks or are expected to be transitioned through adherence to the ISDA IBOR Fallbacks Protocol. Around $5 trillion of the remaining US dollar LIBOR exposures relate to cash products, including bonds.[7]

Lessons from the legacy sterling LIBOR bond transition

4 There are lessons from the legacy sterling LIBOR bond transition for the transition in US dollar LIBOR bonds under English law.[8] In the UK, the market has successfully transitioned a large proportion by value of outstanding legacy sterling LIBOR bonds – in the form of FRNs and securitisations – from LIBOR to compounded SONIA plus a credit adjustment spread. Active transition ahead of the permanent cessation of LIBOR has been encouraged by the UK authorities. But even so, active transition has been – and remains – a challenge. It has to take place bond by bond. The bond market cannot use a protocol in the same way that the derivatives market can use the ISDA IBOR Fallbacks Protocol. The normal route to transition in the bond market is by way of consent solicitation.[9] Alternatives, such as exchange offers and buy backs, have not been widely used. In many cases, consent solicitation *is* feasible under English law, as consent thresholds for investors are significantly lower than 100%. But consent solicitation takes time and can be costly, success is not guaranteed and, in some cases, may not be feasible at all.[10] So, although significant progress on transition was made before the end of 2021, it was not possible to complete the transition by the end of 2021, when panel bank sterling LIBOR ceased to be published.

5 At that point, if nothing had been done, most outstanding legacy sterling LIBOR bonds would have fallen back from a floating rate to a fixed rate.[11] There is a risk that this would have caused market disruption and litigation. So it was important that the UK authorities intervened by directing

5. FCA CP22/11: Winding Down Synthetic Sterling LIBOR and US Dollar LIBOR, 30 June 2022.

6. ARRC March 2021 Progress Report.

7. ARRC March 2021 Progress Report.

8. ICMA chairs the Bond Market Sub-Group in the UK, working with the FCA and the Bank of England. Earlier in 2022, the Bond Market Sub-Group's remit, which had previously been limited to the transition in sterling LIBOR bonds, was extended to include the transition in US dollar LIBOR bonds under English law.

9. In a consent solicitation, an issuer seeks agreement with noteholders to change the contractual terms of the bond, such as the interest rate provisions. Private placements are often less difficult to transition than public bonds.

10. These are sometimes referred to as "tough legacy" contracts, which have been defined by the FSB as "contracts that have no or inappropriate fallbacks, and [which] cannot realistically be renegotiated or amended.": FSB, Reforming Major Interest Rates Benchmarks, 20 November 2020.

11. For bonds governed by English law, fallback triggers generally 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 federal US legislation, the reference bank polling mechanism is disapplied for financial instruments in scope of the legislation.

the IBA to change the methodology for calculating legacy one-month, three-month and six-month sterling LIBOR contracts from panel bank LIBOR to synthetic LIBOR.[12] As synthetic sterling LIBOR consists of term SONIA plus a credit adjustment spread, it continues to provide a floating rate.[13] In addition, the UK Treasury introduced legislation to ensure continuity of contract in law between panel bank LIBOR and synthetic LIBOR.[14] It is important to note that active transition continued after it became clear that synthetic sterling LIBOR would be available; and that, this year, more active transition is still needed, where feasible, because the UK authorities have made it clear that synthetic LIBOR is a temporary and not a permanent solution.

Implications for the legacy US dollar bond transition under English law

6 The market's experience of the legacy sterling LIBOR transition has implications for transitioning legacy US dollar LIBOR bonds under English law. There are almost as many legacy US dollar LIBOR bonds under English law as under New York law by number, though the value under English law is much less. Market participants need to take stock of their back book and check their bond documentation, as documentation for legacy US dollar LIBOR bonds under English law and New York law is not the same:

- Legacy US dollar LIBOR bonds under English law should be able to follow the same process of active transition through consent solicitation as for legacy sterling LIBOR bonds, though active transition of some international legacy US dollar LIBOR bonds under English law is likely to be difficult, as US dollar LIBOR bonds tend to be more widely held around the world, given the US dollar's international role. Where active transition is feasible, the focus should be on transitioning bonds, including securitisations, with fallbacks to a fixed rate at permanent cessation of LIBOR (Type 1) rather than bonds which already have a robust floating rate fallback at permanent cessation (Type 2) or bonds which also have a robust floating rate fallback triggered at pre-cessation if and when LIBOR is declared or becomes unrepresentative (Type 3 or ARRC-recommended fallbacks).
- By contrast to English law, where active transition is feasible in many cases, active transition is not generally feasible for LIBOR bonds governed by US law, as their consent thresholds are commonly 100%.[15] And federal US legislation has been introduced to enable many outstanding legacy US dollar LIBOR bonds at 30 June 2023 to continue to reference a floating rate, such as term SOFR plus a credit adjustment spread.[16]

7 That leaves the question of whether the UK authorities should follow the US, though by a different route under English law, by changing the methodology for panel bank US dollar LIBOR to synthetic US dollar LIBOR for legacy contracts (in other words, term SOFR plus a credit adjustment spread). There is a strong case for providing synthetic US dollar LIBOR for all legacy US dollar LIBOR bonds outstanding at 30 June 2023, for two main reasons.

8 The first is that there are many more legacy US dollar LIBOR bonds under English law than in sterling, where synthetic LIBOR has already been provided. Even though the cessation of panel bank US dollar LIBOR is at a later date than sterling, it will not be feasible to complete the transition of US dollar bonds under English law by 30 June 2023, just as it was not feasible in the case of sterling LIBOR. Many legacy US dollar LIBOR bonds are likely to be difficult to transition, where they are widely held by different types of investors, including retail investors, in jurisdictions where awareness of LIBOR transition may be limited, and with less impetus for investors to engage with the process. There may also be other difficulties to overcome (eg in the case of securitisations).

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12. The FCA has stated that synthetic LIBOR settings "will no longer be representative of the underlying market and economic reality the setting is intended to measure.": FCA Announcement on Future Cessation and Loss of Representativeness of the LIBOR Benchmarks, 5 March 2021.

13. A similar approach was taken in relation to yen LIBOR. The FCA directed IBA to calculate the one-month, three-month and six-month yen settings using TORF plus a credit adjustment spread.

14. The Critical Benchmarks (References and Administrators' Liability) Act 2021.

15. ARRC: "In cash markets, the ARRC recognizes that because debt and securitization instruments issued under US law typically require unanimous consent of all holders to amend, they are difficult to remediate. These securities often fall back to the last published value of LIBOR and would be covered under the LIBOR Act, also making remediation a less pressing issue.": LIBOR Legacy Playbook, 11 July 2022.

16. "The purposes of the Adjustable Interest Rate (LIBOR) Act are to establish a clear and uniform process, on a nationwide basis, for replacing the overnight and one, three, six and 12-month tenors of US dollar LIBOR in existing contracts that do not provide for the use of clearly defined or practicable replacement benchmark rate; to preclude litigation related to such existing contracts; to allow existing contracts that reference LIBOR but provide for the use of a clearly defined and practicable replacement rate to operate according to their terms; and to address LIBOR references in Federal law. [The Act does not affect the ability of parties to use any appropriate benchmark rate in new contracts.] The Federal Reserve Board is proposing a regulation which implements the statute by defining terms used in the statute and establishing Board-selected benchmark replacements for LIBOR contracts.": Draft Federal Reserve Board Regulation Implementing the Adjustable Interest Rate (LIBOR) Act, July 2022.

9 The second reason is that synthetic US dollar LIBOR – with permission for its use in all legacy US dollar LIBOR bonds – could ensure international alignment between the UK market and the US market for as long as synthetic US dollar LIBOR continues to be published, giving more time for active transition of legacy US dollar LIBOR bonds governed by English law with Type 1 fallbacks, where this is feasible, and more time for bonds to mature, where it is not. The synthetic US dollar LIBOR rate would need to be the same as, or as close as possible to, the rate expected under federal US legislation (ie term SOFR plus a credit adjustment spread). The provision of synthetic US dollar LIBOR under English law would avoid an outcome in which many US dollar LIBOR bonds under English law would fall back to a fixed rate on 30 June 2023 when many US dollar LIBOR bonds under US law would continue under federal US legislation to reference a floating rate. As with sterling, the provision of synthetic US dollar LIBOR under English law should help to minimise the risk of market disruption and litigation.

Differences in legislative approach to the transition from LIBOR

10 The legislation introduced in the US (under the LIBOR Act), the UK (under the UK Benchmarks Regulation) and the EU (under the EU Benchmarks Regulation) has the common objective of supporting an orderly wind-down of LIBOR. But the legislative route to achieving an orderly wind-down is not the same. The US approach involves contractual override, as a result of which references to US dollar LIBOR in legacy contracts outstanding at 30 June 2023 are replaced by references to a SOFR-based rate (eg term SOFR) plus a credit adjustment spread.

11 The UK approach involves keeping LIBOR for legacy contracts but changing its methodology from panel bank LIBOR to synthetic LIBOR, which would consist of a term risk-free rate (ie SOFR for US dollars) plus a credit adjustment spread for up to ten years, subject to annual review. The UK approach could produce the same result as the US approach for as long as synthetic LIBOR continues to be published, but synthetic LIBOR needs to appear on the same screen as panel bank LIBOR. It is important to avoid any market confusion between the permanent cessation of US dollar LIBOR under federal US legislation on 30 June 2023 and the continuation of synthetic LIBOR for legacy contracts under English law, if the UK authorities follow the same approach for US dollar LIBOR as they have followed for sterling LIBOR.

12 For contracts that are subject to the laws of one of the EU Member States, the European Commission may choose to designate one or more replacements for LIBOR in the event that LIBOR ceases publication or is found to be no longer representative. These replacement rates would only apply to contracts or financial instruments that do not have fallback provisions or that have fallback provisions that are considered to be not sufficiently robust.[17]

13 Most other jurisdictions have so far not passed specific legislation relating to the transition from LIBOR. The ARRC has noted that, if a LIBOR contract does not have a pre-cessation trigger, then it may continue to reference LIBOR if LIBOR continues to be published using a synthetic methodology under the FCA's powers of compulsion.[18]

US dollar LIBOR ICE Swap Rate

14 Some legacy bonds – including capital instruments – contain references to US dollar LIBOR-based benchmarks, such as the US dollar LIBOR ICE Swap Rate, rather than LIBOR itself. The ARRC has noted that legacy bonds referencing the US dollar LIBOR ICE Swap Rate are not covered by US federal LIBOR legislation and has published a recommended fallback formula for these rates that can be considered for use in determining the successor rate after US dollar LIBOR ends. 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.[19]

Next steps

15 A decision has yet to be taken by the UK authorities on whether to compel the IBA to publish synthetic US dollar LIBOR when panel bank US dollar LIBOR ceases on 30 June 2023. But the FCA consultation on whether to retire one and six-month synthetic sterling LIBOR at the end of March 2023, and on when to retire three-month synthetic sterling LIBOR, has also raised the question of whether synthetic US dollar LIBOR is needed for certain contracts that are not within scope of LIBOR-related federal US legislation.[20]

16 If a decision were to be taken to require publication of any synthetic form of US dollar LIBOR, the FCA has indicated in its consultation that:

- it would expect that any synthetic US dollar LIBOR would follow a similar model to sterling and yen LIBOR: the model the FCA chose for synthetic sterling LIBOR was IBA's term

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17. ARRC LIBOR Legacy Playbook, 11 July 2022. The European Commission may also exercise the powers described above in respect of contracts governed by a non-EU law that does not provide for the orderly wind-down of a benchmark and where all the parties to the contract are established in the EU.

18. ARRC LIBOR Legacy Playbook, 11 July 2022.

19. ARRC LIBOR Legacy Playbook, 11 July 2022.

20. FCA CP 22/11: Winding Down Synthetic Sterling LIBOR and US Dollar LIBOR, 30 June 2022.

SONIA reference rates, plus the respective ISDA fixed spread adjustment;

- the FCA would take into account whether market support had already been established, through public or private sector-led working groups and/or open consultation, on a fair way of calculating a replacement value for the relevant benchmark;
- the ARRC has formally recommended CME's term SOFR rates as an alternative reference rate for US dollar LIBOR in certain cases where such use is in line with its best practice recommendations;
- a model using the ARRC's recommended term SOFR rates would depend on CME's term SOFR rates being available to IBA for use in a synthetic rate under an agreement acceptable to both parties, as in the case of synthetic yen LIBOR (where QUICK Benchmarks Inc has made its TORF rates available to IBA).

17 In its consultation, the FCA stated: "market participants should not rely on any synthetic US dollar LIBOR settings being published, nor on any such rate being available for use in all legacy contracts. The FCA would have to specify which legacy contracts are permitted to use any synthetic US dollar, in line with its policy framework."

18 In its response to the FCA consultation, ICMA argued that synthetic US dollar LIBOR is needed in the bond market for all outstanding legacy US dollar LIBOR bonds governed by English and other non-US laws, for the reasons set out in this assessment.[21] The FCA is assessing feedback to its consultation and is due to respond later in the autumn.

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21. ICMA response to FCA consultation paper CP22/11 on Winding Down Synthetic Sterling LIBOR and US Dollar LIBOR, August 2022.