Synthetic US dollar LIBOR: the remaining task in the bond market

by **Paul Richards**

Summary

Panel bank US dollar LIBOR ceased publication in all five remaining settings – overnight, one month, three months, six months and twelve months – on 30 June 2023, as planned. As regulator of LIBOR, the FCA determined that, from that date, the composition of US dollar LIBOR should change from panel bank to synthetic US dollar LIBOR for all legacy contracts in one, three and six-month settings until a deadline of 30 September 2024.

This Quarterly Assessment reviews the remaining task in the bond market to complete preparations in time for the FCA's proposed deadline. The assessment should be read in conjunction with the ICMA podcast on *The Transition from Legacy US Dollar LIBOR in the Bond Market*, which was recorded by ICMA with four leading law firms – Allen & Overy, Clifford Chance, Freshfields and Linklaters – on 17 July 2023.[1]

The assessment is set out in six main sections: the background; the task of transitioning the legacy US dollar LIBOR bond market under English law; the relationship between the US LIBOR Act, English law and other foreign laws; the methodology for synthetic US dollar LIBOR, based on the sterling model; the rationale for synthetic US dollar LIBOR in the legacy bond market; and the FCA's proposed cessation date of 30 September 2024. The concluding section provides a reminder of the key steps in the long journey away from LIBOR in the bond market from start to completion.

The background

1 For some time, the authorities globally have 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 rates.[2]

2 As the US dollar risk-free rate, the authorities have encouraged the market to adopt the secured overnight funding rate (SOFR) in new US dollar financial contracts:[3]

- Overnight risk-free rates compounded in arrears are the most robust rates, which can be measured by the volume of overnight transactions, and which do not depend on any use of expert judgment.

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1. This Quarterly Assessment and the ICMA podcast do not represent legal advice.

2. Global coordination has been overseen by the FSB Official Sector Steering Group, which is chaired by John Williams, President and CEO 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.

3. The use of US dollar LIBOR in new financial contracts was effectively prohibited by the authorities, with very limited exceptions, at the end of 2021. In the other four LIBOR currencies, the risk-free rates are SONIA in sterling, €STR in euro, SARON in Swiss francs and TONA in Japanese yen.

- Forward-looking term rates are also used in limited cases (eg to provide certainty for calculating interest payments in advance for some products).[4] The authorities have warned against over-reliance on RFR-based term rates outside of these limited cases to avoid undermining the robustness of these rates.
- The authorities have also been critical of the use of credit sensitive rates, on the grounds that they recreate the same risks as LIBOR.
- They have encouraged all market participants to learn from the experience of LIBOR transition and to adopt robust fallbacks in all new contracts.[5]

In their joint article on 17 August 2023 on the lessons learned from the US$400 trillion LIBOR transition, the Federal Reserve Bank of New York and the FCA stated that "transitioning away from LIBOR has been one of the largest financial transformation projects we have seen and an undertaking we do not wish to repeat."[6]

3 In the run-up to the cessation of panel bank US dollar LIBOR on 30 June 2023, many legacy US dollar LIBOR contracts maturing beyond 30 June were converted to SOFR. The vast majority of legacy US dollar LIBOR contracts outstanding (over 90% by notional value) related to derivatives. Cleared derivatives were converted through a series of conversion weekends organised by LCH, Eurex and CME; and other derivatives were converted through the ISDA IBOR Fallbacks Protocol.[7]

The task of transitioning legacy US dollar LIBOR bonds under English law

4 Following the cessation of panel bank US dollar LIBOR on 30 June 2023, the remaining task in the bond market is to complete preparations in time for the FCA's proposed deadline of 30 September 2024 for the cessation of synthetic US dollar LIBOR. Transition away from LIBOR to SOFR is a key element in the preparations. But whereas derivatives can be transitioned *en bloc*, legacy US dollar LIBOR bonds under English law can only be transitioned to SOFR by agreement between issuers and investors, bond by bond, normally through consent solicitation.

Consent solicitation

5 In a consent solicitation, the issuer seeks the agreement of bondholders by a vote to vary the contractual terms of the bonds, in this case by consenting to a proposed change in the interest rate from LIBOR to a risk-free rate. Under English law, the quorum required for a meeting to vote on this change is typically 66% to 75% of which, typically, 75% need to vote in favour of the resolution amending the contractual terms of the bonds. If the quorum is not reached, the initial meeting can be adjourned for a subsequent vote at a later date where a lower quorum will usually apply. So the process of consent solicitation takes time and a successful outcome is not guaranteed.

FRN fallbacks

6 Legacy US dollar LIBOR interest rate fallbacks on FRN contracts under English law tend to fall into three main categories. These categories are for convenience only and do not describe every case. The specific provisions in each contract need to be checked case by case:

- *Type 1* fallbacks were drafted before the permanent cessation of LIBOR was contemplated. They are intended to take account of temporary cessation only, and they are triggered on the non-availability of the rate on a screen on the relevant interest determination date. On permanent cessation, the final fallback is typically to the rate which applied to the previous interest period, and which would then apply for the remaining life of the bond. As a result, the floating rate on the bond becomes a fixed rate until maturity.
- *Type 2* fallbacks were drafted more recently and were designed to take account of the permanent cessation of LIBOR. They are triggered on permanent cessation. Once triggered, they require the issuer or the issuer's appointee to determine the applicable rate and adjustment spread on the basis set out in the contract (eg a statement by a nominating body or the prevailing approach in the market). The determination is likely to result in a floating rate based on the relevant risk-free rate.
- *Type 3* fallbacks are similar to Type 2 fallbacks, but include a pre-cessation trigger, with the effect that the fallback is triggered when the benchmark is no longer representative.

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4. Term rates are based on futures and other derivatives that reference the risk-free rates, rather than directly referencing the risk-free rates themselves.

5. In connection with use of term rates and credit sensitive rates, see, for example, the IOSCO statement on 3 July 2023 on *Alternatives to US Dollar LIBOR* and the FSB statement on *Final Reflections on the LIBOR Transition* on 28 July 2023.

6. John Williams, President and CEO of the Federal Reserve Bank of New York, and Nikhil Rathi, Chief Executive of the FCA: *Innovating for the Future, Heeding Lessons from the Past:* The Teller Window, 17 August 2023.

7. See statements by the FCA and the Bank of England, *Are You Ready?* 12 April 2023, followed by the *Joint Statement on Completing the LIBOR Transition,* 26 April 2023, by the Federal Reserve System and other US agencies; and the Financial Stability Board *Statement to Encourage Final Preparations for the US Dollar LIBOR Transition,* 27 April 2023.

Securitisations

7 In the traditional RMBS/ABS securitisation market under English law, Type 1 fallbacks work in much the same way as FRNs, though there can be some additional complications. A change in the interest rate could affect the cashflows generally in the structure. So where there are multiple tranches or classes of bonds, the terms of the bonds may require the issuer to obtain the consent of all classes of bonds, including classes which reference a different benchmark. It may be challenging to engage those bondholders who do not appear to be directly affected by the proposed change to the benchmark relating to another class of bonds in the structure.

8 Type 2 and 3 fallbacks are not common in the securitisation market. Instead, once the permanent cessation of LIBOR was contemplated, "negative consent" language for amending the benchmark rate began in some cases to be included alongside a standard Type 1 fallback. Where provision is made for negative consent, a full consent solicitation to modify the benchmark rate is not required so long as certain conditions are satisfied. The issuer has to notify bondholders that its proposed change will go ahead so long as the trustee does not receive objections from 10% or more of the bondholders within a prescribed period. If 10% or more do object, then a full consent solicitation (as with FRNs) is required.

Operational issues

9 In the case of Type 1 fallbacks, the use of dealer polls – under which reference banks provide quotations from which a fallback rate can be calculated – were designed for temporary rather than the permanent cessation of LIBOR. As a result, they are often not drafted with the degree of completeness needed to operate them at a practical level. It is understood that the FCA has encouraged banks to put policies and mechanics in place to ensure that Type 1 fallbacks operate smoothly.

10 In the case of Type 2 and 3 fallbacks, account needs to be taken of any operational issues arising as a result of the change from a forward-looking rate determination process (for LIBOR) to a backward-looking process for the new risk-free rate. In particular, agents need to be confident that the relevant provisions can be operated in practice, and that there is sufficient time to reconcile calculations. Care also needs to be taken to avoid a potential mismatch between bonds and related swap transactions.

The relationship between the US LIBOR Act, English law and other foreign laws

11 While the authorities have a shared objective in common to end the market's dependence on US dollar LIBOR as soon as practicable, the approach to achieving this objective taken in the US and the approach taken by the FCA as regulator of LIBOR outside the US are not the same.

12 US dollar LIBOR bonds governed by US law are difficult to transition by way of consent solicitation because they typically require unanimous consent from bondholders to amend the terms and conditions. US federal legislation was enacted in March 2022 ("the US LIBOR Act") to provide a "contract override" for legacy contracts governed by US law that reference US dollar LIBOR and contain no, or unworkable, fallbacks in overnight, one, three, six and twelve-month US dollar LIBOR settings. In the case of these contracts, references to US dollar LIBOR are replaced permanently with the benchmark replacement rate selected by the US Federal Reserve Board under a Final Rule. The US LIBOR Act is not subject to a time limit.

13 The Final Rule became effective on 27 February 2023 and sets out replacement rates for different categories of LIBOR contracts governed by US law. In the case of FRNs, the replacement rate is the same as synthetic US dollar LIBOR. The US LIBOR Act provides a "safe harbour" against liability for contracts which move by operation of law to the statutory replacement rate. The safe harbour also covers conforming changes to the terms of the LIBOR contract under the US LIBOR Act.[8]

14 Outside the US, the FCA as regulator of LIBOR announced on 3 April 2023 that it had instructed the IBA as the administrator of LIBOR to publish synthetic US dollar LIBOR in one, three and six-month settings on a non-representative basis as a temporary bridge for a short period from the cessation of panel bank US dollar LIBOR on 30 June 2023 until 30 September 2024 for all outstanding legacy contracts (except cleared derivatives, which have already been converted).[9] This involves a change in the composition of US dollar LIBOR for legacy contracts instead of "contract override".

15 In the case of other foreign laws, and in the absence of a trigger event based on the unrepresentativeness of US dollar LIBOR, a reference to US dollar LIBOR in any contract typically means synthetic US dollar LIBOR, subject to the application of any statutory override such as the US LIBOR Act. In the case

8. The US LIBOR Act does not apply where a contract has clearly defined and workable fallbacks providing for a replacement rate: eg the rate recommended by the US Alternative Reference Rates Committee (ARRC) or a rate selected by a determining person, who can select the Board's replacement rate, bringing the contract within the scope of the Act, including its safe harbour. Where a rate has not been selected by a determining person by 30 June 2023, the statutory replacement rate under the US LIBOR Act also applies.

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

of the EU, it is understood that the European Commission does not intend to use the statutory replacement power under the EU Benchmarks Regulation in view of the decision of the FCA to compel the publication of synthetic US dollar LIBOR settings until 30 September 2024.

The methodology for synthetic US dollar LIBOR

16 Synthetic US dollar LIBOR has the following characteristics:

- *International consistency:* The synthetic rate is aligned with the US rate proposed by the Federal Reserve under the US LIBOR Act for as long as synthetic LIBOR is published: CME term SOFR plus a fixed ISDA adjustment spread. In its Feedback Statement in May 2023, the FCA stated that "we agree with respondents on the importance of maintaining international consistency to avoid market fragmentation or unwanted risk."[10]
- *Continuity of contract:* There is continuity of contract under English law by way of the Critical Benchmarks Act between the panel bank rate and the synthetic rate.
- *Similar structure:* The CME term SOFR reference rate has been chosen as it has a similar forward-looking structure to panel bank LIBOR. This minimises the need for consequential changes (including in systems) to ensure contracts can continue to operate after the end of the LIBOR panel.
- *The same screen:* The FCA has also received confirmation from Bloomberg and Refinitiv that the three US dollar LIBOR settings will continue to be available on the same screens in synthetic form as in panel bank form, as required in many bond contracts.

17 The FCA has stated that synthetic US dollar LIBOR is unrepresentative, and its use is prohibited under the UK Benchmarks Regulation unless expressly permitted. Use has been permitted for all one, three and six-month legacy US dollar LIBOR contracts other than cleared derivatives until 30 September 2024.

18 The provisions of the UK Benchmarks Regulation, as amended by the Critical Benchmarks Act, empower the FCA to direct the publication of synthetic LIBOR and support contractual continuity for legacy contracts under English law. They are benchmark and currency agnostic and so are intended to apply to US dollar LIBOR in the same way as for sterling and yen LIBOR. However, they apply only to contracts under English law.

Synthetic sterling LIBOR

The model for synthetic US dollar LIBOR is similar to the model already adopted by the FCA for synthetic sterling LIBOR.[11] Following the cessation of panel bank sterling LIBOR at the end of 2021, outstanding legacy LIBOR contracts, including bonds, in one, three and six-month settings, referenced synthetic sterling LIBOR until the end of March 2023 in the case of one and six-month settings. In the case of the three-month setting, synthetic sterling LIBOR will continue until 28 March 2024. The Critical Benchmarks Act introduced by HM Treasury in 2021 has provided continuity of contract between panel bank sterling LIBOR and synthetic sterling LIBOR under English law.

It is important to note that, whereas the bulk of the transition in legacy sterling LIBOR bonds to SONIA took place against a background of historically very low short-term interest rates, the transition in legacy US dollar LIBOR bonds in prospect is due to take place against a background of much higher short-term interest rates.

The rationale for synthetic US dollar LIBOR in the legacy bond market

19 As consent thresholds for agreement to changes in bond conditions by investors under English law are commonly significantly less than 100%, unlike US law, active transition under English law should be feasible (eg through consent solicitation) in many cases, though the process takes time and success is not guaranteed.

20 The rationale for synthetic US dollar LIBOR in the legacy bond market is that it provides more time for legacy US dollar LIBOR bonds to mature, and that the FCA's deadline of 30 September 2024 should encourage the active transition of legacy bonds in the meantime, where feasible. As most FRNs pay interest every three months, the first interest payment due after 30 September 2024 in those cases can be expected to be made by the end of December 2024.

21 There are still a large number of legacy US dollar LIBOR bonds with maturities beyond 30 September 2024 outstanding under English law and other non-US laws. The active transition of some of these (eg private placements) should be relatively straightforward. In the case of the remainder (eg public issues):

10. FCA Feedback Statement (FS23/2) on CP22/21 and Announcement, 31 May 2023.

11. In other LIBOR currencies, panel bank euro and Swiss franc LIBOR ceased permanently at the end of 2021. In the case of Japanese yen, panel bank LIBOR also ceased at the end of 2021, but synthetic yen LIBOR succeeded panel bank LIBOR until the end of 2022.

- the focus of active transition should be on legacy LIBOR bonds with problematic fallbacks: in particular, bonds with Type 1 fallbacks which fall back – on permanent cessation of synthetic US dollar LIBOR – from a floating rate to a fixed rate (ie the last available LIBOR rate) for the remaining life of the bond, which was not the original intention when the bonds were issued;
- legacy LIBOR bonds with Type 2 fallbacks should in many cases, under the terms of their contracts, fall back on permanent cessation to a floating rate; and
- legacy LIBOR bonds with Type 3 fallbacks (which like bonds with Type 2 fallbacks are expected to fall back to a floating rate) should already have been triggered at pre-cessation, when LIBOR was declared unrepresentative by the FCA (ie in response to the cessation of panel bank LIBOR on 30 June).

22 In each case, the terms of the contract need to be checked. This should help determine whether active transition is needed (eg through a consent solicitation). The terms may also provide an opportunity for issuers with call options to redeem their bonds.

The proposed cessation of synthetic US dollar LIBOR on 30 September 2024

23 In commenting on the cessation of synthetic US dollar LIBOR, the FCA stated on 3 April 2023 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."[12]

24 The reasons for the FCA's decision are set out in its Feedback Statement on 31 May 2023 (FS23/2 on CP22/21):

- "Our current assessment that end-September 2024 provides sufficient time for cessation to be orderly is based on the information available to us, including information provided by firms in consultation responses and other engagement with us. We consider the evidence base for our assessment to be robust. Therefore, unless unforeseen and material events were to occur which significantly change the information and circumstances on which our assessment was based, we expect that our reviews will come to the same conclusion as our initial assessment. We therefore expect to follow the timeline we have indicated." (2.17)
- "We consider 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 pose a threat either to market integrity or to an appropriate degree of protection for consumers. Based on evidence currently available to us, we do not believe this will be the case at end-September 2024." (2.18)
- "We have not identified any single issuer with such a large volume of non-US law governed bond exposures that we consider it to be impossible for them to attempt consent solicitations on all such bonds within the extra time provided. This assessment is based on the estimates that have been provided to us by industry of the typical time required for this process. We do not agree that every exposure needs to transition in order for cessation to be orderly." (2.21)
- "Where consent solicitations are attempted but fail, parties are choosing to remain linked to a ceasing benchmark, and we expect that they have considered the implications of doing so, as we have been clear about the temporary nature of any synthetic rate from the outset." (2.21).

25 It is also understood that bank supervisors are monitoring bank exposure to legacy US dollar LIBOR and can be expected to question banks on the steps they are taking to reduce their exposure in time, where necessary.

Conclusion

26 The transition from LIBOR to risk-free rates in the US dollar LIBOR bond market under English law, as in the case of the sterling LIBOR bond market, has required five key steps during the long journey from start to completion:

- first, making sure that new issues, which at that stage were still referencing LIBOR, would fall back to a risk-free rate rather than a fixed rate;
- second, encouraging the development of the new issue market referencing risk-free rates instead of LIBOR;
- third, on the cessation of panel bank LIBOR, providing synthetic LIBOR for a period in order to give more time for legacy LIBOR bonds to mature and for active transition from LIBOR to risk-free rates;
- fourth, introducing the Critical Benchmarks Act to provide continuity of contract between panel bank LIBOR and synthetic LIBOR under English law; and
- fifth, completing preparations in the bond market in time for the permanent cessation of synthetic LIBOR. This is the final task in the bond market under English law·

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12. FCA statement announcing its decision on synthetic US dollar LIBOR, 3 April 2023.