The end of LIBOR and the transition to risk-free rates

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Part 1:

The need for Risk-Free Rates

The problem with LIBOR

- LIBOR - based on submissions of inter-bank lending from a panel of banks
- Limited activity in the interbank lending market led to rate subjectivity and manipulation
- Regulatory authorities globally share consistent messaging:
    - move away from LIBOR
    - do not issue new bonds linked to LIBOR
    - actively transition any instruments that link to LIBOR and will mature after relevant cessation dates

The currency working groups

Sterling market:

Sterling Risk-Free Reference Rates WG (£RFRWG)

£RFRWG recommended SONIA (Sterling Overnight Index Average) - based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions

USD market:

Alternative Reference Rates Committee (ARRC)

ARRC recommended SOFR (Secured Overnight Financing Rate) - a broad measure of the cost of borrowing cash overnight collateralised by U.S. Treasury securities in the repo market

JPY market:

Cross Industry Committee on Japanese Yen Interest Rate Benchmarks

CIC JPY recommended TONA (Tokyo Overnight Average Rate) - a transaction-based uncollateralised overnight call rate

Euro area:

Working Group on Euro Risk-Free Rates

EURIBOR not ceasing

€STR – based on money market statistical reporting of the Eurosystem

ICMA's involvement

- Sterling Risk-Free Reference Rates Working Group
    - Bond Market Sub-Group
    - Communications & Outreach
- Working Group on Euro Risk-Free Rates
- National Working Group on Swiss Franc Reference Rates
- ARRC, LMA and ISDA

Part 2:

The relevant timings for the cessation of LIBOR

Timings for LIBOR cessation

<u>31 December 2021:</u>
Cessation of

- all 7 euro LIBOR settings
- all 7 Swiss franc LIBOR settings
- the Spot Next, 1 week, 2 month and 12 month JPY LIBOR settings
- the overnight, 1 week, 2 month, and 12 month GBP LIBOR settings
- the 1 week and 2 month USD LIBOR settings.

<u>30 June 2023:</u>
Cessation of

- overnight and 12-month USD LIBOR settings.

That leaves 9 remaining LIBOR settings – 1 month, 3 month and 6 month settings in GBP, USD and JPY.

Part 3:

The Risk-Free Rates, how they behave and progress with their adoption

The risk-free rates (RFRs), and how they differ to LIBOR

Two key differences between LIBOR and RFRs

Term:

LIBOR is a ***forward-looking*** or ‘***term***’ rate quoted for five currencies and seven tenors

LIBOR-linked interest rate payable is ***known at the start of the relevant interest period***

Alternative RFRs are ***overnight rates***. Determination of a periodic rate requires different mechanics

Credit:

LIBOR - an average rate representative of the rates at which large, leading internationally active banks with access to the wholesale, unsecured funding market could fund themselves in such a market

LIBOR therefore ***incorporates a bank credit risk element***, which is ***not observable in the alternative RFRs***

RFRs in practice: using RFRs to construct a periodic payment

Compounded in arrears:

- Observe SONIA on a daily basis over a period corresponding to an interest period, and compound it over that period
- used in all the SONIA-linked bonds and securitisations issued in the GBP market
- aligns with SONIA swap market, the fallback rate for derivatives in the ISDA Fallbacks Protocol and ISDA Fallbacks Supplement

Compounded in advance:

- Observe SONIA on a daily basis over a period corresponding to a previous interest period, compounding it over that period and applying it to the next following interest period
- used in some SOFR-linked bonds in the USD market

RFRs in practice - conventions

SONIA market:

- Reference SONIA compounded in arrears over an interest period, with a margin added, and a “lag” in respect of each interest period
- The SONIA rate used to calculate a rate for each day in an interest period is based on the SONIA rate for a prior day (typically, five days prior)
- “Lag” - weights the SONIA rate according to the number of days that apply in the interest period
- A “shift” approach - weights the SONIA rate according to the number of days that apply in the observation period
- Issuers can issue using either the “lag” approach or the “shift” approach

RFRs in practice – conventions contd.

SOFR market:

- Reference SOFR compounded in arrears over an interest period, with a margin added, and a “lag” in respect of each interest period
- Reference SOFR compounded in arrears over an interest period, with a margin added, and a “shift” in respect of each interest period
- Use “lockout” mechanism - one of the daily SOFR rates is “suspended” and repeated for several days
- Use “payment delay” mechanism - payment dates may be delayed for several days after an interest period concludes

RFRs in practice – Indices

- Federal Reserve Bank of New York - SOFR compounded index and SOFR averages
- Bank of England and IBA publish a daily SONIA compound index
- Others under development: €STR, TONA, TLREF, CORRA, SORA
- Use of the Federal Reserve and the Bank of England indices are compatible with the ‘shift’ mechanism

RFRs in practice – Term rates

SONIA:

SONIA term rates have been developed

Limited number of use cases

Part of legislative solution for legacy LIBOR bonds

SOFR:

SOFR term rates have been recommended

Limited number of use cases

Part of USD Fallback for LIBOR-linked bonds

Elsewhere:

Tokyo Term Risk Free Rate (TORF) and €STR term rates under development

RFRs in practice – Credit Sensitive Rates (CSRs)

- CSRs - interest rate benchmarks that seek to measure the credit risk component of unsecured borrowing in certain markets (which RFRs do not contain)
- CSRs have started to emerge as a possible alternative to USD LIBOR
- BSBY, AMERIBOR and others
- Might not be compliant with the IOSCO Principles on Financial Benchmarks
- Concern that some of LIBOR’s shortcomings may be replicated through the use of credit sensitive rates that lack sufficient underlying transaction volumes

New LIBOR issuances - fallbacks

If LIBOR-linked issuance is unavoidable, use robust fallbacks to RFRs

Sterling market:

End of Q1 2021 - no new LIBOR-referencing contracts

USD market:

Still some USD transactions linked to USD LIBOR, although diminishing

ARRC published recommended fallback language in April 2019

First step of the waterfall is Term SOFR

Asia-Pacific:

Issuance of new LIBOR-linked bonds throughout 2019, 2020, and 2021

Some with no fallbacks at all

Part 4:

Legacy transactions, and associated challenges

Legacy bonds – what is legacy/tough legacy?

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Legacy bonds:

Bonds linked to LIBOR in any currency, already in issue, not due to mature before the end of LIBOR in the relevant currency

“Tough legacy” bonds:

Legacy bonds which have *“contracts that have no or inappropriate fallbacks, and [which] cannot realistically be renegotiated or amended”*

Legacy bonds - Types of fallbacks

“Type 1” fallbacks:
Non-availability of LIBOR - fall back to the rate in effect for the last preceding interest period, changing the bonds into fixed rate bonds for life

“Type 2” fallbacks:
On permanent cessation of LIBOR or certain other trigger events, issuer appoints an independent adviser to select a successor rate and adjustment spread on the basis of (a) any recommendations made by relevant nominating bodies or (b) if none, customary market practice

“Type 3” fallbacks:
Same as Type 2 with additional “non-representativeness” of LIBOR trigger

- Type 1 fallbacks are probably tough legacy, unless they can *realistically be renegotiated or amended*

- For Type 2 and Type 3 fallbacks - ***recommended successor rate*** and a ***recommended credit adjustment spread***

Consent solicitation for legacy bonds

- A bond is a contract between an issuer and bondholders
- Consent solicitation – an issuer can propose certain amendments to a bond, and if the quorum and/or consent thresholds are reached, the bonds are amended
- **GBP market, English law:**
  A quorum of two-thirds or 75% of holders, of which 75% have to vote in favour of the extraordinary resolution
- 70+ GBP LIBOR-linked legacy bonds successfully transitioned from GBP LIBOR to overnight SONIA, compounded in arrears. Some consent solicitations have not been successful
- **USD market, New York law:**
  Consent of 100% of holders required. Uncommon and relatively impractical
- **Japanese law:**
  Bondholders' meetings possible, but rarely take place in Japan

Challenges with consent solicitation

- Quorum and voting thresholds can be difficult to achieve
- Large volumes of consent solicitations taking place at the same time
- Takes time, and no guarantee of success
- Cost
- Inefficiencies in the consent solicitation process
- Transaction-specific challenges
- Different elements of securitisations & ratings

Legislative proposals

- **UK:**
  Financial Services Act - empowers the FCA to direct the administrator of GBP and JPY LIBOR to use "synthetic LIBOR" for up to 10 years

- Synthetic LIBOR will be term SONIA plus a fixed credit adjustment spread

- Not yet clear who can use it, or which securities are in-scope

- **US:**
  Statutory override – for USD LIBOR, read SOFR, and a safe harbour from litigation for the use of the recommended benchmark replacement

- **JPY LIBOR:**
  A synthetic version of JPY LIBOR for one additional year. To cease permanently on 30 December 2022

- **EU:**
  Similar to US, statutory override

Interplay of bonds and derivatives

- ISDA Protocol implements
  - **ISDA fallback consultation** - SONIA compounded in arrears
  - **ISDA credit adjustment spread consultation** - historical median over a 5 year lookback period
- Transitioned bonds – overnight SONIA, compounded in arrears ensures no hedge mismatch
- Bonds using synthetic LIBOR – possible hedge mismatch unless specifically excluded from the Protocol

Questions?

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