ICMA
International Capital Market Association

Benchmark reform and the future of LIBOR: implications for the primary bond markets

By Catherine Wade

Summary

Regulatory reform relating to benchmarks has been ongoing for many years but the speech delivered by Andrew Bailey, the Chief Executive of the UK's Financial Conduct Authority (the FCA), on the *Future of LIBOR* on 27 July 2017 triggered increased focus from market participants.

The UK FCA have set a deadline of the end of 2021 after which it will no longer persuade or compel banks to submit data for LIBOR. Alongside this, from 1 January 2018, the European Benchmark Regulation (the BMR) will require certain entities to include robust fall-back plans in contractual documentation, dealing with the demise of an in-scope benchmark.

Here we focus on the impact of regulatory reform and the potential demise of LIBOR (in particular) on the primary bond markets.

Background

The key takeaway from Andrew Bailey's statement is that the FCA, as regulator of LIBOR, will not use its influence or legal powers to persuade or compel the panel banks that submit contributions to the benchmark to make submissions after 2021.

The speech made it clear that market participants will need to (i) develop alternative benchmark rates, and (ii) ensure that there are sufficiently robust fall-back arrangements for contracts entered into now that extend beyond 2021 (when it may well be that LIBOR will cease to exist in its current form).

Data submitted by panel banks for LIBOR is increasingly based upon expert judgment rather than actual transaction data because of the lack of active underlying markets to support the submissions. The FCA stated that this is unsustainable and undesirable for market participants. As a result, many panel banks are uncomfortable providing submissions which are based upon their judgment rather than actual transaction data, given the potential liability this creates.

However, the FCA, which regulates LIBOR, is currently able to compel submitting banks to provide submissions to avoid market disruption. Although the FCA has not yet been required to use its powers of compulsion, it has expressed concern that, once the provisions of the upcoming BMR apply, its powers will be limited.

By giving the market a timeframe to work towards, the hope is that it can allow for a planned and orderly transition away from LIBOR.

This timeframe has simply expedited existing workstreams

The review of major interest rate benchmarks has been ongoing for many years as part of the Financial Stability Board's initiative on interest rate reform. Following the Wheatley Review of LIBOR in 2012 and the Financial Stability Board report on *Reforming Major Interest Rate Benchmarks* in 2014, the three main administrators (EMMI for EURIBOR, ICE for LIBOR and JBA for TRIBOR) have been working on strengthening existing reference rates and developing alternatives. A number of "risk-free rates" are being identified and developed as alternatives to certain benchmarks, including sterling LIBOR.

However, by publicly announcing an end date after which

the FCA intends to stop persuading or compelling banks to submit LIBOR, the speech will accelerate workstreams that were already under way to find alternatives.

European Benchmark Regulation

Separately the BMR is due to apply in the EU from 1 January 2018. This Regulation will impose specific requirements upon administrators of and contributors to benchmarks, as well as to users of benchmarks. The broader remit of the BMR is outside the scope of this article but there is one provision in particular which is relevant to our consideration of fall backs in the case of the permanent discontinuance of LIBOR.

Article 28(2)

Pursuant to Article 28(2) of the BMR, a supervised entity that "uses" a benchmark will be required to have "robust written plans" in place setting out what actions will be taken if a benchmark materially changes or ceases to be available and to reflect such plans in its "contractual relationship with clients". LIBOR is a benchmark for these purposes.

What is a supervised entity? Supervised entities are certain types of EU regulated entities including credit institutions and investment firms.

What is "use"? Use has a specific meaning under the BMR but it can be assumed that use would include the issuance of a bond that uses a benchmark to calculate interest payments. Acting as a dealer under a debt issuance programme or an underwriter for a bond issuance alone is unlikely to bring an entity within the scope of "use" for the purpose of the BMR. It is also unlikely that an investor, by simply holding a bond referencing an in-scope benchmark such as LIBOR, would fall within the remit of Article 28(2) of the BMR. However, if a supervised entity has a role in relation to an issuance which involves determining amounts payable under financial instruments that reference a benchmark, for example as a calculation agent, that entity could be in scope.

What are the relevant contractual documents where this robust written plan should be set out? For a supervised entity as an issuer of bonds which reference a benchmark, the relevant client is the bond investor and so the relevant contract is likely to be the terms and conditions of the bond. A calculation agent appointed in connection with a bond issuance could also be caught by these provisions and so such agent would also need to ensure that robust contractual provisions are set out in the appropriate contractual documentation.

What do market participants need to do now?

There are two key questions that we are focusing on now: (i) a long-term alternative to LIBOR as a reference rate for floating rate notes; and (ii) interim measures for transactions being documented now with maturities extending beyond 2021, as well as fall back provisions for Article 28(2) of the BMR.

A separate issue will be legacy bond transactions which reference LIBOR and which have maturities extending beyond 2021. These same questions will arise in due course for transactions referencing other IBORs if it becomes apparent that they will no longer be published.

What are the long-term alternatives to LIBOR and other IBORs?

The five currency sub-groups (sterling, euro, Swiss franc, dollar and yen) formed by the Financial Stability Board Steering Group are responsible for driving the change to risk-free rates. These groups have each been tasked with identifying risk-free rates which could be used as alternatives to the IBORs.

In the UK, the Bank of England's Working Group on Sterling Risk-Free Reference Rates have announced SONIA (the

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Sterling Over-Night Index Average) as the preferred alternative benchmark to LIBOR for use in sterling derivatives and relevant financial contracts.

SONIA is the main benchmark for overnight unsecured money market transactions (brokered in London and denominated in sterling). Whilst not entirely free from credit risk (and, so, only a proxy for a truly risk-free rate), it incorporates lower credit risk when compared with longer tenors (where the window in which a default may occur is greater). As an overnight rate, SONIA does not have a maturity curve.

The Bank of England's Working Group on Sterling Risk-Free Reference Rates published a White Paper, *SONIA as the RFR and Approaches to Adoption,* in June 2017. ICMA has submitted a response highlighting the importance of ensuring contractual continuity for outstanding legacy debt securities and minimising market disruption.

In the US a broad Treasuries repo financing rate has been selected as an alternative by the relevant working group, the Alternative Reference Rates Committee (ARCC). In contrast to SONIA this is a secured rate. It is also worth noting that this rate is not yet being published.

In relation to the euro area, the risk-free overnight rate has not yet been identified. Under the administration of EMMI, much work has been done with the intention to strengthen the governance of EURIBOR and anchor it more firmly in transactions, yet we understand that challenges remain. On 21 September, the Financial Services and Markets Authority (FSMA), The European Securities and Markets Authority (ESMA), the European Central Bank (ECB) and the European Commission announced the launch of a new working group tasked with the identification and adoption of a risk-free overnight rate which can serve as a basis for an alternative to current benchmarks used in a variety of financial instruments and contracts in the euro area. The signatory public authorities emphasised the need for careful transition planning and safeguarding of continuity of contracts and reiterated that existing rates must continue to be provided in a robust and reliable manner. No deadline has been, or indeed may ever be, set for the demise of EURIBOR.

ISDA and its members are actively working on these long-term alternatives to the IBORs and to a certain degree the bond market and other markets will need to be guided by the derivatives market workstreams to establish IBOR fall backs and alternatives, given the inter-connectivity of the markets and the importance of ensuring matching cashflows between bonds and swaps. However, as mentioned in ICMA's response to the Bank of England White Paper, it will be important that the relevant working groups consider the financial markets as a whole and the full spectrum of products utilising the IBORs as a reference rate when determining the appropriateness of alternative rates. The absence of effective coordination and consideration of the impact upon the full product range could lead to basis risk, fragmentation and market disruption for issuers and investors alike. At ICMA, we are liaising closely with the UK authorities and other trade associations in this regard.

What are the differences between the IBORs and a risk-free rate?

The IBORs are based on unsecured interbank lending and therefore a proportion of the rate reflects the perceived credit risk (ie the premium charged by a lender to account for the risk that a borrower will not repay). By contrast, risk-free rates seek to isolate the interest rate without the credit element. The various currency working groups will need to consider how to adapt an overnight risk-free rate, or indeed a secured rate, to formulate an alternative to a forward-looking term IBOR incorporating a credit risk element.

Until the market lands on a mechanism for producing a robust alternative to the current IBORs that can be used as a reference rate for floating rate notes in the long term, bond market participants need to consider what actions to take in relation to transactions happening now.

What interim measures should the market adopt?

In the plain vanilla bond market long-term floating rate notes are not hugely prevalent, with many having a maturity of less than three years.

However, long-term securities referencing IBORs are more common in the context of regulatory capital for banks, with for example reset provisions from fixed to floating rate, corporate hybrid issuance, insurance regulatory capital and in the securitisation market.

How do bond terms and conditions referencing IBORs work?

There is no standard master form of terms and conditions for the international bond market. This is in contrast to the derivatives market which uses the various ISDA definitions. There is, however, a great deal of communality in the drafting of the relevant provisions in bond terms and conditions, with the outcomes being broadly consistent.

Currently the most common provisions found in bond terms and conditions are known as "ISDA determination" or "screen rate determination". Depending upon which option is selected by the bond issuer, the relevant fall backs which would apply in the event of a failure or termination of a chosen benchmark are set out in the contractual documentation as a waterfall of options. If the reference rate cannot be determined by application of the first specified fall back, the following applicable fall back applies and so on until the final fall back is reached.

Each of screen rate determination and ISDA determination provisions has a different fall-back waterfall. Screen rate determination is the more prevalent.

Taking each of these two options in turn:

(i) *Screen rate determination:* ie the IBOR rates quoted on the relevant screen page plus or minus a margin. Where the rate is not published on the relevant screen, the provisions provide for a fall back to various iterations of rates to be determined by reference banks and finally a fixed rate using the last available floating rate for the life of the bonds. A fall back to reference banks may not be effective if an IBOR is permanently discontinued. The relevant reference banks are likely to include the same or a similar group of banks to those that are no longer submitting data to allow for LIBOR to be published on the relevant screen. In any event, these fall backs are only intended for a temporary period as, in the case of a permanent discontinuance of a reference rate, it would effectively result in instruments becoming fixed rate.

(ii) *ISDA determination:* This typically refers to calculation on the same basis as the floating rate leg of an interest rate swap for the relevant designated maturity, determined by the calculation agent on the basis of the ISDA definitions. If the bond issuer has a swap in place to exchange the cashflows on the notes for another stream, then it makes sense for these to match. If this is the chosen option, the fall back will be to ISDA fall back provisions.

There may also be variations on these alternatives described, as well as different historic provisions in documentation in relation to legacy floating rate notes.

ICMA is participating in data gathering on the volume of long term outstanding floating rate notes to quantify the challenges in relation to legacy trades. However, any such high-level data will not give granular information on the specific bond terms and conditions that apply to those legacy bonds.

What are the options for new bond issues or debt issuance programmes updating now prior to a long-term solution?

Screen rate determination

In the case of a screen rate no longer being available on the relevant screen the fall-back provisions could defer to a successor or replacement screen.

At present any alternative rate chosen for LIBOR, for example, is not expected to be published on the same screen and it is also unlikely that it will be considered a "successor" to LIBOR (but this could depend upon the specific drafting of the bond terms and conditions and final outcome of the deliberations of various working groups and ISDA). Providing for the alternative rate to be published, or at least referenced on the screen that is currently used, could facilitate a smoother transition to an alternative rate.

As an alternative, a bond issuer could use a revised fall-back waterfall now to add an additional fall back providing for the issuer, calculation agent, trustee or independent third party to make a determination based upon what is customarily used in the market as an alternative screen or alternative benchmark at the time required. This assumes that in due course, and by the time the relevant IBOR is no longer published and an alternative is required, there will have been a clear determination by the market of what the alternative benchmark should be. However, whilst there remains uncertainty as to the direction of travel on alternatives, some may consider that this gives too much flexibility for the issuer, which could be detrimental to bondholders. In the case of a third party there may well be reluctance to take on liability for making this determination. There may eventually be no one clear alternative applicable to all outstanding securities.

Another alternative or additional last resort approach in the fall-back waterfall could be for issuers to provide for easier amendments to interest rate provisions, in the future, in the bondholder meeting provisions to allow for a liability management exercise once an alternative benchmark is established. Finally, an issuer could choose to use an alternative reference to LIBOR or the relevant IBOR from the outset.

Using an alternative reference rate from the outset

At this stage work in relation to the various risk-free rates to enable them to be used as an alternative to an IBOR for a new bond issue is insufficiently advanced. In the case of SONIA, this is an overnight rate which is backward looking and does not include credit risk. SONIA alone will result in an economically different outcome to LIBOR.

It is difficult for market participants to pre-judge the outcome of the on-going work on the risk-free rates to produce an interim or long-term rate as any alternative to the relevant IBOR.

For market participants looking to other alternative reference rates that could be used by a bond issuer now, it will be important to select a rate with certainty that this reference will continue to be available in the long-term future. One such reference could be government bond yield curves plus a spread, instead of an IBOR. Another option could be to use an alternative screen rate which does not defer to an IBOR definition or other rate that may cease to exist.

ISDA determination

Similar options to those described above could also apply to ISDA determination provisions.

These provisions typically defer to the 2006 ISDA definitions but market participants could use language to incorporate any future amendments to the relevant ISDA definitions in relation to IBOR fall backs in the event that the relevant IBOR ceases to exist.

We understand that ISDA is working on amendments to its 2006 definitions, among others, to address the permanent discontinuance of the IBORs. We also anticipate that ISDA will use a protocol mechanism to provide for amendments to existing contracts for those that elect to adhere to the amendments. At this stage, using drafting which incorporates future amendments to ISDA definitions could introduce too much uncertainty or result in unintended consequences for issuers and or bondholders.

Risk factors

Some issuers are taking the precaution of introducing additional risk factor language to highlight any risks that may are as a result of the demise of LIBOR (or other IBORs), as appropriate. Any such risk factor would need to be carefully worded and tailored to the specific circumstances of the bond terms and conditions. A risk factor alone would not address the outstanding questions highlighted above and there remains some debate about the relevance or value of a risk factor, particularly for wholesale debt issuances or programmes targeted at sophisticated investors for whom such a risk factor is unlikely to be informative.

Legacy issues

Unlike in the derivatives market, changes to pre-existing bond terms and conditions cannot be made via a protocol mechanism. Amendments to legacy bond terms and conditions would typically require a liability management exercise such as a consent solicitation. This could be costly and time consuming for issuers and with an uncertain outcome. An alternative mechanism could be some form of coordinated statutory measure in the main jurisdictions. However, this is potentially complex to deliver.

Conclusion

At ICMA we are actively engaged with the relevant authorities. We are also coordinating with other trade associations to facilitate a market wide approach to documentation. We are seeking feedback from members via relevant committees as to appropriate short-term and long-term alternatives to relevant IBORs, as well as robust fall-back provisions; and working with external law firms to reflect market practice in bond documentation. Our current sense is that there is not yet a consistent approach to new bond documentation, with decisions being made on a case-by-case basis. We will continue to monitor developments and facilitate member engagement and solutions for the market.

We will keep members updated via future editions of the ICMA Quarterly Report, member briefings, and our committees as necessary.

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