Adjustment spread for use in certain LIBOR bond fallbacks

As previously described in the Q3 2019 edition of this Quarterly Report, the fallbacks in floating rate notes (FRNs, which for these purposes includes FRNs issued pursuant to a securitisation) typically fall into three categories: Type 1 fallbacks, typically included in FRNs which were issued prior to Andrew Bailey's July 2017 speech[1], and which usually fall back to the rate in effect for the last preceding interest period (ie a fixed rate); Type 2 fallbacks, which, upon the *permanent cessation* of a rate, typically envisage the issuer appointing an independent adviser to select a *replacement rate* and an *adjustment spread* to be applied to such rate, in each case, on the basis of (a) any recommendations made by relevant official bodies or (b) if no such recommendations have been made, customary market practice; and Type 3 fallbacks, which operate in a similar way to Type 2 fallbacks upon the occurrence of a *pre-cessation* event, being a statement of unrepresentativeness of the original benchmark by the regulator of the benchmark administrator.

The purpose of the adjustment spread element of the Type 2 and Type 3 fallbacks is to maintain the economics of the original FRN by reflecting the bank credit risk element which is present in LIBOR, but is not observable in risk-free rates, such as SONIA.

In 2019, ISDA issued a series of consultations on methodologies for calculating the spread adjustment on the permanent cessation and pre-cessation of LIBOR in derivatives transactions, resulting in agreement that a historical five-year median approach is the most appropriate methodology to be used for sterling LIBOR interest rate swaps. Following the progress made by ISDA in this respect, the Sterling Risk-Free Rate Working Group (£RFRWG) consulted on an adjustment spread methodology for sterling cash products (including bonds, loans and securitisations) in December 2019. This consultation also identified a strong consensus in favour of the historical five-year median approach as the most appropriate methodology for an adjustment spread for both permanent cessation and pre-cessation fallbacks.

The £RFRWG, in its capacity as a relevant official body, subsequently issued a statement of recommendation in response to this consensus, recommending the use of the historical five-year median spread adjustment methodology when calculating the credit adjustment spread which should then be applied to the SONIA rate, following either the permanent cessation or pre-cessation of sterling LIBOR.

The £RFRWG has said that it will monitor the availability of data sources to support use of this spread adjustment methodology for use in cash products, and consider whether any further work is needed in this area in due course.

It is important to note that this adjustment spread methodology will only be applicable when a fallback is triggered on cessation or pre-cessation, and *not* in the case of an active transition from LIBOR to a risk-free rate, for instance, by way of consent solicitation.

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1. Andrew Bailey, former Chief Executive of the FCA: The Future of LIBOR, 27 July 2017.