From LIBOR to SONIA in the bond market

By Paul Richards

Summary

The transition from LIBOR to near risk-free rates is a global challenge affecting financial markets as a whole.[1] As part of ICMA's campaign to raise market awareness, this Quarterly Assessment considers progress in the transition from LIBOR to near risk-free rates in the bond market, using the transition from LIBOR to SONIA as an example, and covers: new SONIA issuance; the SONIA Compounded Index; the legacy sterling LIBOR bond problem; fallbacks in legacy LIBOR bond contracts; the adjustment spread and successor rate; consent solicitations; tough legacy bond contracts; regulatory dependencies; supervision of firms' preparations; and international coordination.[2]

Introduction

1 In a statement on the impact of the coronavirus (COVID-19) pandemic on firms' LIBOR transition plans published on 25 March 2020, the FCA, Bank of England and the Working Group on Sterling Risk-Free Reference Rates (RFRWG) said: "The central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and end-2021 should remain the target date for all firms to meet.[3] The transition from LIBOR remains an essential task that will strengthen the global financial system."[4] As part of ICMA's campaign to raise market awareness, this Quarterly Assessment considers the progress that has been made in the sterling bond market towards meeting the objective that the end of 2021 should remain the target date for all firms to meet.[5]

New SONIA issuance

2 All new sterling bond issues in the form of FRNs and most securitisations have for some time been referencing SONIA rather than LIBOR. From the first SONIA bond issue by the EIB in mid-2018 until the end of the first half of 2020, new issuance referencing SONIA amounted to

1. In all the main jurisdictions, the near risk-free rates chosen are overnight rates: SONIA in the UK; SOFR in the US; €STR in the euro area; SARON in Switzerland; and TONA in Japan.

2. ICMA is a member of the Sterling Risk-Free Rate Working Group, and chair of the Bond Market Sub-Group, an observer on the Euro Risk-Free Rate Working Group, and a member of the Swiss National Working Group.

3. In parallel, in the US, the Chair of the Alternative Reference Rates Committee (ARRC) said: "It is critical that market participants continue to make progress on executing a complete transition away from LIBOR by the end of 2021: ARRC, *Best Practices for Completing the Transition from LIBOR,* 27 May 2020.

4. A further statement from the RFRWG setting out revised interim timelines for the transition in loans was published on 29 April. In addition, on 7 May, the Bank of England stated: "Recent market volatility has highlighted the long-standing weaknesses of Libor benchmarks, which remain in widespread use. Libor rates – and hence costs for borrowers – rose as central bank policy rates fell, and underlying market activity was low. This has reinforced the importance of completing the transition to alternative rates by end-2021." *Interim Financial Stability Report,* May 2020.

5. In July 2017 the FCA, as regulator of LIBOR, stated that it would not persuade or compel banks to submit quotations for LIBOR beyond the end of 2021.

£88 billion in 181 transactions, including £21 billion in 56 transactions in the first half of 2020 despite the impact on the market of the coronavirus (COVID-19) pandemic.[6]

3 All bond market transactions referencing SONIA so far have used a backward-looking overnight compounded rate. The use of a compounded overnight risk-free rate wherever possible is the authorities' preference, as overnight rates are the most robust, with robustness measured primarily by the volume of underlying observable transactions.[7] Given the authorities' preference for compounded SONIA and the use of compounded SONIA in the bond market to date, it is not currently expected that a forward-looking term rate will be widely used for new transactions in the SONIA bond market when it becomes available in due course, though it may be used in some legacy transactions and in some other market sectors.[8]

4 Until January 2020, all new SONIA bond issuance used the same market conventions: overnight SONIA compounded in arrears over the interest period with a five-day lag, and with the margin added. In February, the EBRD issued the first new SONIA issue using the shift method. Whereas the lag method calculates interest according to the number and weighting of days in the interest period, the shift method calculates interest according to the number and weighting of days in the observation period.

The SONIA Compounded Index

5 The RFRWG welcomed the Bank of England announcement on 26 February that the Bank will publish a SONIA Compounded Index on a daily basis that is free to use. This is due to start on 3 August. Like the SOFR Compounded Index published daily by the Federal Reserve Bank of New York since 2 March, the SONIA index will be compatible with the shift method rather than the lag method. It is expected that new SONIA bond issues will increasingly reference the SONIA Compounded Index, once it is published. This is because it should standardise and simplify the method of calculating SONIA-linked instruments and could be referenced in documentation. It should also reduce operational risk by making it easier to reconcile interest amounts between market counterparties. This should encourage an increase in the scale of compounded SONIA used across different products.

6 A move from the lag method to the shift method for new SONIA issues would involve adapting IT systems and revising documentation, but this is not regarded as a major change for the bond market. If issuers want to continue to use the lag method for new issues, they can do so, and previous SONIA issues using the lag method should not be affected. But if the shift and the lag methods are to co-exist, it will be important for investors to be able easily to identify which approach is used for each individual bond.[9]

The legacy sterling LIBOR bond problem

7 A good start has been made in addressing the legacy sterling LIBOR bond problem. As new issues in the bond market are now referencing SONIA rather than LIBOR, fallbacks from LIBOR to SONIA are no longer needed in new bond contracts. The problem relates to legacy LIBOR bond contracts maturing beyond the end of 2021, when LIBOR may no longer exist.

8 The latest estimates of legacy sterling LIBOR bonds maturing after the end of 2021 are of the order of 315 FRNs and 170 securitisations with 560 tranches, with a total value of around £110 billion.[10] Maturing bonds will reduce the scale of the problem in time, but it has been estimated that only around 30% of legacy bonds by value fall due for maturity in 2022 and 2023. A significant proportion of legacy bonds mature beyond 2030, and some bonds are perpetual, with no maturity date.[11]

9 Permanent cessation of LIBOR is due to take place at or after the end of 2021. If permanent cessation does not take place until after the end of 2021, it is already clear that some banks will withdraw from submitting quotations for LIBOR, when they are no longer obliged to do so.[12] In those circumstances, the FCA may declare that LIBOR is no longer representative of its underlying market. Such a declaration would mean that LIBOR could no longer be

6. In the US, the ARRC has set a deadline of the end of 31 December 2020 after which no new FRNs are to be issued using LIBOR and maturing after the end of 2021: *Best Practices for Completing the Transition for LIBOR,* 27 May 2020.

7. See, for example: RFRWG Statement on *SONIA Conventions and Summary of Responses on Conventions for Referencing SONIA in New Contracts,* August 2019; and Statement on *Bond Market Conventions and Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives.*

8. A forward-looking term rate would incorporate a derivative of the risk-free rate. As with term LIBOR, and unlike compounded SONIA, each interest payment referencing term SONIA would be known at the start of the interest period.

9. RFRWG Statement on *Lags, Shifts and the SONIA Compounded Index,* 9 March 2020.

10. Source: HSBC Bank plc and NatWest Markets (March 2020).

11. Source: RBC Capital Markets (October 2018).

12. FCA Chief Executive: speech in New York, June 2019.

used for new transactions. Whether, and on what basis, LIBOR would continue to be used in legacy transactions is addressed in a legislative proposal by HM Treasury and the FCA on 23 June.[13]

Fallbacks in LIBOR bond contracts

10 Before the announcement in July 2017 by the FCA, as the regulator of LIBOR, that it will no longer persuade or compel banks to submit quotations for LIBOR after the end of 2021, the permanent cessation of LIBOR was not contemplated in sterling bond contracts, which only took account of LIBOR being temporarily unavailable. Many of these LIBOR bond contracts contain fallback clauses which will fall back, on the permanent cessation of LIBOR, to the last available LIBOR fix (ie the floating rate will become a fixed rate for the remaining life of the bond). This would not have been the original intention of the parties when the contracts were written with a floating rate. For convenience, these are referred to as "Type 1" fallbacks. They are estimated to represent the largest proportion – at least 70% – of the total of legacy sterling LIBOR bonds.

11 After the FCA's announcement in July 2017, fallback clauses in sterling LIBOR bond issues began to take account of the permanent cessation of LIBOR in future by providing for the issuer or an independent adviser to select a successor or alternative rate, and an appropriate adjustment spread, which would apply at the permanent cessation of LIBOR, or in the event of a pre-cessation trigger. A pre-cessation trigger would take place before permanent cessation of LIBOR if the FCA, as regulator of LIBOR, declares that LIBOR is no longer representative of its underlying market. For convenience, these fallbacks are referred to as "Type 2" (cessation) and "Type 3" (pre-cessation) respectively. Type 2 and Type 3 fallbacks typically provide that a relevant nominating body (eg the RFRWG) should nominate a successor rate and an appropriate adjustment spread. It is important to note that the three types of fallback clause outlined are common examples, but do not describe every case.

Adjustment spread and successor rate

12 In the case of legacy sterling LIBOR bond contracts, there are two issues that need to be resolved in order to clarify how Type 2 and Type 3 fallbacks to SONIA would work.

- The first is that a credit adjustment spread is needed to take account of the economic difference between LIBOR and SONIA. In response to a recent RFRWG consultation on the credit adjustment spread in the cash markets, the overwhelming majority of market participants recommended the use of a fixed credit adjustment spread aligned with ISDA's proposals for a five-year median approach in the derivatives market: ie the median of the spread between LIBOR and risk-free rates over a five-year look-back period.[14] In line with the market's response to the consultation on the credit adjustment spread in the cash markets, the method for calculating the credit adjustment spread would be expected to be the same at pre-cessation and at permanent cessation of LIBOR.
- The second issue is what the successor rate in Type 2 and Type 3 fallbacks should be. In the case of sterling LIBOR bonds in the form of FRNs and securitisations, most bond market participants would prefer the successor rate to be compounded overnight SONIA (by reference to the SONIA Compounded Index to be published by the Bank of England). But that is not necessarily the case with other cash products (eg in the loan market), where market participants might prefer a term rate; and a term rate is at the top of the ARRC's waterfall of potential fallbacks in the US.

Consent solicitations

13 How should the remaining legacy sterling LIBOR bond contracts be addressed, particularly those with Type 1 fallbacks which are due on permanent cessation of LIBOR to fall back to the last LIBOR fix (ie a fixed rate)? The UK authorities' approach has been to encourage the market to transition as many bonds as possible from LIBOR to SONIA as soon as possible to avoid the risk that, while LIBOR is certain to end, it is not possible at this stage to rely on legislation to solve the legacy LIBOR bond problem. Consequently, the best way to avoid LIBOR-related risks is to move off LIBOR altogether.[15]

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13. See paragraphs 17-19 below.

14. "The consultation identified a strong consensus in favour of the historical 5 year median approach ... as the preferred methodology for credit adjustment spreads across both cessation and pre-cessation fallbacks for cash products maturing beyond end-2021.": Summary of response to the RFRWG *Consultation on Credit Adjustment Spread Methodologies for Fallbacks in Cash Products Referencing GBP LIBOR,* [March] 2020.

15. Edwin Schooling Latter: *Next Steps in Transition from LIBOR:* London, 21 November 2019.

14 In the sterling bond market, the most straightforward way for market participants to transition from LIBOR to SONIA is to use consent solicitation, which is a process envisaged in most bond contracts.[16] This involves issuers seeking the consent of investors to convert their bonds from LIBOR to SONIA. (Cash tender offers, exchange offers or open market repurchases are a potential alternative, but they risk leaving a rump of unconverted LIBOR bonds and could have accounting and other implications.) Initial progress has been made through the successful use of consent solicitations in 18 bond market transactions, with a market value of £11 billion, up to the end of the first half of 2020. All these transactions have used a credit adjustment spread based on a market rate[17] at which to convert bonds from LIBOR to SONIA. Over the period between now and the permanent cessation of LIBOR, the market rate for consent solicitations is expected to converge on ISDA's proposal for a fixed credit adjustment spread.

15 But there are two reasons why it is not expected to be practicable to convert the bond market *as a whole* through consent solicitations by the end of 2021. First, some bonds are expected to be too difficult to convert: eg because the thresholds for consent from investors are too high: in the US, consent thresholds are commonly 100%.[18] Second, there are too many bonds to convert by the end of 2021. The process of seeking consent is voluntary, costly and time-consuming: bond contracts have to be amended bond by bond: it is not possible to use protocols to convert the bond market as a whole. In addition, the transition has been complicated by the market impact of the coronavirus (COVID-19) pandemic. While the end-2021 deadline by which market firms need to be ready for the cessation of LIBOR remains the same, there is less time available in practice to meet it.

Tough legacy bond contracts

16 So it is expected that there will be legacy sterling LIBOR bonds outstanding at the end of 2021 which will fall back to a fixed rate on the permanent cessation of LIBOR unless the authorities decide to intervene. The arguments for exploring the feasibility of official intervention, which would be intended to provide legal certainty about the treatment of tough legacy contracts, are:

- first, *fairness:* the permanent cessation of LIBOR was not contemplated when LIBOR contracts were written to fall back to the last LIBOR fix: instead, the LIBOR rate will become a fixed rate for the remaining life of the bond, which would not have been the original intention;
- second, *clarity:* there may be other contracts where the fallbacks are unclear or there are no fallbacks at all;
- third, *feasibility:* it would not be feasible to convert all legacy sterling LIBOR bonds (eg because the consent thresholds are too high);
- fourth, *shortage of time:* there would also be too many legacy sterling LIBOR bonds to convert by the end of 2021, as bond contracts need to be amended bond by bond and consent solicitation is a time-consuming process; and
- finally, *international consistency:* in the US, where consent solicitation is not expected to be practicable, as consent thresholds are commonly 100%, legislative relief is being sought under New York law: it would be beneficial internationally if US dollar LIBOR legacy bond contracts under New York law and US dollar LIBOR legacy bond contracts under English law are treated in a consistent way (See Box on page 11.)

17 In the UK, following the conclusions of the Tough Legacy Task Force, a market-based group chaired by the FCA, the RFRWG has recommended that "there is a case for action to address tough legacy exposures in the bond market" and has proposed that the British Government "considers legislation to address tough legacy exposures in contracts governed by English law that reference at least sterling LIBOR, and ideally other LIBOR currencies, that are still in operation when LIBOR is expected to cease on or after the end of 2021." The Task Force also "considers that a similar approach [to the ARRC approach in the US] for contracts governed by English law would, assuming the ARRC work continues, help to bring about international consistency in the treatment of tough legacy contacts."[19]

18 The British Government responded on 23 June. In a written statement, HM Treasury said that the Government recognises that legislative steps could help deal with the narrow pool of "tough legacy" contracts that cannot transition from LIBOR. Unlike many jurisdictions, the UK has an existing regulatory framework for critical benchmarks such as LIBOR. The Government therefore intends to legislate to amend and strengthen that existing regulatory framework, rather than directly to impose legal

16. In the case of consent solicitations to convert legacy bond contracts with Type 1 fallbacks from LIBOR to SONIA, a credit adjustment spread and successor rate are relevant as well.

17. This has been defined as the linear interpolation for the relevant tenor of LIBOR versus SONIA basis swaps, which is then added to the original margin of the legacy bond.

18. In addition, in the case of some securitisations, there is no longer a decision maker, nor a party willing to assume the costs of amendment. See also RFRWG: *Paper on Identification of Tough Legacy Issues,* May 2020.

19. RFRWG: *Paper on the Identification of Tough Legacy Issues:*29 May 2020.

ARRC proposal for legislative relief under New York law

The Alternative Reference Rates Committee (ARRC) proposal for legislative relief is designed to minimise the risk of costly and disruptive litigation by providing legal certainty for the issues that are likely to arise under New York law. Under the proposal, a statute would permit the application of an ARRC-recommended SOFR fallback rate and spread adjustment to US dollar LIBOR instruments governed by New York law across all asset classes. Instruments with fallbacks to rates other than LIBOR would not be subject to the legislation. The key components of the proposed statute and its effects on contractual provisions are as follows:[20]

Mandatory versus permissive application of the statute

Mandatory: If the legacy contract is silent as to fallbacks.

Mandatory: If the legacy language falls back to a LIBOR-based rate (such as the last quoted LIBOR).

Permissive: If the legacy language gives a party the right to exercise discretion or judgment regarding the fallback, that party can decide whether to avail itself of the statutory safe harbour.

Degree of override of legacy contract fallback provisions

Override: Where the legacy language falls back to a LIBOR-based rate (such as the last quoted LIBOR).

Override: If the legacy language includes a fallback to polling for LIBOR or other interbank funding rate, the statute would mandate that the polling not occur.

No override: Where the legacy language is silent as to fallbacks or gives a party the right to exercise judgment to override and the statute would apply the recommended benchmark replacement.

No override: The statute would not override legacy language that falls back to an express non-LIBOR based rate (such as Prime).

Mutual "opt-out"

Parties would be permitted to mutually opt out of the application of the statute, in writing, at any time before or after the occurrence of the trigger event.

Trigger events

The statute would become applicable or available (as described in "mandatory" versus "permissive" above) upon the occurrence of statutory trigger events.

Scope

No exclusions: No product would be categorically excluded from the statute. Parties can opt out as described above.

Conforming changes

The statute would be drafted to provide safe harbour protection for parties who add conforming changes to their documents to accommodate administrative/operational adjustments for the statutory endorsed benchmark rate.

20. ARRC: *Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition:* 6 March 2020.

changes on LIBOR-referencing contracts that are governed by UK law. The legislation will ensure that, by end-2021, the FCA has the appropriate regulatory powers to manage and direct any wind-down period prior to eventual LIBOR cessation in a way that protects consumers and/or ensures market integrity.[21]

19 In an accompanying statement, the FCA said that the new powers proposed will be available where the FCA has found that a critical benchmark is not representative of the market it seeks to measure and representativeness will not be restored. The FCA and other authorities have been clear that those who can amend their contracts so that they move away from LIBOR at or before this point, should do so. The legislation would empower the FCA to protect those who cannot amend their contracts in this way by directing the administrator of LIBOR to change the methodology used to compile the benchmark if doing so would protect consumers and market integrity. Although this would not make the benchmark representative again, it would allow the FCA to stabilise certain LIBOR rates during a wind-down period so that limited use in legacy contracts could continue, if suitable robust inputs to support such a methodology change are available.[22] In this context, the FCA has noted the market consensus that has emerged internationally and in the UK on how to calculate fair alternatives to LIBOR in some important markets, notably derivatives, bonds and some parts of the loan market, using the risk-free rates chosen by each LIBOR currency area, adjusted for the relevant term of the contract, and with a fixed credit spread adjustment added.[23]

Regulatory dependencies

20 Regulatory dependencies resulting in obstacles to the transition from LIBOR to SONIA have been identified in letters from the Chair of the RFRWG to the FCA and the PRA so that these obstacles can be addressed. In the case of prudential regulation, it is important that the change of benchmark does not result in existing securities being re-classified as new securities. In the case of conduct regulation, it is important that any conduct risks associated with the change of benchmark are managed appropriately.

Supervision of firms' preparations

21 In the UK, the Bank of England, PRA and FCA have sent "Dear CEO" letters to the chief executives of the banking and insurance firms – and more recently the asset management firms – they supervise to raise awareness of the need to prepare for the transition from LIBOR to risk-free rates. The UK authorities are also gathering information on progress in the transition through a regular data collection exercise to provide feedback on risks and to share good practices.[24] Supervisors in other jurisdictions do not necessarily use the same mechanisms as the UK, but their objective is the same. That is to check on a regular basis that the firms they supervise are identifying and quantifying their LIBOR exposure and planning ways to reduce it by transitioning to risk-free rates, taking account of prudential and conduct risks during the transition to risk-free rates and at the cliff-edge when LIBOR is discontinued. Firms also have a responsibility to train their staff and communicate with their clients.

International coordination

22 The transition to risk-free rates internationally is coordinated by the Official Sector Steering Group (OSSG) of the Financial Stability Board, which has also been considering legacy contracts globally and how they should be addressed. In addition to the OSSG's work in overseeing the transition generally, it is clear that international coordination of any official intervention on the replacement of LIBOR would be important as well so as to ensure consistency of treatment internationally. For example, in addition to financial contracts denominated in sterling, English law is used in financial contracts denominated in a number of other currencies (eg US dollars) internationally. LIBOR legacy bond contracts denominated under New York law and under English law would benefit from being treated in a consistent way.

23 International coordination of the timing of any official intervention (eg through legislation) on the permanent cessation of LIBOR is also likely to be important. As permanent cessation of LIBOR is due to take place at or after the end of 2021, market firms need to be ready for permanent cessation by the end of 2021. But if official intervention is required (eg through legislation) to override legacy LIBOR contracts in multiple jurisdictions, and this cannot be achieved in all these jurisdictions by the end of 2021, the question would arise whether LIBOR would continue to be needed in some form for a wind-down period before permanent cessation.[25]

24 There are some differences of approach to the transition between national jurisdictions. For example, some risk-free rates are secured (like SOFR in the US and

21. HM Treasury: Financial Services Regulation, Written Statement: 23 June 2020.

22. FCA Statement on Planned Amendments to the Benchmarks Regulation: 23 June 2020.

23. FCA: Benchmarks Regulation – Proposed New Powers: Q&A. 23 June 2020.

24. Andrew Hauser, Executive Director, Markets, Bank of England: *Turbo-charging Sterling LIBOR Transition:* London, 26 February 2020.

25. See RFRWG: *Paper on the Identification of Tough Legacy Issues,* 29 May 2020.

SARON in Switzerland); and some unsecured (like SONIA in the UK and €STR in the euro area). And while the focus in the US and the UK is on replacing LIBOR, the focus in the euro area is currently on replacing EONIA by €STR, and implementing fallbacks to €STR for EURIBOR rather than replacing it, at least at this stage. So there is not a "one-size-fits-all" approach to the transition in different national jurisdictions. But the direction of travel towards risk-free rates is much the same and, despite the market impact of the pandemic, considerable progress is being made, including in the bond market.

ICMA's contribution to the transition to risk-free rates

ICMA is contributing to the transition to risk-free rates in a number of complementary ways:

ICMA is participating in the Sterling Working Group on Risk-Free Rates and chairing the Bond Market Sub-Group. ICMA is also participating in the Euro Risk-Free Rate Working Group (as an observer) and the Swiss National Working Group; and ICMA is in regular contact with the FRN Group Chair on the Alternative Reference Rates Committee in the US.

ICMA has set up a risk-free rate webpage on the ICMA website with hyperlinks to official publications and speeches globally, as well as to ICMA's own work and joint work with other trade associations.

ICMA has published regular updates on the transition to risk-free rates in the ICMA Quarterly Report, including a global summary (with hyperlinks) in the Quarterly Report for the Second Quarter of 2020.

ICMA has held regular calls to brief members on progress in the transition to risk-free rates.

And ICMA moderated official sector panels on the transition to risk-free rates at the Conference after the ICMA AGM in Madrid in 2018 and Stockholm in 2019 and a virtual official sector panel in June 2020. This latest panel included senior representatives from the UK FCA, the Federal Reserve Bank of New York, the European Central Bank, the Swiss National Bank and the European Investment Bank. A recording of the panel is available on the ICMA website.

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