The transition from LIBOR: "tough legacy" bonds

by **Paul Richards**

Summary

This Quarterly Assessment focuses on "tough legacy" bonds referencing LIBOR: why there is a tough legacy problem in the bond market; what the bond market has done to address the problem; how the authorities are proposing to help address the problem through legislative proposals for the orderly wind-down of LIBOR; and whether tough legacy bonds are being addressed in a consistent way internationally.

Introduction

1 The Financial Stability Board considers that continued reliance by global financial markets on LIBOR poses clear risks to global financial stability.[1] For some time, the authorities have argued that the market for unsecured wholesale term lending between banks is no longer sufficiently active to support such a widely used reference rate as LIBOR.[2]

- In July 2017, the Chief Executive of the FCA, the regulator and supervisor of the IBA, the administrator of LIBOR, announced that the FCA would no longer persuade or compel banks to submit quotations for LIBOR after the end of 2021.
- On 5 March 2021, the IBA and the FCA formally confirmed the dates on which panel bank submissions for all 35 LIBOR settings in the five LIBOR currencies will cease or lose representativeness of their underlying market at the end of 2021, with the exception of certain US dollar settings, which will continue to be representative until the end of June 2023 to support legacy contracts only.[3]
- On 2 June 2021, global agreement was announced by the Financial Stability Board and IOSCO to stop the use of LIBOR in new transactions, including in US dollars, by the end of 2021.[4]

2 The authorities have encouraged the market to transition from LIBOR to near risk-free rates: SOFR for US dollars; SONIA for sterling; €STR for euro; SARON for Swiss francs; and TONA for Japanese yen. In each case, the most robust risk-free rates are overnight rates, which are measured by the volume of overnight transactions and do not depend on any use of expert judgment. To take account of local market conditions, risk-free rates in some currencies are based on secured transactions and in others on unsecured transactions.

3 Although the authorities prefer the market to use overnight risk-free rates, wherever practicable, because these rates are the most robust, they also recognise the need for the

1. See FSB Global Transition Roadmap, 2 June 2021.

2. This was illustrated during the market turmoil at the start of the COVID-19 pandemic in March 2020, during which LIBOR rates rose when central bank policy rates fell. See the FSB *Statement on the Impact of COVID-19 on Global Benchmark Reform,* July 2020.

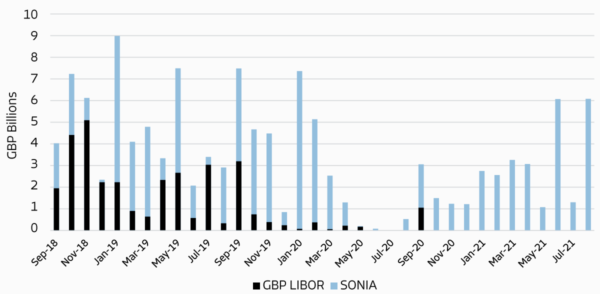
3. Overnight, one, three, six and 12 month US dollars LIBOR settings. For these five US dollar LIBOR settings, the FCA set out on 29 September 2021, for consultation (CP21/29), its proposed decision for restricting new use of these LIBOR settings after end-2021, in line with existing US supervisory guidance.

4. The US authorities have set out very limited exceptions.

market to use forward-looking term risk-free rates in some limited cases. Term risk-free rates have been, or are being, developed in some currencies, though not in Swiss francs. In particular, the authorities in the US and the UK want the market to avoid the use of credit-sensitive rates, which they consider would run similar risks in the future to those experienced with LIBOR in the past.[5]

4 Very considerable progress has been made in transitioning the bond market, as well as the derivatives and loan markets, from LIBOR to risk-free rates in the different LIBOR currencies and jurisdictions. In the sterling bond market, all new issues have referenced overnight SONIA compounded in arrears for some time. The remaining problem in the bond market relates to tough legacy LIBOR bonds, where the authorities are keen to ensure an orderly wind-down of LIBOR.

Sterling floating rate note issuance, to end-August 2021



Source: Bloomberg Finance L.P & Bank of England calculations

Why is there a tough legacy problem in the bond market?

5 Tough legacy contracts are defined by the Financial Stability Board as "contracts that have no or inappropriate fallbacks, and [which] cannot realistically be renegotiated or amended."[6] The tough legacy problem in the sterling bond market arises as a result of a combination of circumstances:

- First, a large number of legacy sterling LIBOR bonds are due to mature beyond the end of 2021, when panel bank LIBOR is due to cease. In June 2021, the value of outstanding legacy FRNs and securitisations in one, three or six month sterling settings was estimated by the FCA at around £90 billion in 480 transactions at the end of 2021.[7] In many cases, these bonds have long maturities.
- Second, most legacy LIBOR bonds are due to fall back from a floating rate to a fixed rate at the permanent cessation of LIBOR when LIBOR is no longer available on screen. When these fallbacks in bond contracts were written, it was assumed that LIBOR could become unavailable temporarily, but it was not generally envisaged that LIBOR would become unavailable permanently. Consequently, there is a risk of market disruption if nothing is done to prevent this.
- Third, changing the interest rate provisions in the fallbacks of these bond market contracts is not straightforward. The customary mechanism in the bond market involves consent solicitation, under which an issuer seeks agreement with investors to change the contractual terms of the bond. The consent threshold for agreement by investors is often high, and the process takes time and can be costly, as consent solicitation needs to take place bond by bond, and there is no guarantee of success. A multilateral protocol to change the terms of contracts is not possible in the bond market, unlike the derivatives market.

6 Legacy bonds referencing LIBOR in Japanese yen and US dollars under English law are likely to operate in a similar way to sterling LIBOR bonds. For bonds governed by New York law, consent thresholds are commonly 100%, which makes consent solicitation of legacy US dollar bonds referencing LIBOR under New York law impracticable. In Swiss francs and euro, the number of legacy bonds referencing LIBOR is not considered to be significant and, in both these currencies, LIBOR is due to cease permanently at the end of 2021. In the EU, while EONIA is due to be replaced by €STR from 3 January 2022, the benchmark most widely used in the bond market is EURIBOR, which is not currently planned to cease, though €STR fallbacks are being included in new issues.

What has the sterling bond market done to address the problem?

7 The UK authorities have recommended that legacy sterling LIBOR bonds should be reduced to an irreducible core before LIBOR becomes unrepresentative of its underlying market and panel bank LIBOR ceases at the end of 2021. The sterling bond market has addressed the problem in three main ways.

- First, following the FCA's announcement in July 2017, new issues referencing LIBOR in the sterling bond market began to use different fallbacks. Instead of fallbacks to a fixed rate (so-called Type 1s), fallbacks on new issues referencing LIBOR began to provide for an Independent Adviser to select a successor rate plus a fixed credit adjustment spread, either at LIBOR cessation or earlier in some cases, eg in the case of a prohibition on use (so called Type 2s). In some more recent cases, there is in addition a pre-cessation trigger if and when LIBOR is designated as unrepresentative of its underlying market

5. See also the IOSCO *Statement on Credit Sensitive Rates,* 8 September 2021.

6. FSB, *Reforming Major Interest Rate Benchmarks,* 20 November 2020.

7. FCA consultation (CP21/19).

by the FCA (so called Type 3s).[8] The introduction of Type 2 and 3 fallbacks at an early stage into bond documentation for new issues still referencing LIBOR capped the number of bonds with Type 1 fallbacks from a floating rate to a fixed rate.

- Second, during the course of 2018, the bond market began to reference overnight SONIA compounded in arrears in place of LIBOR for new issues of both FRNs and securitisations and, over a period of time, stopped using LIBOR for new issues altogether. The transition from LIBOR to SONIA in new issues capped the overall size of the legacy LIBOR problem. This is in line with the authorities' preference for the use of overnight SONIA compounded in arrears as the most robust rate. As a result, the number and value of legacy sterling LIBOR bonds outstanding has now begun to diminish as bonds mature, and certain fallbacks are triggered. In some cases, there are also call options which issuers can exercise before the maturity date of the bonds.
- Third, a significant number of legacy sterling LIBOR bonds have already been converted in the market to compounded SONIA plus a fixed credit adjustment spread, using consent solicitation, where this is practicable. Active transition of legacy LIBOR bonds is designed to meet the UK authorities' recommendation that legacy sterling LIBOR bonds should be reduced to an irreducible core before the end of 2021.

8 In the case of legacy sterling LIBOR bonds, there are two main factors influencing the size of the irreducible core: (i) some bonds are too difficult to convert (eg the consent thresholds are too high); and (ii) there are too many bonds to convert by the end-2021 deadline as they need to be converted bond by bond, and consent solicitations take around two months' each on average. While over £50 billion (ie roughly one half of the estimated overall total) has been converted by value, this represents under 20% by number. So the bond market will not be able to transition all the outstanding legacy sterling LIBOR bonds by the end of 2021. The bond market cannot solve the legacy LIBOR problem on its own.

How are the UK authorities proposing to help address the problem?

9 To tackle the irreducible core, the UK authorities have introduced legislation under the Financial Services Act, which amends the UK Benchmarks Regulation. This is designed to ensure an orderly wind-down of LIBOR under English law, including in the bond market. Under the legislation, the FCA can exercise its new powers to require continued publication of LIBOR by IBA on a different basis, if and when the FCA decides that panel bank LIBOR is no longer representative of its underlying market. In these circumstances, LIBOR will no longer be intended for use in new contracts. It will be intended for use only in tough legacy contracts.

10 The methodology proposed by the FCA for tough legacy contracts involves a change from panel bank LIBOR to synthetic LIBOR. This change is designed to enable tough legacy contracts to continue to reference a floating rate rather than falling back to a fixed rate.[9] From the end of 2021, synthetic LIBOR is due to apply to tough legacy LIBOR contracts denominated in the most commonly used sterling and Japanese yen settings. In all cases, synthetic LIBOR is due to consist of the relevant term risk-free rate plus a fixed credit adjustment spread, as follows:

- the relevant risk-free rate (ie the ICE Term SONIA Reference Rates provided by ICE Benchmark Administration for sterling, and the Tokyo Term Risk Free Rates (TORF) provided by QUICK Benchmarks Inc., adjusted to be on a 360 day count basis, for Japanese yen);[10] plus
- the respective ISDA fixed spread adjustment (that is published for the purpose of ISDA's IBOR Fallbacks for the six LIBOR settings).[11]

11 During the wind-down period, the FCA has stated that "synthetic LIBOR remains LIBOR and should flow through to allow the continued operation and valuation of outstanding legacy contracts".[12] To support the orderly wind-down of LIBOR, on 8 September 2021 HM Treasury introduced further legislation in the form of a Critical Benchmarks (References and Administrators' Liability) Bill into Parliament on behalf of HM Government. In the case of LIBOR, the Bill "will provide certainty that contractual references to LIBOR should continue to be treated as references to that benchmark where the FCA has directed a change in how LIBOR is calculated: ie synthetic LIBOR."[13]

12 The FCA has stated that "we consider with a high level of confidence that there will be a material amount of legacy contracts, both within and outside the UK, referencing

8. It is important to note that these three types of fallback are used for convenience only and do not describe every case.

9. "Contracts that include fallbacks that operate only when the relevant LIBOR setting ceases permanently are not likely to be triggered at the end of 2021.": FCA CP 21/29 paragraph 1.24, September 2021.

10. A forward-looking term rate has been chosen for synthetic LIBOR because it can be used in a similar way to forward-looking term LIBOR, unlike a compounded risk-free rate, which is a backward-looking overnight rate.

11. FCA announcement on further arrangements for the orderly wind-down of LIBOR at end-2021, 29 September 2021.

12. FCA consultation (CP 21/19).

13. Critical Benchmarks (References and Administrators' Liability) Bill, Explanatory Notes, 8 September 2021.

each of the six LIBOR settings [three in sterling and three in Japanese yen] with maturities beyond end-2021 that contain no fallbacks or inappropriate fallbacks that cannot practicably be amended by the time the relevant LIBOR panels cease. We consider that, without our intervention, these [tough legacy] contracts may not function as intended or could be at risk of frustration beyond end-2021, which would potentially lead to a disorderly cessation. We assess that most of these contracts are in cash markets (ie bonds and securitisations, loans including mortgages and commercial lending) referencing the six sterling and Japanese yen LIBOR settings."[14]

13 There are two questions that are of particular concern in the sterling bond market: first, whether all outstanding legacy LIBOR contracts will be permitted to use synthetic LIBOR, and second, for how long?

- On the first question, the FCA announced on 29 September 2021 that it will decide and specify before the end of 2021 which legacy contracts are permitted to use synthetic LIBOR, and it published a consultation on its proposed decision. At least for the duration of 2022, the FCA is proposing to permit legacy use of synthetic sterling and Japanese yen LIBOR in all contracts except cleared derivatives. Clearing houses plan to transition all cleared sterling, Japanese yen, Swiss franc and euro LIBOR contracts to risk-free rates by end-2021.[15]
- On the second question, in announcing permission for legacy use at least for the duration of 2022 the FCA stated that it must review the use of its power to require publication of a ceasing benchmark at least annually (up to a maximum period of 10 years), and that, for the 3 Japanese yen settings, the FCA does not intend to renew the requirement, and publication will therefore cease at end-2022.[16] The FCA also stated that "users of LIBOR should continue to focus on active transition rather than relying on synthetic LIBOR. Synthetic LIBOR will not be published indefinitely. ... The FCA will also consider progressively restricting continued permission to use synthetic LIBOR in legacy contracts if this would help maintain progress towards an orderly cessation, and thereby support its objectives to protect consumers or market integrity. This may be necessary if, for example, work to reduce the stock of outstanding legacy LIBOR contracts does not continue."[17]

Is tough legacy being addressed in a consistent way internationally?

14 Given the international scope of the bond market, it is important that the wind-down of LIBOR currencies and jurisdictions is internationally aligned. But this does not mean that the timetable and the approach need to be identical. In practice, the timetable for the orderly wind-down in different currencies varies: euro and Swiss franc LIBOR are both due to cease permanently at the end of 2021; Japanese yen LIBOR at the end of 2022; sterling LIBOR in a maximum of ten years, subject to regular review in the meantime. Certain US dollar LIBOR settings will continue to be representative for legacy transactions until the end of June 2023.

15 There are also some international differences in the approach to the wind-down. In particular:

- While the UK is proposing to change the methodology for sterling LIBOR from panel bank LIBOR to synthetic LIBOR, but keeping the same LIBOR benchmark, the US is proposing to replace the US dollar LIBOR benchmark with a commercially reasonable and equivalent substitute. Given the large number of legacy US dollar contracts under English law, it will be important to establish whether the result is consistent. In the case of legacy US dollar contracts under English law, no decision has yet been taken by the authorities on what should happen after 30 June 2023.[18]
- Under English law, synthetic sterling LIBOR is subject to a 10 year time limit, and also subject to regular review in the meantime, while there is no time limit on the replacement benchmark for US dollar LIBOR under New York law.[19]

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14. FCA consultation (CP 21/19).

15. FCA announcement on further arrangements for the orderly wind-down of LIBOR at end-2021. This provides a link to the FCA consultation paper (CP21/29).

16. In the UK, the Financial Services Act specifies that the FCA can compel IBA to continue to publish LIBOR using its Article 21(3) power for a maximum period of 12 months. The FCA will need to review its decision by the end of that period. The period for the review of the FCA's exercise of its Article 23D powers is two years. The FCA must publish a report of the review as soon as reasonably practicable after the end of the two-year review period." (Article 23E).

17. FCA announcement on further arrangements for the orderly wind-down of LIBOR at end-2021, with a link to the FCA consultation paper (CP21/29).

18. Overnight and 12 month US dollar LIBOR settings will cease, and one, three and six month US dollar LIBOR settings will no longer be representative immediately after 30 June 2023. The FCA is continuing to consider the case for using its proposed powers to require continued publication on a synthetic basis of the one month, three month and six month US dollar LIBOR settings for a further period after 30 June 2023, taking account of views and evidence from the US authorities and other stakeholders.

19. Article 23E of the UK Benchmarks Regulation.

- And while the New York legislation abolishes the need for agents to poll reference banks under Type 1 fallbacks, the use of synthetic LIBOR under English law only delays the need for agents to poll reference banks until synthetic LIBOR ceases permanently.[20]

16 But although the timing and approach to the wind-down differ between LIBOR currencies and jurisdictions, the direction of travel away from LIBOR and towards risk-free rates in the different LIBOR currencies and jurisdictions is much the same.[21] And there is global coordination of the transition from LIBOR to risk-free rates through the FSB Official Sector Steering Group. An example of this is the agreement globally in June 2021 that there should be no further use of LIBOR for new transactions, including in US dollars, after the end of 2021. And although tough legacy legislation needs to be introduced separately in each relevant jurisdiction and needs to take account of local factors, the authorities have shown that they are aware of the importance of avoiding a conflict of laws between the UK, the US and the EU.

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20. The fallback provisions in legacy bonds with Type 1 fallbacks often contain provisions to poll reference banks for quotations before the bonds fall back to the previous LIBOR fix for the remaining life of the bond. Although a contractual requirement, polling reference banks is not expected to be feasible in practice or lead to an appropriate outcome.

21. See, for example, the video recording of *The Official Sector Risk-Free Rate Panel,* moderated by ICMA, launched on 2 June 2021 on the RFR webpage on the ICMA website. The panellists were: Edwin Schooling Latter for the FCA; Nate Wuerffel for the Federal Reserve Bank of New York; Roman Baumann for the Swiss National Bank; and Thomas Vlassopoulos for the European Central Bank.