Legacy sterling LIBOR bonds

By Charlotte Bellamy

Summary

RFR The transition away from LIBOR is a global issue affecting various financial products in various currencies. One of the key questions for the bond market is how to deal with legacy bonds referencing LIBOR with a maturity beyond the end of 2021, when LIBOR may cease to be available. There is an increasing focus on this issue, with various authorities and other bodies commenting publicly on it. This article seeks to raise awareness of the issue by exploring the challenges and possible options for dealing with one segment of the market affected by the transition away from LIBOR, namely legacy sterling LIBOR bonds, drawing together various sources of publicly available information.

Background

In July 2017, Andrew Bailey, the Chief Executive of the UK Financial Conduct Authority, said that the FCA would no longer intend to persuade or compel banks to submit contributions for LIBOR after the end of 2021, and he stressed the need to transition away from LIBOR before the end of 2021.[1]

When he spoke again about LIBOR at Bloomberg in London on 12 July 2018, Andrew Bailey said that the importance of transitioning away from LIBOR had not changed; discontinuation of LIBOR should not be considered a remote event; firms should treat it as something that will happen and for which they must be prepared.[2]

To avoid the problems associated with LIBOR[3], the authorities want financial markets to transition away from LIBOR to alternative rates known as near risk-free rates, which are based on very liquid underlying markets. In all the LIBOR jurisdictions, the chosen risk-free rates are overnight rates: SONIA in the UK; SOFR in the US; €STR in the euro area; SARON in Switzerland; and TONAR in Japan.

In transitioning from LIBOR to risk-free rates, one of the key questions for the bond market is how to deal with legacy bonds referencing LIBOR with a maturity beyond the end of 2021, when LIBOR may cease to be available.

The scale of the legacy LIBOR bond problem

It has been estimated that at least the equivalent of $864 billion bonds referencing LIBOR is currently outstanding and due to mature after the end of 2021. This estimate excludes some issues and issuers, such as sovereigns.[4]

Of that estimated total, roughly 80% references USD-LIBOR, 11% references JPY-LIBOR, 9% references GBP-LIBOR and 0.2% references CHF-LIBOR. Roughly 40% of the estimated total has a maturity date before the end of 2025, but over 43% has a maturity date beyond the end of 2034. This may include some perpetual instruments that reference LIBOR.

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

2. Andrew Bailey, Chief Executive of the FCA: *Interest Rate Benchmark Reform: Transition to a World Without LIBOR*, 12 July 2018.

3. See further *The Transition from LIBOR to Risk-Free Rates* by Paul Richards, ICMA, originally published in the *ICMA Quarterly Report, First Quarter 2019*.

4. Source: Royal Bank of Canada Capital Markets.

The challenges associated with legacy sterling LIBOR bonds

Traditional fallback provisions are likely to result in floating rate bonds becoming fixed rate bonds in the event that LIBOR is permanently discontinued

Legacy bonds are likely to contain fallback provisions on how to calculate interest in the event that the nominated rate/screen page is unavailable. The fallback provisions in traditional legacy LIBOR bonds will typically depend on reference banks providing quotes for the relevant rate. In the context of LIBOR discontinuation, reference banks may not be willing to provide quotations on a voluntary basis. The majority of floating rate bonds are also likely to provide that, as an ultimate fallback, where the interest rate cannot be determined through the preceding fallbacks, then the rate defaults to the most recently calculated rate, for an earlier interest period.[5]

In the context of a permanent discontinuation of LIBOR, this would effectively result in the floating rate bonds becoming fixed rate bonds, because the last determined rate would be applied for the remainder of the life of the bond. This may be commercially unacceptable for both the issuer and investors. From an investor perspective, such issues may become illiquid and may cease to perform the commercial purpose investors intended for them. From an issuer perspective, those that aim to match liabilities via other instruments may be adversely affected.[6]

In the light of this, market participants and authorities are considering various options for avoiding a situation in which a large majority of legacy LIBOR bonds become fixed rate instruments. Some of those options are discussed in this article.

An industry protocol of the type used in the derivatives market cannot be used to amend bond contracts

While an industry-level framework could help to facilitate the process for amending bond terms and conditions (see further below), it is not possible to amend bond terms and conditions using an industry protocol such as those used in the derivatives market. There are several reasons for this. One reason is that bond contracts do not envisage amendment by way of an industry protocol. Another is that bond terms and conditions are not completely standardised.

Bond trustees are unlikely to be able to use their discretion to agree to necessary amendments

As indicated in an ICMSA Bulletin, *The Discontinuation of LIBOR/IBORs - Implications for English-law Note Trustees*, except in very rare cases (where transaction documents and terms and conditions explicitly allow), it will not be within a bond trustees' power to exercise its discretion to amend bond documents to cater for a permanent discontinuation of LIBOR. In addition, not all bond issues involve a trustee.

Bonds are, by their nature, freely transferable and often widely distributed to a variety of investors

Bonds are freely transferable and often widely distributed. A single bond may be held by a large number (eg several thousand) investors. The issuer is unlikely to know the identity of the ultimate beneficial owners (or "investors"). This contrasts with the loan market, which (even in a syndicated context) is likely to involve a smaller number of lenders, the identity of whom will be known by the borrower.

In addition, bond market participants include not only financial institutions, but also "real economy" entities such as corporates, pension funds and insurance companies, as well as central banks and sovereign and supranational agencies. Legacy bonds may also be held by retail investors. This needs to be taken into account when considering any approach to handling legacy LIBOR bonds.

Options for handling legacy sterling LIBOR bonds

The following options for handling legacy sterling LIBOR bonds are discussed further below:

- consent solicitation and other liability management exercises; and
- the possibility of legacy sterling LIBOR bonds continuing to reference sterling LIBOR in some form.

This article does not consider legislative intervention, which would be a matter for the authorities.

Consent solicitation and other liability management exercises

Bonds will typically contain provisions allowing their terms and conditions to be amended by way of bondholder consent. This usually involves the issuer proposing

5. See *New Issuance of Sterling Bonds Referencing LIBOR*, published by The Working Group on Sterling Risk-Free Reference Rates, July 2018.

6. See *New Issuance of Sterling Bonds Referencing LIBOR*, published by The Working Group on Sterling Risk-Free Reference Rates, July 2018.

certain changes to the terms and conditions of the bond, either by way of written resolution or by convening a bondholders' meeting. Bondholders can then vote on the proposed changes. If the necessary quorum and/or consent thresholds are reached, then the proposed amendments will be made to the terms and conditions of the bond.

This process could be used to amend legacy sterling LIBOR bond terms and conditions so that they reference an alternative rate going forward or include alternative fallback provisions which would be less likely to result in the bond becoming a fixed rate instrument in the event of a permanent discontinuation of sterling LIBOR.

Each bond would need to be amended individually in order to ensure that the changes were legally valid. It is possible to envisage that some of the terms of the proposed amendments, and potentially other aspects, could be agreed at an industry level and set out in some form of industry framework document or "code". The framework or "code", while not having any binding effect, could be endorsed by relevant authorities and market participants could adhere to it publicly to indicate that they accept its terms at an industry level. This could increase the chances of success for legacy sterling LIBOR bond consent solicitations because it could (a) reduce some of the administrative burdens for issuers and investors and (b) give issuers more confidence in launching a consent solicitation if they are able to see that a large number of investors have indicated publicly that they accept (at an industry level) the terms that the issuer will be proposing.

It is important to note, however, that even with such an industry framework or code in place, each bond contract would need to be amended individually. In other words, adherence to such an industry framework or code would not be effective in amending bond contracts automatically.

There are several significant challenges associated with a consent solicitation approach for handling the legacy LIBOR bond issue.

- The first challenge is that this option is entirely voluntary. It depends upon issuers proposing, and investors accepting, the changes. Both issuers and investors will want (and need) to act in their best commercial interests. In particular, investors will need to act in accordance with their fiduciary duties to their clients and issuers will need to act in the interests of their shareholders. This means that, in order to succeed, the proposed amendment to the bond would need to result in an outcome that is, to the largest degree possible, in both the issuer's and investors' commercial interests. The extent to which this can be achieved in practice is unpredictable and would depend in part on prevailing interest rate conditions at the time any consent solicitation is launched.
- Consent solicitations can be very time consuming, administratively burdensome and expensive for both issuers and investors, particularly in the context of LIBOR discontinuation where they would need to be conducted in respect of a high number of bonds. It is also not clear whether the service providers who would need to be involved in the consent solicitation process (eg law firms, investment banks, clearing systems, paying agents and others) could cope with a high number of consent solicitations being launched at the same time.
- There are likely to be additional practical challenges and considerations for securitisations, capital securities and structured products, which could impact the efficacy of this approach for those products.
- Issuers and investors would need to consider how any change made to bond terms and conditions pursuant to a consent solicitation would impact upon their hedging arrangements.
- Finally, consent thresholds for some bonds (particularly those that are governed by New York law or have been distributed in the US) may be set at 100%. Therefore a consent solicitation approach may not be viable for those legacy LIBOR bonds. However, a consent threshold of 100% is likely to be most prevalent in US dollar denominated legacy LIBOR bonds and rarer in sterling legacy LIBOR bonds.

Some issuers may also wish to consider other forms of liability management exercise, such as offering bondholders alternative securities or cash in exchange for legacy bonds, repurchasing legacy bonds on the open market or exercising any call options in legacy bonds in order to redeem them. These liability management exercises could be used in conjunction with a consent solicitation and/or in combination with each other. However, many of the challenges noted above would apply in the context of these approaches as well.

Overall, consent solicitation or other forms of liability management exercise may be an option for some legacy LIBOR bonds, but it seems unlikely that it will be a solution for all legacy LIBOR bonds.

The possibility of legacy sterling LIBOR bonds continuing to reference sterling LIBOR in some form

In January 2019, the FCA raised the "potential solution of allowing continued publication of LIBOR for use in legacy instruments that do not have mechanisms to remove their dependence on LIBOR".[7] This followed a previous speech

7. Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA: *LIBOR transition and contractual fallbacks*, 28 January 2019

given by Andrew Bailey of the FCA in July 2018, in which he discussed the concept of LIBOR being continued for legacy instruments when it is not available for new business; either on its current basis or by "adding appropriate term credit spreads to overnight risk-free rates".[8]

As acknowledged by the FCA, the idea of LIBOR being continued on its current basis (ie on the basis of continued panel bank submissions) "might seem like an easy way out".[9] IBA (the benchmark administrator for LIBOR) has surveyed market participants in order to identify the LIBOR settings that are most widely used and has stated that it will work with globally active banks to seek to publish certain LIBOR settings after year-end 2021, with the aim of providing those settings to users with outstanding LIBOR-linked contracts that are impossible or impractical to modify. However, IBA states that there is no guarantee that any LIBOR settings will continue to be published after year-end 2021[10] and, as noted above, the FCA and others have made it clear that the future of LIBOR cannot be guaranteed beyond the end of 2021.

There are also challenges associated with the alternative idea discussed in Andrew Bailey's July 2018 speech of continuing to publish LIBOR but adjusting its methodology so that it becomes based on an overnight risk-free rate plus an adjustment spread. In particular, the FCA drew attention to the following:

- "We have not seen a compelling answer to how one-month, three-month, six-month and twelve-month term bank credit spreads can be reliably measured on a dynamic and daily basis. … the term credit spread would almost certainly need to be fixed rather than dynamic because of the lack of market to measure."
- "There is also the issue of how to address the term element of the risk-free interest rate. A calculation based on compounding of the realised overnight rate over the relevant term can work as a fallback to LIBOR in derivatives contracts in which arrangements for calculation of payment can also be amended. It is not clear how it could work more generally as a synthetic LIBOR. Many in cash markets would not be able to adjust their contracts or systems to accommodate this type of payment structure."
- "It should be clear to current LIBOR users that they must not rest any hopes in a synthetic solution to continuing LIBOR publication."

Conclusion

This article has discussed some of the challenges associated with legacy sterling LIBOR bonds in the context of a permanent discontinuation of LIBOR and possible options to handle that issue. At the moment, there is no clear option or combination of options that has emerged as the best way of tackling the issue surrounding legacy LIBOR bonds. What is clear is that market participants need to prepare for the possibility that LIBOR will not be available at the end of 2021 and consider what that means for their legacy LIBOR bonds. This is a big task and ICMA will aim to support its members with this process by continuing to engage with authorities and members on this important topic. More information on ICMA's activities in this area is available on the ICMA benchmark reform and transition to risk-free rates webpage.

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8. Andrew Bailey, Chief Executive of the FCA: *Interest Rate Benchmark Reform: Transition to a World Without LIBOR*, 12 July 2018.

9. Andrew Bailey, Chief Executive of the FCA: *Interest Rate Benchmark Reform: Transition to a World Without LIBOR*, 12 July 2018.

10. See https://www.theice.com/iba/ice-benchmark-administration-survey-on-the-use-of-libor .