New sterling bonds referencing LIBOR

By Charlotte Bellamy

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In July, the Working Group on Sterling Risk-Free Reference Rates (for which Paul Richards, Head of Market Practice and Regulatory Policy at ICMA, chairs a sub-group focusing on benchmark transition issues in bond markets) published a paper on new issuance of sterling bonds referencing LIBOR. The considerations in the paper are likely to have relevance for issuance of international floating rate bonds in all currencies for which LIBOR is quoted.

The paper is addressed to bond market participants who are continuing to issue, offer or purchase new sterling bonds referencing LIBOR, in particular where those bonds mature beyond the end of 2021 when LIBOR may cease to be available.

While the clear direction of travel is a move away from LIBOR, the paper acknowledges that market participants need uninterrupted access to financing and risk management products, and that, in the light of this, LIBOR usage might continue in the near term.

With that in mind, the paper is intended to raise market awareness of the potential risks of continuing to reference LIBOR in new bond issues, and ways that market participants might seek to mitigate those risks. The paper does not deal with the impact of LIBOR discontinuation on outstanding, legacy bonds.

The paper identifies seven examples of potential risks that market participants could face when they are involved in a new issue of bonds referencing LIBOR; and five suggested steps for mitigating those risks. It is worth noting that the risks identified in the paper are just examples of the potential risks to market participants, and there may be others (for example in relation to accounting, tax and/or credit ratings).

The first risk identified in the paper is that floating rate bonds referencing LIBOR may become fixed if LIBOR is discontinued. The paper explains how typical provisions in bond terms and conditions relating to interest calculation (known as "fallback" provisions) work. If LIBOR were to be permanently discontinued, traditional fallback provisions are likely to mean that floating rate bonds would become fixed rate bonds, because it is likely that the last rate that could be calculated would be applied for the remainder of the life of the bond. This may be commercially unacceptable for issuers and investors.

The second risk is that a liability management exercise may be required if LIBOR is discontinued. This is because the terms and conditions of floating rate bonds may need to be amended if LIBOR is discontinued and neither issuers nor investors wish the bonds to switch to a fixed rate of interest. For the majority of bonds, amendments to terms and conditions will require bondholder consent by way of bondholder meetings. The paper explains that this is neither quick nor easy.

The third risk is the possibility that hedging arrangements could be impacted. This is because the fallback provisions under swaps and bonds could operate differently or be triggered at different times in the event of LIBOR discontinuation. This may result in mismatches on payments due under the bond and any associated swaps, which could impact both issuers and investors.

The fourth risk is that market participants may be subject to increased litigation risk, for example where there is a transfer of economic value in the event that LIBOR is discontinued.

The fifth risk identified in the paper is that bank capital instruments referencing LIBOR may not operate as intended after the end of 2021, when LIBOR may not be available. This is something that regulated bank issuers will wish to keep in mind.

The sixth risk flagged in the paper relates to LIBOR continuing to be published but being based on submissions from fewer panel banks or a different methodology. In those circumstances, the provisions of traditional floating rate bonds would be likely to continue to use LIBOR, even if it were an unrepresentative rate. Again, this may not be agreeable to issuers or investors.

The seventh risk relates to regulatory obligations. The paper notes that banks acting as manufacturers of floating rate bonds will need to consider their product governance obligations. Where relevant, firms will also need to ensure compliance with UK FCA Principles.

Having identified those potential risks, the paper goes on to discuss ways of mitigating those risks.

As an initial comment, the Sterling Risk Free Rate Working Group believes that the most effective way of avoiding risks related to LIBOR discontinuation is to transition to alternative benchmarks, in particular SONIA in the case of sterling transactions.

This view was also expressed by Andrew Bailey, Chief Executive of the FCA, in a speech on 12 July, in which he stated:

"The best option is actively to transition to alternative benchmarks. The most effective way to avoid LIBOR-related risk is not to write LIBOR-referencing business."

This approach has been adopted by some issuers already, who have referenced SONIA (or SOFR, in the case of US dollar-denominated transactions) in new bond issues over the course of the summer and autumn.

Nevertheless, the paper also discusses other possible ways of mitigating risks related to LIBOR discontinuation where LIBOR continues to be referenced in new sterling bonds issued in the interim period before market conventions and infrastructure for referencing alternatives to LIBOR are fully developed.

In that context, the paper highlights four areas that market participants might wish to consider:

First, market participants should make themselves fully aware of the implications of the uncertainties surrounding LIBOR. For sell-side market participants, it is appropriate to include detailed risk factors in prospectuses for new LIBOR bonds. Even though a prospectus can only speak as of its date, and so cannot predict future developments, prospectus disclosure is still a key way of ensuring that the risks associated with LIBOR discontinuation are clearly communicated to investors. Andrew Bailey also acknowledged in his 12 July speech that the FCA is already seeing the necessary changes in prospectuses.

The paper also notes that it may also be prudent for sell-side market participants to examine how products are labelled and marketed.

Second, issuers could include an alternative fallback in the terms of new bonds. This alternative fallback could attempt to provide for a switch to an alternative rate in certain defined circumstances. If such a provision is included in bond terms and conditions on issue, then the application of the alternative rate in accordance with those terms would not require a bondholder meeting and bondholder consent later on. This type of provision is already being included in some bond terms and conditions. However, the efficacy of these provisions depends upon it being possible to select and apply an alternative rate and calculate any necessary adjustment spread at the relevant time in accordance with the relevant provisions. Given the current uncertainty surrounding each of these aspects, alternative fallback provisions may not operate as expected in the event of LIBOR discontinuation.

Another option might be for issuers to include provisions in bond terms and conditions which facilitate easier amendments to the interest rate provisions. These provisions would still require some action by the parties in order to effect a switch of reference rate at the relevant time, but the process would be easier. This approach has been used in the securitisation market in particular.

Finally, the paper flags some conduct-related steps that regulated entities who are offering LIBOR products might wish to consider. For example, regulated entities may wish to take the uncertainties of LIBOR discontinuation into account when identifying the appropriate target market or investor base for new floating rate issues. Senior managers within UK credit institutions may wish to consider their duty to take reasonable steps to prevent regulatory breaches from occurring, or continuing to occur, in their area of responsibility. Regulated entities might also wish to document the reasons for concluding that the particular floating rate issuance was acceptable for regulatory purposes, at the time of issuance.

To sum up, this paper is important for any market participants involved in the new issuance of floating rate bonds referencing LIBOR, regardless of the currency.

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Other recent developments related to the transition to risk-free rates

Set out below is a selection of some of the key recent developments related to the transition to risk-free rates. Please also see the article on euro risk-free rates in this ICMA Quarterly Report.

ISDA IBOR fallback consultation: ISDA published a consultation on certain aspects of fallbacks for derivatives referencing certain inter-bank offered rates (IBORs) in July. The consultation closes on 12 October. This consultation relates to ISDA's work to amend its standard documentation to implement fallbacks for certain IBORs. The fallbacks will apply if the relevant IBOR is permanently discontinued, based on defined triggers. The fallbacks will be to alternative RFRs that have been identified for the relevant IBORs as part of recent global benchmark reform work (eg SONIA in the case of sterling LIBOR). The consultation seeks input on the approach for addressing certain technical issues associated with adjustments that will apply to the RFRs if the fallbacks are triggered. These adjustments are necessary because of the differences between the IBORs and the RFRs. For example, LIBOR is a forward-looking rate quoted for a number of tenors. The alternative RFRs are backward-looking, overnight rates.

Subsequently the Working Group on Sterling Risk-Free Reference Rates published a set of considerations to assist market participants in assessing each of the three proposed methodologies for the credit spread adjustment in the ISDA consultation.

ISDA's consultation will be of interest to bond market participants on at least two levels. First, because bond market participants may have entered into swaps to hedge their positions. Second, because it is possible that the adjustments used in ISDA IBOR fallbacks might also be considered for adaptation and/or use in a bond market context in due course.

ISDA Benchmarks Supplement: ISDA also published its Benchmarks Supplement in September. This Supplement is separate from (and covers a wider range of benchmarks than) ISDA's work on IBOR fallbacks. ISDA states: "While two separate initiatives, the ISDA Benchmarks Supplement complements the IBOR fallback work, as it enables firms to agree interim fallback arrangements should an IBOR cease to exist before the IBOR fallbacks are implemented. The IBOR fallbacks will take precedence for specified IBORs once implemented, but the ISDA Benchmarks Supplement will continue to provide an additional layer of protection with respect to index cessation in the event an IBOR fallback fails. It also enables parties to specify primary fallbacks if a benchmark (including an IBOR) is prohibited from use in a derivatives transaction."

FCA/PRA Dear CEO Letter: The FCA and PRA wrote to the CEOs of large UK banks and insurance companies regarding LIBOR transition in September. The purpose of the letter is to seek assurance that firms' senior managers and boards understand the risks associated with this transition and are taking appropriate action now so that firms can transition to alternative rates ahead of end-2021. Among other things, the FCA and PRA request in response to the letter, by Friday 14 December, a board-approved summary of firms' assessment of key risks relating to LIBOR discontinuation and details of planned actions to mitigate those risks.

US ARRC consultation on fallbacks: On 9 July 2018, the US Alternative Reference Rates Committee (ARRC) released guiding principles for the development of fallback language for new financial contracts for cash products to ensure they will continue to be effective in the event that US dollar LIBOR ceases to be produced. Subsequently, the ARRC published consultations on fallback language for floating rate notes and syndicated business loans referencing US dollar LIBOR in September. The deadline for comments is 8 November 2018. Debt capital market participants may also wish to consider if the concepts in this consultation could have application for floating rate notes denominated in other currencies.

Term SONIA consultation: The Working Group on Sterling Risk-Free Reference Rates announced in April 2017 that SONIA is its preferred RFR for use in sterling derivatives and relevant financial contracts. LIBOR is a forward-looking rate quoted for a number of tenors whereas SONIA is an overnight rate. In light of feedback from market participants that suggested that a forward-looking, term rate was important for them, the Working Group on Sterling Risk-Free Reference Rates launched a consultation seeking feedback on practical recommendations aimed at catalysing the development of term SONIA reference rates (ie a forward-looking term rate derived from the RFR), which could play a role in facilitating transition to SONIA and complement ongoing efforts to encourage the direct use of RFRs. The deadline for the consultation was 30 September. A summary of feedback is expected to be published.

Many of the publications noted above and other relevant information is available on the ICMA webpage on benchmark reform and transition to risk-free rates.

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