

Transition to Risk-Free Rates

Successor rates for LIBOR bond fallbacks

Bond documentation¹ typically contains fallbacks which are intended to operate in the event that a particular benchmark or interest rate is no longer available. There are generally three broad categories of fallbacks:

- (i) “Type 1” fallbacks, which effectively mean that bonds become fixed rate instruments in the event of a permanent cessation of LIBOR, because the rate in effect for the last preceding interest period is used for every interest period for the remaining life of the bond;
- (ii) “Type 2” fallbacks, which, *on the permanent cessation of the relevant reference rate*, typically envisage the issuer appointing an independent adviser to select (or to advise the issuer in the selection of) an alternative rate and adjustment spread to be applied to such rate, in each case, on the basis of (a) any recommendations made by relevant nominating bodies or (b) if no such recommendations have been made, customary market practice; and
- (iii) “Type 3” fallbacks which operate in a similar way to the Type 2 fallbacks, but *on the announcement of “non-representativeness” of the relevant original benchmark by the supervisor of the administrator of the benchmark*.

In the sterling market, Type 1 fallbacks are common in the majority of legacy LIBOR bonds, with Type 2 fallbacks tending to feature in bond documentation drafted after [the FCA Chief Executive’s speech on the future of LIBOR](#) in July 2017 and Type 3 fallbacks typically featuring in bond documentation from 2019.

There has thus far been no recommendation of a successor rate by a relevant nominating body for the purposes of these fallbacks, although the credit adjustment spread methodology for use with SONIA-based rates was the subject of a [recommendation](#) by the Sterling Risk-Free Rate Working Group (the RFRWG) in September 2020.

To recommend a successor rate for bonds containing the Type 2 and Type 3 fallbacks would be to direct the determination of the successor rate in those bonds. If there were no recommended successor rate, the fallback would be to an alternative rate, which would typically be the rate which is *customarily applied for the purposes of determining rates of interest*. The issuer or independent adviser would have to make this determination, which could potentially expose them to litigation risk in the event that the rate they determine is challenged.

In the sterling market, the RFRWG’s preferred risk-free rate for GBP LIBOR is SONIA. But as SONIA is an overnight rate, it needs to be constructed for use in bonds in different ways: either compounded in arrears, or as a component of a term rate.

- *SONIA compounded in arrears*: Interest on bonds is typically payable periodically. But as SONIA is an overnight rate which is published the following day, that daily SONIA rate must be aggregated in some way over the relevant period to determine the interest amount for the period. In the SONIA-referencing bond market, the convention has been to aggregate the daily SONIA rates on a compounded basis.

- *Term SONIA*: LIBOR is a forward-looking or “term” rate, where the LIBOR-linked term interest rate payable is known at the start of the relevant interest period. Term rates for SONIA are currently under development by three administrators ([FTSE Russell](#), [ICE Benchmark Administration](#) and [Refinitiv](#)).

There are a number of issues to consider when deciding which rate should be recommended as the successor rate. SONIA compounded in arrears is the rate which has been used in all the SONIA-linked bonds issued in the sterling market². As for the term SONIA rate, a paper on [Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives](#) concluded that, although “bond issuance, including securitisation, was initially seen as a potential use case for a [term SONIA reference rate] ... this market had demonstrably adopted overnight SONIA, compounded in arrears for all new GBP issuance over the last year”.

SONIA compounded in arrears aligns with the conventions already used in the SONIA swap market, and with the fallback rate for derivatives included in the [ISDA Fallbacks Protocol](#) and [ISDA Fallbacks Supplement](#). Consistency between the existing SONIA-linked bond market, the derivatives and loan markets is considered desirable and should give rise to fewer instances in which instruments used to hedge cash products need to be amended or excluded from the ISDA Fallbacks Protocol.

The choice of successor rate carries economic, operational and contractual implications. For instance, with SONIA compounded in arrears, as the interest rate and amount are not known at the start of the interest period, this may have implications for cash flow planning and may require additional operational practical steps. Changes may be required to certain elements of contracts that are designed to work with LIBOR, although this generally would not require recourse to bondholders.

Global consistency of approach for fallbacks across different IBORs is important, particularly for issuers who issue in different currencies and use different reference rates. In this respect, it is worth noting that, in the case of USD LIBOR legacy bonds, the first step in the ARRC’s waterfall of fallbacks is to a term SOFR rate; this could create inconsistency if the successor rate to GBP LIBOR is SONIA, compounded in arrears. And in the UK, the basis for any change in methodology of LIBOR (which may be directed by the FCA pursuant to the [proposed legislative solution](#) for tough legacy transactions) may differ to that of SONIA, compounded in arrears.

Nevertheless, from the authorities’ point of view, one of the Working Group’s 2020–2021 Top Level Priorities, as set out in the September 2020 updated [Working Group Roadmap](#), has been to: “*Take steps throughout 2020 to promote and enable widespread use of SONIA compounded in arrears*”. According to the Roadmap, a statement on successor rates is a Q1 2021 deliverable, as to which a full market consultation on the successor rate is expected.



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1. Including FRNs, securitisations, covered bonds, capital securities and structured products.

2. As at the date of this Quarterly Report, at least 208 SONIA-linked bonds have been issued using SONIA compounded in arrears. Source: Bloomberg.