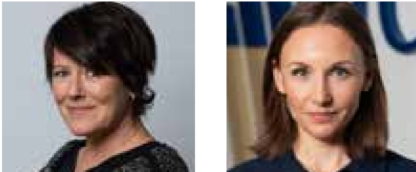
ICMA
International Capital Market Association

Transition from LIBOR to Risk-Free Rates



by **Katie Kelly and Charlotte Bellamy**

"Tough legacy" bonds

Introduction

The end of 2021 was a particularly significant milestone in the long-running transition away from LIBOR. The most commonly-used sterling and yen LIBOR settings (namely the one, three and six month settings) were transitioned to a new "synthetic" methodology[1]; restrictions were placed upon certain entities using five US dollar LIBOR settings[2] in certain new contracts or arrangements[3]; and the remaining 24 LIBOR settings (including all euro and Swiss franc LIBOR settings) ceased to be published[4].

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."[5] This article follows several other articles in ICMA Quarterly Reports documenting the transition away from LIBOR and focusing on the question of "tough legacy" LIBOR bonds[6].

As outlined in those articles, there is considered to be a tough legacy problem in the legacy LIBOR bond market due to a combination of circumstances. These circumstances include the large number and volume of bonds with maturities beyond the end of 2021 with no or inappropriate fallbacks catering for LIBOR cessation; and the challenges for market participants in transitioning those legacy bonds to alternative rates.[7]

Authorities, legislators and official sector-sponsored working groups in different jurisdictions have taken or are taking a number of steps to try to address the challenges of tough legacy contracts.

- In the US, legislation has been introduced in New York and Alabama[8] and is being discussed at a Federal level[9]. The legislation would deem certain contractual references to US dollar LIBOR as referring to a replacement benchmark rate upon the occurrence of certain events affecting LIBOR.
- In the EU, the EU Benchmarks Regulation was amended to allow the European Commission to designate statutory replacement rates for benchmarks such as LIBOR in contracts governed by an EU law or another law that does not provide for an orderly wind-down of the benchmark and where all parties are located in the EU. The European Commission exercised its powers in respect of CHF LIBOR[10] in October 2021.

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1. *Further Arrangements for the Orderly Wind-down of LIBOR at End-2021*, FCA, September 2021.

2. The overnight, one month, three month, six month and 12 month US dollar LIBOR settings.

3. *US Interagency Statement on LIBOR Transition,* November 2021 and FCA *Article 21A Benchmarks Regulation – Notice of Prohibition on New Use of a Critical Benchmark*, which took effect from 1 January 2022 at 00:01.

4. *Announcement on Future Cessation and Loss of Representativeness of the LIBOR Benchmarks,* 5 March 2021.

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

6. See, for example, *The Transition from LIBOR: "Tough Legacy" Bonds,* Paul Richards, ICMA Quarterly Report, Fourth Quarter 2021.

7. *The Transition from LIBOR: "Tough Legacy" Bonds,* Paul Richards, ICMA Quarterly Report, Fourth Quarter 2021.

8. *ARRC FAQs Regarding State LIBOR Legislation,* December 2021.

9. *ARRC Welcomes Passage of LIBOR Transition Bill by U.S. House of Representatives,* December 2021.

10. Commission Implementing Regulation (EU) 2021/1847 of 14 October 2021 on the designation of a statutory replacement for certain settings of CHF LIBOR. The European Commission also exercised its powers in relation to EONIA: Commission Implementing Regulation (EU) 2021/1848 of 21 October 2021 on the designation of a replacement for the benchmark Euro overnight index average.

- The UK took a different approach by amending the UK Benchmarks Regulation to give the FCA new powers to require continued publication of LIBOR by IBA on a different basis following the FCA determination that panel bank LIBOR is no longer representative of its underlying market. This is known as "synthetic LIBOR".

Synthetic LIBOR

Synthetic LIBOR was introduced for the one, three and six month sterling and yen LIBOR settings at the beginning of 2022. It is based upon:

- 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); plus
- the respective ISDA fixed spread adjustment (that is published for the purpose of ISDA's IBOR Fallbacks for the six LIBOR settings)[11].

Synthetic LIBOR is available on the same screens and at the same time that LIBOR was historically published[12], which is important from a practical and legal perspective.

Authorities and official sector-sponsored working groups have been clear that synthetic LIBOR is not to be used in new transactions[13], and UK supervised entities are restricted from using it in new transactions under the UK Benchmarks Regulation[14]. Synthetic LIBOR does, however, provide a temporary bridging solution for tough legacy contracts, including in the bond market[15].

The key issues for the bond market concerning the introduction of synthetic LIBOR related to (a) contract continuity; (b) restrictions upon use of synthetic LIBOR; and (c) the interaction of synthetic LIBOR with fallbacks for typical floating rate notes. Looking ahead, there is a remaining question on the length of time that synthetic sterling LIBOR will be available.

Contract continuity

On the first question of contract continuity, the issues for bond market participants surrounded whether or not synthetic LIBOR would fit with all the different types of LIBOR references that are seen in legacy LIBOR bond contracts; and whether parties would seek to argue that synthetic LIBOR was not the rate they agreed to reference when they entered into their contract and that contractual fallbacks have been triggered.[16]

In the UK, the Critical Benchmarks (References and Administrators' Liability) Act 2021 was passed in December 2021 with the aim of addressing these issues. The Government stated in Explanatory Notes that the legislation 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".

Outside of the UK, the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks published a *Final Report on the Results of the Public Consultation on the Treatment of Tough Legacy Contracts in Japan* in November 2021 setting out, among other things, information for market participants relating to questions of contract continuity and litigation risks. In the EU, the Chair of the Euro Risk Free Rates Working Group wrote a letter to the European Commission on a possible designation of a statutory replacement rate for sterling and yen LIBOR under the EU Benchmarks Regulation, which is addressed in a subsequent section of this Quarterly Report.

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11. *Further Arrangements for the Orderly Wind-down of LIBOR at End-2021,* FCA, September 2021.

12. FCA *Q&A on LIBOR and the FCA's Powers under the UK Benchmarks Regulation*: "We welcome communication from Bloomberg and Refinitiv that all continuing LIBOR settings (including the 6 settings under a 'synthetic' methodology) will continue to be available on the same screens from the start of 2022 as they will at the end of 2021. We also welcome confirmation from IBA that it expects to make all continuing LIBOR settings (including the 6 settings under a 'synthetic' methodology) available to licensees through existing IBA licensee distribution services, as is the case for all current LIBOR settings."

13. See, for example, *Further Arrangements for the Orderly Wind-down of LIBOR at End-2021,* FCA, September 2021: "These 6 LIBOR settings will be available only for use in some legacy contracts, and are not for use in new business" and Working Group on Euro Risk Free Rates' Statement, December 2021: "the Working group on euro risk-free rates ("WGRFR") reminds market participants to cease entering into new contracts that use EONIA and EUR, GBP, CHF, JPY and USD LIBORs as soon as practicable and in general terms by 31 December 2021."

14. UK Benchmarks Regulation, Article 23B.

15. See, for example, FCA *Q&A on LIBOR and the FCA's Powers under the UK Benchmarks Regulation*: "[Synthetic LIBOR] should be viewed as providing a further period to complete transition of legacy contracts, rather than an alternative."

16. See ICMA's response to HM Treasury's *Consultation on Supporting the Wind-down of Critical Benchmarks,* March 2021 for further details.

Restrictions on use of synthetic LIBOR

As noted above, authorities have been clear that synthetic LIBOR is not to be used in new transactions, and UK supervised entities are restricted from using it in new transactions under the UK Benchmarks Regulation.

The UK Benchmarks Regulation also restricts UK supervised entities from using synthetic LIBOR in *legacy* transactions, unless the FCA grants them permission to do so[17]. The FCA decided in November 2021 to permit, at least for the duration of 2022, use of synthetic sterling and yen LIBOR in all contracts except cleared derivatives[18].

This broad permission is welcome for the bond market. It is likely that there would be significant legal and practical issues if synthetic LIBOR is published on a relevant screen page but UK supervised entities are restricted from using it for certain legacy bonds. Many bond contracts were not drafted with this scenario in mind, and so it is likely that there would be uncertainty as to whether fallbacks are triggered or not. In some cases, there might be other, quite significant, implications, such as events of default being triggered or mandatory redemption of legacy securitisations at par. From a practical perspective, it would be challenging to determine which bonds are able to use synthetic LIBOR and which are not.[19]

Interaction of synthetic LIBOR with bond market fallbacks

The approach taken with respect to fallbacks in more recent LIBOR bonds has differed between the floating rate note and securitisation markets.

For floating rate notes, the precise formulation of fallback language varies but can be broadly categorised into three broad types:

- *Type 1 fallbacks.* These are traditional bond fallbacks triggered when the reference rate does not appear on the relevant screen page or the relevant screen page is unavailable. They are likely to provide for a "dealer poll" (see further below) before an ultimate fallback of applying the rate from the previous interest period. Type 1 fallbacks are therefore expected to result in floating rate notes becoming fixed rate notes in the event of LIBOR cessation.
- *Type 2 fallbacks.* These provide for the issuer to appoint an independent agent to select an alternative rate and appropriate credit adjustment spread following certain trigger events, typically the permanent cessation of LIBOR and other events such as a prohibition or restriction on use.
- *Type 3 fallbacks.* These are the same as Type 2 fallbacks but have an additional trigger event based on an announcement that the reference rate is or will no longer be representative.[20]

In the securitisation market, Type 2 and Type 3 fallbacks were considered less appropriate for many sections of the securitisation market for ratings and other reasons. The large majority of legacy LIBOR securitisations are likely to include Type 1 fallbacks. This includes securitisations issued after July 2017[21] that include AFME's Model Benchmark Rate Modification Language allowing for a streamlined process for modifying references to LIBOR.[22]

Overall, bonds (including securitisations) with Type 1 fallbacks are likely to account for the large majority of legacy sterling LIBOR bonds with a maturity beyond the end of 2021 – probably in the region of 70%[23].

For bonds and other contracts and arrangements governed by English law or another law of the UK, the Critical Benchmarks (References and Administrators' Liability) Act 2021 is designed not to prevent or affect the operation of fallback provisions. However, the Act clarifies that where a contract or arrangement has a fallback clause that is triggered by the cessation or unavailability of the benchmark in question, those clauses would *not* be triggered by the introduction of synthetic LIBOR[24].

This, together with the FCA's permission to use synthetic LIBOR, means that typical Type 1 and Type 2 fallbacks in English law-governed floating rate notes are *not* expected to have been triggered by the introduction of synthetic LIBOR[25], although legal analysis of the precise bond provisions in each case is required.

17. UK Benchmarks Regulation, Article 23B.

18. *FCA Confirms Rules for Legacy Use of Synthetic LIBOR Rates and no New Use of US dollar LIBOR*, FCA, November 2021.

19. See *ICMA Response to FCA Consultation Paper CP21/29 on Proposed Decisions on Use of LIBOR,* October 2021 for further information.

20. *ICMA Response to FCA Consultation Paper 21/15,* June 2021, paragraph 4 on pages 4 – 5.

21. 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.

22. *ICMA Response to FCA Consultation Paper 21/15,* June 2021, paragraph 6 on page 5.

23. *ICMA Response to FCA Consultation Paper 21/15,* June 2021, paragraph 5 on page 5.

24. Critical Benchmarks (References and Administrators' Liability) Bill Explanatory Notes, paragraph 30.

25. Clifford Chance, *Synthetic LIBOR and the UK Critical Benchmarks (References and Administrators' Liability) Act 2021: 10 Things That You Need to Know*, December 2021.

In relation to Type 3 fallbacks, the FCA has issued announcements related to the non-representativeness of the synthetic LIBOR settings[26]. As such, it seems likely that many Type 3 fallbacks in floating rate notes will have been triggered[27], although legal analysis of the precise bond provisions in each case is required.

For securitisations that contain AFME's Model Benchmark Rate Modification Language, it may be possible for the parties to adopt the streamlined process for transitioning away from LIBOR set out in those provisions. Legal analysis of the precise bond provisions in each case is required.

Length of availability of synthetic LIBOR

Synthetic yen LIBOR will be available until the end of 2022[28]. It is currently unclear when synthetic sterling LIBOR will cease to be published. The UK Benchmarks Regulation allows the FCA to compel IBA to publish synthetic LIBOR for up to ten years, but the FCA must review its decision to compel IBA to continue to publish it at least annually[29].

The FCA has been clear that users of LIBOR should continue to focus on active transition rather than relying on synthetic LIBOR, and that the FCA may consider progressively restricting continued permission to use synthetic LIBOR in legacy contracts if this would help to maintain progress towards an orderly cessation[30]. The minutes of the Working Group on Sterling Risk-Free Reference Rates meeting in November 2021 state: "The FCA noted that, although the case for publishing synthetic LIBOR was strong, the scale of outstanding contracts varied across settings and tenors. The FCA will consider whether certain synthetic settings could be retired more rapidly than others." And in a speech in December 2021, Edwin Schooling Latter of the FCA noted: "Based on the data for [2021], we concluded the case for continuing all three of these sterling tenors for 2022 was made. But it is worth noting that the case for 3-month sterling LIBOR was stronger than for 1-month and 6-month. When outstanding contracts that still reference a particular LIBOR setting have reduced significantly, it may no longer be proportionate for the FCA to require continued publication of that setting on a synthetic basis."

ICMA outlined the implications for the bond market of the withdrawal of synthetic sterling LIBOR in its response to FCA consultation CP 21/29 on proposed decisions on the use of LIBOR; and noted that, for all legacy sterling LIBOR bonds referencing synthetic LIBOR, it will be important that the FCA engages with the market and gives market participants sufficient notice (at least one year) before synthetic sterling LIBOR ceases to be published.

Bonds referencing LIBOR settings that have ceased to be published: dealer polls

The majority of legacy LIBOR bonds are understood to reference LIBOR settings that continue to be published after the end of 2021, either on a representative, panel-bank basis (ie overnight, one month, three month, six month or 12 month US dollar LIBOR settings) or a non-representative, synthetic basis (ie one month, three month or six month sterling or yen settings).

A relatively small number of bonds were understood to reference one of the LIBOR settings that ceased to be published at the end of 2021. For those bonds that are still outstanding and that have not been actively transitioned to an alternative rate, it is likely that the relevant fallback provisions (if any) have needed to be, or will need to be, applied in respect of the next interest determination following 31 December 2021.

Where the fallback provision is a Type 1 fallback, this will typically involve the operation of a "dealer poll" in which quotes for borrowing rates are collected from a range of dealers, in lieu of LIBOR itself.

Leading up to the cessation of the less frequently-used LIBOR settings at the end of 2021, some market participants queried how Type 1 fallbacks involving "dealer polls" were expected to operate.

Edwin Schooling Latter of the FCA provided clarification in a speech in December 2021, noting: "...it seems rather optimistic to think [dealer polls] will work given that a principal reason for the end of LIBOR is banks' unwillingness to continue to provide such quotes for LIBOR itself. And we are now hearing exactly that prediction from various market participants – ie they won't work because quotes will not in practice be offered. Although we have asked for any information that suggests otherwise, we are not aware at this point of any firm that has confirmed a willingness to provide rates in response to such a poll after the relevant LIBOR setting is no longer published, other than where they have a contractual commitment to do so."

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26. See, for example, *FCA Announcement on Future Cessation and Loss of Representativeness of the LIBOR Benchmarks,* 5 March 2021 and *FCA Notice of First Decision under Article 21(3) UK Benchmarks Regulation,* 10 September 2021.

27. Clifford Chance, *Synthetic LIBOR and the UK Critical Benchmarks (References and Administrators' Liability) Act 2021: 10 Things That You Need to Know,* December 2021.

28. *FCA Announcement on Future Cessation and Loss of Representativeness of the LIBOR Benchmarks,* 5 March 2021.

29. UK Benchmarks Regulation, Article 21(3).

30. *Further Arrangements for the Orderly Wind-down of LIBOR at End-2021,* FCA, September 2021.

"We do not think it would be appropriate or reasonable for us to put regulatory pressure on firms to respond to such polls. We understand that this would create a variety of conduct and other risks."

"However, it is helpful if market participants are able to assess and conclude at appropriate speed whether such dealer polls will work, and thus whether they must proceed to the next step in the waterfall, or contact the counterparty to agree alternative arrangements. Banks that might receive such requests may wish to consider setting up a centralised point to receive and make clear if any response will be provided to such requests. They may wish to consider being clear in their client or other communications where they have policies to decline to respond."

This position was also reflected in the minutes of the Working Group on Sterling Risk-Free Reference Rates meeting in November 2021.

Conclusion

It is clear that synthetic LIBOR is not a permanent solution for tough legacy sterling and yen LIBOR bonds. Market participants will therefore need to continue to prioritise active transition away from legacy LIBOR bonds where that is feasible.

The approach taken to the operation of bond fallbacks that have been triggered due to cessation of publication or loss of representativeness of the relevant LIBOR setting at the end of 2021 could provide useful background and practical lessons for the time that other LIBOR settings cease to be published or lose representativeness in the future. However, bond fallback provisions vary in their general approach and precise drafting, and a careful legal analysis on a case-by-case basis will always be needed.

ICMA will continue to engage with members and the official sector, as appropriate, on the issue of tough legacy LIBOR bonds across the remaining LIBOR currencies.

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Continued active transition of sterling LIBOR-linked legacy bonds

The consistent message from regulatory authorities globally has been, first, to cease new issuance of LIBOR-linked bonds, and second, to encourage the active transition of any instruments that already link to LIBOR. Aligning with this messaging, market-led developments in terms of SONIA conventions over the last number of months have helped to ensure that conditions for issuance of, and transition to, SONIA are optimal.

In the sterling market, over 90 sterling LIBOR-linked legacy bonds have already successfully transitioned to a SONIA basis using consent solicitation, a process which facilitates the amendment of bond terms. But while this represents roughly two thirds by value, the FCA estimates that there are 480 outstanding sterling LIBOR-linked legacy bonds. There are some challenges associated with consent solicitation: quorum and voting thresholds are high, and it can be hard to identify all investors and ensure their engagement. The cascade of information and communications between the parties is cumbersome, and may be compounded if there are different ownership structures in place, in particular as much of the operations process is conducted manually. Consent solicitations can be costly, time consuming and potentially complex. And some transactions may be too difficult to amend, such as securitisations where parties may be absent and there are complexities in the structure itself.

The FCA has confirmed that it will "allow the temporary use of synthetic sterling and yen LIBOR rates in all legacy LIBOR contracts, other than cleared derivatives, that have not been changed at or ahead of the end of December 2021". But in its associated questions and answers (FCA Q&A), the FCA also states that "the ongoing availability of synthetic LIBOR beyond 2022 cannot be assured. The availability of synthetic LIBOR rates will be subject to annual review, so active transition will provide more certainty for the future".

So, although synthetic sterling LIBOR provides a pathway for transition for sterling LIBOR-linked legacy bonds, it is only temporary. This means that, notwithstanding the challenges already highlighted, the focus should remain on active transition, even when synthetic sterling LIBOR is published, for those longer-dated or perpetual bonds which may not be able to avail of it. The FCA Q&A also suggests that "in many cases there will also be advantages to moving to use of compounded risk-free rates at an earlier stage. It has the most robust underlying markets, and as the new market standard for most products, it will benefit from the greatest liquidity in hedging products".

The end date for the availability of synthetic yen LIBOR will be the end of 2022. Convening bondholder meetings to amend the terms of bonds is not a common process in Japan, and is not likely to be familiar to many Japanese market participants. However, according to the results of a survey on the use of JPY LIBOR conducted by the Financial Services Agency in Japan and the Bank of Japan, many of the 27 financial institutions surveyed replied that, for a large number of contracts that were not amended yet, they had already agreed with contracting parties on terms and conditions such as alternative interest rate benchmarks and the spread adjustment methodology.

US dollar LIBOR settings will cease at the end of June 2023, allowing more time for transition of US dollar LIBOR-linked legacy bonds. However, as under New York law amendments

to interest rate provisions typically require the consent of 100% of holders of the outstanding principal amount of bonds, the consent solicitation process is uncommon and relatively impractical, so the New York law statutory override of LIBOR in certain legacy contracts is helpful.

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EU designation of synthetic LIBOR

In November 2021, the Chairman of the Euro Risk-Free Rates Working Group (EUR RFR WG) wrote to Tilman Lueder, Head of Securities Markets at the European Commission, suggesting alignment for tough legacy contracts *under EU law* with the approach taken by the UK *under English law*, ie synthetic LIBOR for sterling and Japanese yen LIBOR-referencing contracts. In order to achieve this, it suggests the adoption of specific legislation by way of designation of a statutory *replacement rate* under the EU Benchmarks Regulation referencing the underlying components of synthetic LIBOR (ie term risk-free rate plus spread). According to the letter, this designation would provide legal certainty for contracts linked to synthetic LIBOR and a consistent approach for all tough legacy contracts. However, the letter also acknowledges certain challenges with full alignment with the UK approach and with other operational aspects, and it invites further discussion on the most appropriate approach.

The European Commission has since published details of a planned initiative for each of sterling and Japanese yen LIBOR stating (a) that adoption of implementing regulations to designate statutory replacement rates is planned for the first quarter of 2022 and (b) that the statutory replacement rates will replace contractual references to certain sterling and Japanese yen LIBOR rates (as applicable) in the EU by operation of law from the date on which the implementing act applies.

As a non-voting member of the EUR RGR WG, ICMA will monitor developments to seek to ensure that any efforts to designate a statutory replacement rate do not undermine or adversely affect the work done to ensure the contractual continuity between sterling and Japanese yen LIBOR and synthetic LIBOR under English law by way of the Critical Benchmarks Act 2021.

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Completion of SARON transition

The National Working Group on Swiss Franc Reference Rates (NWG) met on 9 November to discuss the progress of the LIBOR transition in Switzerland. At the meeting, FINMA (the Swiss financial market supervisory authority) provided an update on its self-assessment survey, according to which those firms that were closely monitored had made strong progress and largely adhered to the milestones of the roadmap set out in FINMA Guidance 10/2020. The transition from CHF LIBOR to SARON has been largely successful with a 97% reduction of contract volumes without robust fallbacks since mid-2020. Given the progress made, FINMA no longer considers a disorderly and disruptive LIBOR transition as one of the main risks for Switzerland, but stressed that a lot of work remains to be done, in particular with regards to the US dollar LIBOR transition.

Members concluded that the transition to SARON is conceptually completed in Switzerland, and the operational transition to SARON is on track. Consequently, in line with its statutes, there is no further NWG meeting planned and the NWG and its sub-groups will cease to exist after the end of Q1 2022.

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