ICMA International Capital Market Association

Transition from LIBOR in the bond market

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The transition from LIBOR to risk-free rates (RFRs) has been under way for some time now, and ICMA has been closely involved from an early stage. In particular, ICMA chairs a Bond Market Sub-Group, which is a substantive sub-group of the overall Sterling Risk-Free Rate Working Group (RFRWG), charged with addressing LIBOR transition in the bond markets, including securitisations.

Alternative RFRs

In considering the transition from LIBOR, it is important to understand the evolution and operation of the new RFRs. Globally, the authorities have recommended RFRs as alternatives to LIBOR, and their uptake has been very healthy in the sterling (SONIA) and US dollar (SOFR) FRN markets. As the new RFRs are based on actual overnight rates, they are applied retrospectively to the notional amount at the end of an interest period, and are compounded, which is a fundamental shift in approach to LIBOR, which was determined at the start of an interest period.

Term RFRs, which mirror LIBOR in that they are known at the start of the interest period, are available for certain LIBOR currencies, but the Financial Stability Board noted the importance of using overnight RFRs where possible in 2018[1] and official sector-sponsored working groups, including the RFRWG, have subsequently recommended that usage of term RFRs be limited.[2] The RFRWG's Term Rate Use Case Task Force has however provided guidance[3] on where the usage of a term rate may be necessary.[4] This includes, for instance, Islamic finance, where for Shariah law-compliance, a variable rate of return can be paid, so long as the variable element is pre-determined.

RFR conventions

This change in approach to computing interest amounts has necessitated different market conventions which, in the SONIA market, are well enshrined but, in the SOFR market, are more changeable. In the SONIA market, the SONIA rate applied to the notional amount is taken typically five business days before the end of an interest period, which allows enough time for the payment flows to operate smoothly. This convention is also used in the SOFR market, but other conventions also feature, such as locking-in the rate a certain number of days before the end of an interest period and applying that rate for the rest of the period.

There are also different approaches to weighting for days when the relevant rate is not published, such as weighting the rate according to the number of days that apply in the interest period or according to the number of days that apply in the observation period. SONIA and SOFR indices are also published to support the rates, but thus far, their use has been sporadic.

Anecdotally, the fact that there are different conventions as between the RFRs does not appear to be problematic for the market, with most investors capable of accommodating the variations. But it is important that the conventions are captured correctly by data sources so that they can be easily identified and understood by investors.

LIBOR transition timings

Moving on, a key milestone was achieved on 31 December 2021, when the Financial Conduct Authority in the UK (FCA) announced that most LIBOR settings (including all euro and Swiss franc settings) ceased to be published, and 1, 3 and

1. *Interest Rate Benchmark Reform – Overnight Risk-Free Rates and Term Rates,* FSB, July 2018.

2. *Term SONIA Reference Rate Publication Summary,* RFRWG, updated July 2021.

3. *Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate, and Further Alternatives,* RFRWG, January 2020..

4. See also *ARRC Best Practice Recommendations Related to Scope of Use of the Term Rate*, updated August 2021.

6-month sterling and yen LIBOR transitioned to a "synthetic" methodology which, as outlined below, is to help support an orderly wind-down of LIBOR. This stage of the LIBOR transition passed off smoothly, in no small part due to market preparedness and clear pathways and messaging from the authorities.

The transition from US dollar LIBOR is running to a different timetable, and panel bank US dollar LIBOR will only permanently cease to be published on 30 June 2023, although restrictions were placed upon its use as of 31 December 2021[5]. So, US dollar LIBOR should not be used in any new transactions, and all firms have been encouraged since last year to plan for its end. As the Chair of the Alternative Reference Rates Committee (ARRC, which is the official working group charged with US dollar LIBOR transition) puts it: "you wouldn't wait until the moving van arrives to pack up the china; you would carefully package and label everything beforehand[6]".

Legacy LIBOR bonds

The question of how to transition legacy LIBOR bonds (and indeed other contracts that reference LIBOR) away from LIBOR has been, and continues to be, a key question for financial markets.

In the bond market, LIBOR or LIBOR-based rates have been used in a wide range of instruments, some of which have a very long maturity or indeed no maturity (like perpetual instruments). Historically, before market participants knew about LIBOR cessation, those contracts would not have been drafted with that scenario in mind. This means that the provisions catering for the reference rate being unavailable (known as fallback provisions) typically cater for a temporary cessation of the reference rate but do not cater for a permanent cessation. In many cases, they will operate such that the most recently used rate is applied for the remainder of the term of the bond. In other words, a floating rate instrument becomes a fixed rate instrument upon the permanent cessation of LIBOR.

This outcome is not considered to be palatable because it is different from what the parties originally agreed when they issued or bought the security. Bond market participants can take steps to avoid this outcome. This is known as "active transition". As outlined below, active transition is not straightforward in all cases. In addition, there are various other asset classes, such as loans and mortgages, in which legacy LIBOR contracts and instruments face similar or other issues. For these reasons, legislators and authorities in the US, UK and EU have put in place legislation to help support an orderly wind-down of LIBOR.

The introduction of legislation in the US, UK and EU is an interesting illustration of official sector support for an orderly wind-down of LIBOR on a global basis, and an acknowledgement of the significance of this task. Broadly speaking there are two different legislative approaches: a "contract override" approach (introduced by US and EU legislators) and the "synthetic LIBOR" approach (introduced by UK legislators).

The contract override approach in federal US law will apply to certain contracts referencing US dollar LIBOR that are governed by a law of the US, such as New York law. Many international bonds are governed by New York law, and so this legislative solution is important for the bond market. The Federal Reserve Bank of New York has responsibility for specifying a SOFR-based rate that will be the automatic replacement for US dollar LIBOR references in in-scope contracts when US dollar LIBOR ceases. It is anticipated that some types of bonds will be in-scope. The legislation also specifies a credit adjustment spread that will apply. This is intended to reflect the difference between LIBOR (which embeds a bank credit element) and a SOFR-based rate (which is a "risk-free" rate). The aim of the legislation is to establish a clear and uniform process for replacing LIBOR in existing contracts where the terms do not provide for the use of a clearly defined or practicable replacement benchmark.

A similar approach has been taken in the EU Benchmarks Regulation, where the European Commission has discretion to select a replacement rate and credit adjustment spread for certain contracts that are: (a) governed by EU law; or (b) governed by a third country law that does not provide for the orderly wind-down of a benchmark and where all the parties are established in the EU.

The synthetic LIBOR approach is different. Synthetic LIBOR involves the FCA (which is the supervisor of IBA, the LIBOR administrator) directing IBA to change the methodology for how it calculates LIBOR. The FCA has already exercised its powers to compel IBA to continue to publish the most commonly-used sterling and yen settings on the basis of a different methodology. As of the start of 2022, those sterling and yen LIBOR settings are no longer being calculated based on panel-bank submissions and are based instead on a risk-free rate and a credit adjustment spread (so-called synthetic LIBOR). The application of the synthetic LIBOR rate to legacy LIBOR contracts is supported in UK law via the Critical Benchmarks (References and Administrators' Liability) Act 2021, which the UK Government introduced in order to provide certainty that contractual references to LIBOR should continue to be treated as references to

5. See also statement of the Board of Governors of the Federal Reserve System (Reserve Board), the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, November 2020; the Reserve Board's related examination guidance, March 2021; IOSCO's statement, June 2021; and CFTC statement, July 2021.

6. See press release, ARRC, October 2021

LIBOR where the FCA has directed a change in how LIBOR is calculated, ie to introduce synthetic LIBOR.

The FCA has not yet decided whether to exercise these powers in relation to US dollar LIBOR.

Legacy US dollar LIBOR bonds after end June 2023

The outcome for US dollar LIBOR bonds after the end of June 2023 (when panel bank US dollar LIBOR is due to cease) will depend on a number of factors including the governing law of the bond and whether it is subject to the US or EU contract override legislation, as well as the fallback provisions contained in the bond's terms and conditions.

Broadly speaking, it is anticipated that bonds that have been issued recently and that contain fallbacks designed to cater for permanent cessation of LIBOR (in particular where the fallbacks are triggered by LIBOR being unrepresentative) are likely to operate in accordance with their terms resulting in the bond transitioning to a SOFR-based rate. However, if the FCA chooses to exercise its powers to compel IBA to publish synthetic US dollar LIBOR, this could mean that certain types of updated fallback provisions (primarily those *without* triggers based on LIBOR's representativeness) contained in bonds that are *not* subject to the US or EU legislation might *not* be triggered, meaning those bonds would reference synthetic US dollar LIBOR.

The situation is likely to be different for those bonds with older fallbacks that are not designed to deal with LIBOR cessation:

- If those bonds are governed by a law of the US, such as New York law, they may be subject to the US legislation and therefore automatically transition to a SOFR-based rate for the remainder of their term.
- If the bonds are governed by another law, such as English law, and if the FCA exercises its powers to compel IBA to publish synthetic US dollar LIBOR, then those bonds may reference synthetic LIBOR after June 2023.
- It is also possible that the EU legislative override might be relevant, for example if the bonds are governed by a law of the EU and the European Commission decides to exercise its powers under the EU Benchmarks Regulation to specify a successor rate for US dollar LIBOR.

It is possible that any synthetic US dollar LIBOR, the US legislative override and the EU legislative override might all use the same SOFR-based rate and credit adjustment spread. This would mean that, at least to start with, there would be the same commercial outcome for legacy US dollar LIBOR bonds that are subject to these legislative solutions, albeit achieved via different mechanisms.

There is a fundamental difference, though, between the synthetic LIBOR route and the legislative override route, which is that synthetic LIBOR is not guaranteed to be published for the remainder of the term of the instrument. In fact, the FCA must review whether or not to continue to compel IBA to continue to publish synthetic LIBOR on an annual basis up to a maximum of 10 years. For sterling and yen LIBOR, the FCA has been clear that synthetic LIBOR is not a permanent solution and will be wound down. Synthetic yen LIBOR settings will cease at the end of 2022. For synthetic sterling LIBOR, the FCA is currently consulting on retiring the 1-month and 6-month settings at the end of March 2023, and on when to retire 3-month sterling synthetic LIBOR, via a public consultation. This consultation also seeks information on US dollar LIBOR in advance of the FCA needing to assess whether it should require continued publication of US dollar LIBOR on a synthetic basis when the US dollar LIBOR panel ends on 30 June 2023.

Taken together, the question of what will happen to legacy US dollar LIBOR bonds after the end of June 2023 is a complicated picture with some elements that have not yet been confirmed. What is certain is that market participants will need to be looking very carefully at their US dollar LIBOR exposure with a view to managing it down and understanding how the different legislative-based approaches will impact them from the end of June 2023.

Actively transitioning away from LIBOR

The importance of managing down LIBOR exposures by actively transitioning them cannot be overstated. The FCA has been clear that synthetic sterling LIBOR is not a permanent solution and will be wound down. This means active transition remains an important part of a sterling LIBOR transition strategy, in particular for longer dated/perpetual transactions. It is our understanding that there is quite a significant number of US dollar LIBOR bonds governed by English law, and as explained, the pathway to a solution is not confirmed. So there is no doubt that the best way to retain control and achieve certainty of outcome in US dollar LIBOR transition is to undertake a consent solicitation exercise to switch from US dollar LIBOR to SOFR.

But doing so may not be straightforward, because it requires changing the interest rate provisions of bonds – a process known as consent solicitation, whereby an issuer seeks agreement with noteholders to change the contractual terms of the bond. The consent solicitation process takes time and can be costly, and there is no guarantee of success. Under English law, typically 75% of the required quorum can agree the changes, which will then be binding on all noteholders, but that threshold can be difficult to achieve. However, these challenges are not insurmountable, and consent solicitation has been used successfully to transition a large number of sterling LIBOR

legacy transactions already. In the UK, the FCA has stated that it will continue to monitor UK regulated entities' progress in relation to US dollar LIBOR transition.

Conclusion

It has been clear for some time that market participants need to pay close attention to LIBOR cessation and actively manage the risks arising from it. This is ever more the case following the end of June 2022, as there is now less than one year left for the remaining US dollar LIBOR settings in panel bank format. Although US dollar LIBOR represents a unique and new challenge in terms of the scale and truly global nature of the transition effort that is required, there is a wealth of knowledge and experience that has been gained in the sterling and yen LIBOR transitions that can be drawn upon.

ICMA staff will continue to engage with market participants and the relevant authorities on these issues and remain available to discuss with ICMA members.

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