The orderly wind-down of LIBOR in the bond market

by **Paul Richards**

The background to the global transition away from LIBOR

The Bank of England and the FCA, among other authorities, have made it clear for a number of years that the market for unsecured wholesale term lending between banks is no longer sufficiently active to support such a widely used reference rate as LIBOR.[1] In July 2017, the FCA's then Chief Executive said that the FCA would no longer intend to persuade or compel banks to submit contributions for LIBOR after the end of 2021. In that context, the FCA plays an international role: partly because the FCA is the regulator and supervisor of the administrator of all the five main LIBOR currencies internationally: ie sterling, US dollars, euro, Swiss francs and Japanese yen; and partly because a large number of financial contracts have been written under English law referencing LIBOR, not just in sterling, but in US dollars and other currencies.

As LIBOR has for many years been embedded in the international financial system, the transition away from LIBOR is a global initiative. The authorities globally consider that the transition away from LIBOR is an essential task and a priority for the G20. In the five main LIBOR currencies, there are established successors in the form of near risk-free rates: SONIA for sterling; SOFR for US dollars; €STR for euro; SARON for Swiss francs; and TONA for Japanese yen. To take account of conditions in different national markets, some of these risk-free rates are based on secured transactions and some are based on unsecured transactions. But they all have an important feature in common. They are all overnight rates, as these rates are the most robust, measured by the volume of actual transactions. Overnight risk-free rates differ from LIBOR because LIBOR is a forward-looking term rate which includes bank credit risk. Forward-looking term rates based on the successor risk-free rates have been, or are being, developed in some currencies, though not in Swiss francs.[2]

The transition from LIBOR to risk-free rates is being coordinated globally by the Financial Stability Board Official Sector Steering Group (FSB OSSG), which is chaired jointly by Andrew Bailey, Governor of the Bank of England, and John Williams, President of the Federal Reserve Bank of New York.[3] At national level, the transition to risk-free rates is being overseen by Risk-Free Rate Working Groups (RFRWGs) involving the authorities and the market working together.[4]

1. This was illustrated during the market turmoil at the start of the COVID-19 pandemic in March 2020, during which LIBOR rates rose when central bank policy rates fell. See the FSB *Statement on the Impact of COVID-19 on Global Benchmark Reform,* July 2020.

2. Andrew Bailey, Governor of the Bank of England: "Let me be clear – forward-looking term rates can support transition. But let me be equally clear in setting out that a broad-based transition to the most robust overnight rates – for sterling that is compounded in arrears SONIA, underpinned by deep underlying markets - will support a stronger more transparent financial system and ultimately benefit all market participants.": *Descending Safely: Life After LIBOR,* 11 May 2021.

3. The Financial Stability Board published an updated version of its *Global Transition Roadmap for LIBOR* on 2 June 2021.

4. ICMA is represented on the Sterling Risk-Free Rate Working Group, and chairs the Bond Market Sub-Group, the Euro Risk-Free Rate Working Group (as an observer), the Swiss National Working Group, and is in regular contact with the Chair of the FRN Group in the US Alternative Reference Rates Committee (ARRC).

Introduction

1 This Quarterly Assessment considers plans for the orderly wind-down of LIBOR in the bond market under English law. It focuses on the wind-down of LIBOR in the sterling bond market, as the wind-down of sterling LIBOR is now due to take place ahead of the wind-down of US dollar LIBOR. As a result, the wind-down in the sterling bond market has become a test case. It is also a case in which ICMA is actively involved.

2 The assessment covers: the background to the international transition away from LIBOR (see box); the proposals for an orderly wind-down of LIBOR announced by the authorities on 5 March; an overview of the transition in the sterling bond market; the operation of fallbacks in the bond market under English law; active transition of legacy LIBOR bonds; legislation to seek an orderly wind-down of tough legacy contracts; and the key remaining challenges to ensure that the wind-down works in an orderly way internationally with the minimum of market uncertainty.

Official announcement on the cessation of LIBOR panel bank settings

3 On 5 March 2021, the FCA announced the future cessation or loss of representativeness of all 35 LIBOR panel bank benchmark settings currently published by ICE Benchmark Administration (IBA), the authorised administrator regulated and supervised by the FCA, using its powers under the UK Benchmarks Regulation.[5]

4 Publication of 26 of these LIBOR settings will permanently cease immediately after publication on the following dates:

- *31 December 2021:* all 7 euro LIBOR settings; all 7 Swiss franc LIBOR settings; the Spot Next, 1 week, 2 month and 12 month Japanese yen LIBOR settings; the overnight, 1 week, 2 month and 12 month sterling LIBOR settings; and the 1 week and 2 month US dollar LIBOR settings;
- *30 June 2023:* the overnight and 12 month US dollar LIBOR settings.

5 In the case of the 9 remaining LIBOR settings:

- the FCA will consult on requiring IBA to continue to publish the 3 remaining sterling LIBOR settings (1 month, 3 month and 6 month) after the end of 2021 on the basis of a changed methodology ("synthetic LIBOR");
- the FCA will consult on requiring IBA to continue to publish the 1 month, 3 month and 6 month Japanese yen LIBOR settings after the end of 2021 on a synthetic basis for one additional year, when they are due to cease permanently; and
- the FCA is continuing to consider the case for using its proposed powers also to require continued publication on a synthetic basis of the 1 month, 3 month and 6 month US dollar LIBOR settings for a further period after 30 June 2023, taking account of views and evidence from the US authorities and other stakeholders.

6 In the case of these 9 LIBOR settings, the FCA has stated that LIBOR will no longer be representative of its underlying market and representativeness will not be restored:

- *immediately after 31 December 2021*, in the case of 1 month, 3 month and 6 month sterling and yen LIBOR; and
- *immediately after 30 June 2023,* in the case of 1 month, 3 month and 6 month US dollar LIBOR.

7 In addition, the FCA has said that "firms should ensure they cease new use of US dollar LIBOR as soon as practicable and no later than the end of 2021, in line with the supervisory guidance issued by US authorities".[6]

Overview of the transition in the sterling bond market

8 Ahead of the cessation of sterling LIBOR panel bank settings at the end of 2021, the transition away from LIBOR in the sterling bond market involves three main steps:

- The first step has involved encouraging the use of overnight SONIA compounded in arrears instead of LIBOR for new bond issuance as soon as practicable after the original FCA announcement in July 2017 that LIBOR will cease on or after the end of 2021. In the UK, new sterling bond issues both in the form of FRNs and securitisations have now been referencing overnight SONIA compounded in arrears instead of LIBOR for some time. This is in line with the authorities' preference for the use of overnight SONIA compounded in arrears as the most robust rate.[7] The adoption of SONIA in

5. There were accompanying statements jointly by the Bank of England and the FCA; by ICE Benchmarks Administration (IBA) as the administrator of LIBOR; by the US ARRC and by ISDA: (I) FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks. (ii) IBA feedback statement for the consultation on its intention to cease the publication of LIBOR settings. (iii) Joint Bank of England and FCA statement on the announcements on the end of LIBOR.

6. Dear CEO letter from the PRA and FCA dated 26 March 2021, referring to the statement on LIBOR transition from the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency Statement on LIBOR transition, 30 November 2020.

7. See the Dear CEO Letter from the PRA and FCA dated 26 March 2021: "Wherever possible firms should use the most robust alternative reference rate to LIBOR appropriate for the applicable use case. In sterling this will often be SONIA compounded in arrears in line with existing market practice in derivative and bond markets and with the use cases identified in loan markets by the RFRWG. … From 1 April 2021 we do not expect to see incremental sterling LIBOR loan, bond, securitisation or linear derivatives business being written by PRA and FCA regulated firms and groups, unless specifically permitted within the RFRWG milestones."

new issues has also had the effect of capping the number of legacy LIBOR bonds outstanding. This number of legacy LIBOR bonds outstanding then diminishes as bonds mature and is also reduced when certain LIBOR bond fallbacks are triggered.

- The second step is actively to transition legacy LIBOR bonds to SONIA, where this is practicable, to reduce them to an irreducible core by the end of 2021, as recommended by the authorities. Active transition in the bond market is currently in progress, where practicable.
- The third step is to address the remaining legacy LIBOR bonds outstanding through the authorities' proposals for "tough legacy" in order to ensure an orderly wind-down of LIBOR in the bond market.

Sterling LIBOR bond fallbacks

9 As new bond issues have been referencing compounded SONIA for some time, the priority now is to ensure an orderly wind-down of legacy LIBOR bond contracts under English law. This is not straightforward in the bond market, owing to the nature of the fallbacks in legacy sterling LIBOR bond contracts and the difficulty of converting them to risk-free rates:

- Most legacy sterling LIBOR bonds (estimated at around 70% of the total) are expected to fall back to the previous LIBOR fix for the remaining life of the bond, with the result that floating rate bonds become fixed rate bonds at LIBOR cessation ("Type 1" fallbacks).
- Some more recent sterling LIBOR bonds have "Type 2" fallbacks, which broadly provide for an independent adviser to select a successor rate plus a fixed credit adjustment spread, either at LIBOR cessation or earlier in some cases (eg if a prohibition on use applies).
- "Type 3" fallbacks are like Type 2s, but also include a pre-cessation trigger if and when LIBOR is designated as unrepresentative of its underlying market by the FCA.

10 Type 2 and Type 3 fallbacks are estimated to represent around 30% of the total. Some Type 2 and all Type 3 fallbacks are expected to be triggered this year. It is important to note that the three types do not describe every case.

11 On 18 May 2021, following a consultation, the Sterling RFRWG published a recommendation[8] that the successor rate (for Type 2 and Type 3 fallbacks) should be overnight SONIA compounded in arrears. To operate Type 2 and Type 3 fallbacks, a credit adjustment spread needs to be added. In September 2020, following a consultation, the RFRWG recommended[9] the same credit adjustment spread methodology for fallbacks in cash products referencing sterling LIBOR where the relevant language exists as ISDA has proposed in the derivatives market.

12 It is also important to note that ISDA issued a statement on 5 March 2021 confirming that the FCA announcement constituted an "index cessation event" under the IBOR Fallbacks Supplement and the ISDA 2020 IBOR Fallbacks Protocol for all 35 LIBOR settings. As a result, the fallback spread adjustment published by Bloomberg is fixed as of the date of the announcement for all LIBOR settings. ISDA also published guidance related to the announcements.[10]

Active transition of legacy LIBOR bonds

13 On 26 March 2021, the UK PRA and the FCA published a Dear CEO letter to encourage the active transition of LIBOR-linked contracts before the end of 2021:

- "We expect firms to intensify efforts to execute plans to transition the stock of legacy LIBOR-linked contracts ahead of confirmed cessation dates of panel bank LIBOR, wherever it is feasible to do so. All legacy sterling LIBOR contracts should, wherever possible, have been amended by end Q3 2021 to include at least a contractually robust fallback that takes effect upon an appropriate event, or, preferably, an agreed conversion to a robust alternative reference rate."
- "It remains in the interests of financial markets and their customers that the pool of contracts referencing LIBOR is shrunk to an irreducible minimum ahead of LIBOR's expected cessation, leaving behind only those contracts that genuinely have no or inappropriate alternatives and no realistic ability to be renegotiated or amended."[11]

14 In a supplementary statement on *Active Transition of Legacy GBP LIBOR Contracts* on 23 April 2021, the Sterling RFRWG recommended the active transition of contracts ahead of sterling LIBOR pre-cessation as the primary method to ensure contractual certainty and to retain economic control, and encouraged market participants to:

- prioritise the amendment of contracts which do not contain or have not yet adopted robust fallback arrangements;
- consider the potential benefits of active transition to SONIA, rather than via the adoption and execution of contractual fallbacks;

---

8. The Working Group on Sterling Risk-Free Reference Rates statement (bankofengland.co.uk)

9. Statement on behalf of the Working Group on Sterling Risk-Free Reference Rates: *Recommendation of Credit Adjustment Spread Methodology for Fallbacks in Cash Market Products Referencing GBP LIBOR (bankofengland.co.uk)*.

10. See also: *FSB OSSG Supports Use of the ISDA Spread Adjustments in Cash Products*, 2 June 2021.

11. See also the speech by Andrew Bailey, Governor of the Bank of England, on *LIBOR: Entering the Endgame*, July 2020.

- determine the effectiveness and suitability of fallback provisions: and, unless they are contractually robust and specifically anticipate the envisaged end of GBP LIBOR, not to rely on them as a primary method of transition from GBP LIBOR to SONIA or alternative reference rates; and
- be aware, in the sterling bond market, of potentially long lead times in consent solicitations and capacity constraints and to prioritise accordingly.

15 The sterling bond market has successfully transitioned, through consent solicitations, around one third by value and just over 10% by number by number of legacy sterling LIBOR bonds due to mature after the end of 2021: that is almost 70 out of around 500 legacy sterling LIBOR bonds outstanding in nearly 900 separate tranches.[12] The number is important, as the bond market needs to transition them bond by bond. The bond market cannot use a multilateral protocol like ISDA in the derivatives market. Some legacy bonds are too difficult to transition: for example, if the consent thresholds are too high or there are too many investors, who cannot all be identified and who may not all agree. There are also too many bonds to transition before the end of 2021 at the rate that would be required. They are currently taking on average around two months each. So that leaves the bond market with a "tough legacy" problem.

Tough legacy legislation

16 The authorities are addressing the tough legacy problem through legislation for the orderly wind-down of LIBOR. Tough legacy contracts are described by the FSB as "contracts that have no or inappropriate fallbacks, and [which] cannot realistically be renegotiated or amended."[13]

17 In the UK, legislative changes to the UK Benchmarks Regulation (BMR) were enacted at the end of April 2021 under the Financial Services Act. The Financial Services Act amends the UK BMR to enable the FCA to manage a situation in which a critical benchmark has become or is at risk of becoming unrepresentative and in which it may be impractical or undesirable to restore its representativeness. In particular, the FCA may designate a benchmark that is unrepresentative or is at risk of becoming unrepresentative under Article 23A, with the result that its use (as defined in the UK BMR) is prohibited by virtue of Article 23B, except where legacy use is permitted by the FCA under Article 23C. The Article 23A benchmark may be published under a changed methodology, which may no longer be representative of the underlying market or economic reality that the benchmark sought to measure, using powers under Article 23D, in order to facilitate an orderly cessation.[14]

18 As a result of the changes to the UK BMR under the Financial Services Act, the FCA can exercise its new powers to require continued publication by IBA of LIBOR on a synthetic basis, if and when the FCA decides that panel bank LIBOR is no longer representative of its underlying market. In those circumstances, LIBOR will no longer be intended for use in new contracts. It will be intended for use only in tough legacy contracts. The FCA has indicated that the methodology it proposes to use for any settings published on a synthetic basis would be a forward-looking term rate version of the relevant risk-free rate plus a fixed credit spread adjustment calculated over the same period and in the same way as proposed by ISDA.[15]

19 By comparison, in the US the New York State Senate and Assembly passed NY State Senate Bill S297 relating to LIBOR discontinuation. The Bill was subsequently signed by the Governor and has become law. This development was welcomed by the Alternative Reference Rates Committee (ARRC).[16] The ARRC noted that, while the mid-2023 cessation date will address a substantial portion of legacy contracts, there will still be a significant portion of contracts that would mature after that, including those that have no effective means to replace LIBOR upon its cessation. The legislation addresses those legacy US dollar LIBOR contracts maturing after mid-2023 without effective fallbacks that are written under New York law. This is important because New York law governs many of the financial products and agreements referencing US dollar LIBOR. The legislation will provide legal clarity for these contracts and will lessen the burden on New York courts, as legal uncertainty surrounding the transition would have been expected to prompt disputes.[17] US legislation of the same kind at Federal level is also being considered.

20 Similarly, the EU has amended the EU Benchmarks Regulation to empower the European Commission to designate a replacement for LIBOR when this is necessary to avoid financial market disruption in the EU.[18]

12. Estimates as at the end of June 2021.

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

14. HM Treasury, *Supporting the Wind-Down of Critical Benchmarks: Consultation,* February 2021.

15. FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks: 5 March 2021. On 24 June, the FCA launched a consultation on its proposed decision to require synthetic LIBOR for 6 sterling and Japanese yen settings.

16. For a high-level overview of the New York, and other legislative initiatives, please see *Tough Legacy Legislative Proposals: A Snapshot,* ICMA, October 2020.

17. ARRC welcomes passage of LIBOR legislation by the New York State legislature, 24 March 2021.

18. European Commission statement: *The EU Prepares for the End of LIBOR:* 30 November 2020.

Key remaining challenges

Qualifying for synthetic LIBOR

21 In our view, there are three main tough legacy challenges in the sterling bond market. The first is that the bond market will not be able to transition all the outstanding legacy sterling LIBOR bonds by the end of this year. As around 70% of them are expected to fall back from a floating rate to a fixed rate for the remaining life of the bond at LIBOR cessation, doing nothing about this runs the risk of market disruption. The UK authorities' proposal to address the problem through legislation will allow "synthetic LIBOR" to continue as a floating rate for tough legacy contracts when panel bank sterling LIBOR ceases at the end of 2021.

22 The FCA published on 20 May 2021 a consultation on the use of critical benchmarks in the orderly wind-down of LIBOR, with a deadline for responses on 17 June. This is due to lead to a policy statement by the FCA in the third quarter on (a) permitting some or all legacy use of unrepresentative critical benchmarks that have been designated under Article 23A of the UK Benchmarks Regulation and (b) restricting new use of other critical benchmarks. The FCA then aims to consult in the third quarter on its proposed decisions on precisely what legacy use to allow in the case of any synthetic sterling and yen LIBOR, and how it might restrict new use of LIBOR rates, including US dollar LIBOR, before confirming its final decisions as soon as practicable in the fourth quarter (ie shortly before they take effect).[19] Under Article 23C(2) of the UK Benchmarks Regulation, the FCA has the power to permit some or all legacy use of LIBOR after it has been designated under Article 23A and is unrepresentative. ICMA has argued that the FCA should allow all outstanding legacy bonds where fallbacks have not already been triggered to use synthetic LIBOR, not just some of them. If sterling LIBOR is available on screen but some legacy sterling LIBOR bonds outstanding are prohibited by the FCA from using it, this could create market uncertainty and potential legal problems. ICMA responded to the FCA consultation on 16 June.

Minimising market uncertainty and the risk of litigation

23 The second challenge is the need to minimise market uncertainty and the risk of litigation. In particular, when sterling panel bank LIBOR ceases, it will be important to ensure that synthetic LIBOR is treated in the market as the continuation of the previous LIBOR panel bank rate.

24 On 15 February 2021, HM Treasury launched a consultation on whether to introduce contract continuity and safe harbour provisions to support the orderly wind-down of LIBOR, with a deadline for responses of 15 March. The purpose of the Treasury consultation was to understand the extent to which there is uncertainty over the continued application of LIBOR to contracts where the FCA has exercised its power to direct a change in how the benchmark is determined under the UK BMR, and the risk of associated litigation. The ICMA response to the consultation supported the introduction of continuity of contract and safe harbour provisions. It also noted that the legislation that has already been passed under New York law includes continuity of contract and safe harbour provisions; and that there are a very large number of legacy US dollar contracts under English law: many more in US dollars than in sterling.

25 On 21 April, the Chair of the Sterling RFRWG sent a letter to the Economic Secretary to the Treasury to ask for a formal update from the UK Government on the feedback received to the Treasury's consultation, and on how the Government intended to proceed. The letter stated that "the Working Group would welcome the addition of safe harbour provisions to complement the existing tough legacy provisions included in the Financial Services Bill, to provide more express protections for contracts governed by UK law."

26 On 7 May, the reply from the Economic Secretary was accompanied by an announcement that, following the HM Treasury consultation, "the Government intends to bring forward further legislation, when the Parliamentary time allows, to address issues identified in the consultation. The legislation will seek to reduce disruption that might arise from LIBOR transition with regard to the potential risk of contractual uncertainty and disputes in respect of contracts that have been unable to transition from LIBOR to another benchmark (so-called "tough legacy" contracts), where the FCA has exercised the powers given to it in the Financial Services Act."[20]

Ensuring international alignment

27 The third challenge is the need to ensure international alignment between different currencies and jurisdictions to support an orderly wind-down in the transition away from LIBOR. This does not mean that the timetable and the approach to the orderly wind-down of LIBOR needs to be identical. There are some differences between currencies and jurisdictions in the timetable planned for the orderly wind-down. LIBOR settings in euro and Swiss francs are due to cease permanently at the end of 2021. Japanese yen LIBOR may continue on a synthetic basis for certain legacy contracts after the end of 2021 for one further year.[21] Synthetic

19. See FCA consultation on *Use of New Powers to Support Orderly Wind-down of Critical Benchmarks,* 20 May 2021.

20. HM Government response to the HM Treasury consultation on further measures to support the wind-down of critical benchmarks, 7 May 2021.

21. FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks.

sterling LIBOR is due to continue after the end of 2021 for certain legacy contracts for a maximum of ten years, subject to annual review. Panel bank LIBOR in US dollars is due to continue to be representative for use in legacy contracts until 30 June 2023. And while there are plans for the replacement of EONIA by €STR by 3 January 2022, there are currently no plans for the discontinuation of EURIBOR, though robust fallback language addressing permanent cessation, temporary non-availability and non-representativeness of EURIBOR has been recommended in case this is needed in future.[22]

28 There are also some differences in the approach to the orderly wind-down in the different LIBOR currencies and jurisdictions. While the UK is proposing to address tough legacy contracts through synthetic LIBOR when panel bank LIBOR ceases, the US is proposing a different approach. The difference arises because the UK is keeping the same benchmark (ie LIBOR) for certain legacy transactions, but changing the methodology to be used for its composition from panel bank LIBOR to synthetic LIBOR, whereas the US is proposing to replace the LIBOR benchmark with a commercially reasonable substitute for, and a commercially substantial equivalent to, LIBOR.[23] It will be important to establish whether the result is the same, given the large number of legacy dollar contracts under English law. An additional difference is that, while the use of synthetic LIBOR under English law is limited to a maximum of ten years, subject to annual review, there is no time limit on the use of the replacement benchmark under New York law.

29 Although the timing and approach differ between LIBOR currencies and jurisdictions, the overall direction of travel away from LIBOR towards risk-free rates is much the same.[24] And there is international coordination between the authorities through the FSB Official Sector Steering Group, chaired by Andrew Bailey, as Governor of the Bank of England, and John Williams, as President of the Federal Reserve Bank of New York. As a result of international coordination, for example, global agreement has been reached by the FSB and IOSCO and was announced on 2 June 2021 to stop the use of LIBOR in new transactions, including in US dollars, by the end of 2021. And while tough legacy legislation needs to be introduced and implemented at national level, the authorities have shown that they are aware of the importance of avoiding a conflict of laws between the UK, the US and the EU.

Contact: Paul Richards
paul.richards@icmagroup.org

22. As recommended by the Working Group on Euro Risk-Free Rates.

23. See New York legislation 297 on LIBOR discontinuance.

24. See, for example, the video recording of *The Official Sector Risk-Free Rate Panel,* moderated by ICMA, launched on 2 June 2021 on the RFR webpage on the ICMA website. The panellists were: Edwin Schooling Latter for the FCA; Nate Wuerffel for the Federal Reserve Bank of New York; Roman Baumann for the Swiss National Bank; and Thomas Vlassopoulos for the European Central Bank.