The global transition from LIBOR to risk-free rates

by **Paul Richards**

Summary

The transition from LIBOR to risk-free rates is a global initiative. As part of ICMA's campaign to raise market awareness of the need to prepare, particularly in the international bond market, this Quarterly Assessment considers: the background; the global transition in new transactions; the global transition in legacy transactions; tough legacy legislation; plans for the orderly wind-down of tough legacy contracts referencing LIBOR; FSB recommendations to the authorities globally; and global preparations needed by firms.

The global transition: background

1 The international financial markets need to be ready by the end of 2021 for the cessation of LIBOR on or after that date. In July 2017, the FCA's 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. The LIBOR role of the FCA is an international rather than just a UK role: partly because the FCA is the regulator of the administrator of all five main LIBOR currencies internationally; 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.

2 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. They want financial markets to transition away from LIBOR to near risk-free rates by the end of 2021. In the five main LIBOR currencies, there are established successor risk-free rates: SOFR for US dollars; €STR for euro; SONIA for sterling; SARON for Swiss francs; and TONA for Japanese yen. To take account of local market conditions, some of these risk-free rates are secured and some are unsecured. 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. Forward-looking term rates based on the successor risk-free rates are also being developed in some currencies, though not in Swiss francs.

3 The changeover 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. 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.[1] Raising market awareness of the transition is a top priority for the authorities.

4 In July 2020, the FSB OSSG issued a statement on the impact of COVID-19 on global benchmark reform:[2]

- In the statement, the FSB recognised that some aspects of firms' transition plans are likely to be temporarily disrupted or delayed, while others can continue. But the FSB "maintains its view that financial and non-financial sector firms across all jurisdictions should continue their efforts in making wider use of risk-free rates in order to reduce reliance on IBORs where appropriate and in

1. For ICMA's contribution to the transition to risk-free rates, see the Box at the end of this assessment.

2. FSB *Statement on the Impact of COVID-19 on Global Benchmark Reform,* July 2020.

particular to remove remaining dependencies on LIBOR by the end of 2021."

- The FSB said that LIBOR transition "remains an essential task that will strengthen the global financial system. COVID-19 has highlighted that the underlying markets LIBOR seeks to measure are no longer sufficiently active. Moreover, these markets are not the main markets that banks rely upon for funding. The increase in the most widely used LIBOR rates in March put upward pressure on the financing cost of those paying LIBOR-based rates. For those borrowers, this offset in large part the reductions in interest rates in those jurisdictions where central banks have lowered policy rates."
- The FSB added: "Relevant national working groups are coordinating changes to intermediate milestones in their benchmark transition programmes, where appropriate, to ensure global coordination. Financial and other firms should continue to ensure that their transition programmes enable them to transition to LIBOR alternatives before end-2021."

Global transition to risk-free rates in new transactions

5 The starting point for the transition is for market participants to use risk-free rates – or another alternative rate – instead of LIBOR in new financial transactions. Substantial progress has been made in using risk-free rates in wholesale markets internationally, including in the sterling and US dollar bond market and the derivatives market. Progress is now being made also in the loan market, where alternatives to LIBOR other than risk-free rates are being used in some cases, particularly for retail transactions. In the sterling floating rate bond market, new issuance has been referencing SONIA compounded in arrears for some time and new issuance referencing LIBOR has all but ceased.[3]

6 The market conventions being used for new transactions referencing risk-free rates compounded in arrears are broadly similar internationally, though there are marginal differences between products and within the same product. For example, both the observation "lag" method and the observation "shift" method for determining the interest rate for a risk-free rate compounded in arrears are being used in cash markets. The lag method calculates interest according to the number and weighting of days in the interest period, while the shift method calculates interest according to the number and weighting of days in the observation period. Both the Federal Reserve Bank of New York (since March) and the Bank of England (since August) have been publishing daily compounded indices, for SOFR and SONIA respectively. These indices are compatible with the use of the observation shift.

Global transition to risk-free rates in legacy transactions

7 Despite good progress in the transition to risk-free rates in new transactions, there is a stock of outstanding legacy transactions, many of which mature beyond the end of 2021, still referencing LIBOR. The authorities have encouraged the market to reduce the legacy stock to an irreducible core through active transition from LIBOR to risk-free rates before the end of 2021 or to introduce fallbacks from LIBOR to risk-free rates, where this is practicable.[4] As risk-free rates are economically not the same as LIBOR, a credit adjustment spread needs to be added. In the case of fallbacks, the cash markets have adopted the same method of calculating the credit adjustment spread as the derivatives market: the historical median over a five-year look-back period.

8 In the derivatives market, a multilateral protocol has been launched by ISDA to incorporate fallbacks from LIBOR to a compounded risk-free rate in the relevant currency plus a fixed credit adjustment spread. These fallbacks will be triggered when LIBOR ceases or on pre-cessation, when LIBOR is judged by the FCA no longer to be representative of its underlying market. The FSB has welcomed the release of ISDA's updated documentation and strongly encouraged all market participants to consider adhering as soon as possible to the ISDA Protocol as a means to mitigate risks in legacy contracts.[5]

9 But a multilateral protocol is not feasible in the bond market. In the UK, active transition from LIBOR to risk-free rates in the bond market needs to be carried out bond by bond.[6] Most legacy LIBOR bonds were issued before July 2017 and, when LIBOR ceases, will fall back to a fixed rate for the remaining life of the bond.[7] Some bond contracts are too difficult to transition, as consent thresholds are high:

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3. Around £95 billion of bonds referencing compounded SONIA were issued before the end of 2020 in at least 208 transactions.

4. "This remains the only way for parties to have full certainty and control over transition timing and contractual terms when LIBOR ceases or is no longer presentative.": FSB, *Reforming Major Interest Rate Benchmarks,* 20 November 2020.

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

6. In the sterling bond market, 37 consent solicitations from LIBOR were successfully completed in 2020, nearly all to compounded SONIA using a market rate agreed by bilateral negotiation.

7. These are sometimes referred to as Type 1 fallbacks. Type 2 fallbacks provide for an independent advisor to select a successor rate (plus a fixed credit adjustment spread) on permanent cessation. Type 3 fallbacks are Type 2s with a pre-cessation trigger. See *Fallbacks for LIBOR Floating Rate Notes,* Catherine Wade, ICMA, July 2019.

often 75% under English law and 100% under New York law. There are also too many to transition by the end of 2021 at the current rate, though potential ways of speeding up the transition process are being examined.[8]

Tough legacy legislation

10 As a result, there will be an irreducible core of "tough legacy" contracts referencing LIBOR in the bond market outstanding at the end of 2021.[9] The UK authorities are proposing to legislate for tough legacy contracts. In response to the FCA's international role as the regulator of the administrator of LIBOR, UK legislation was introduced on 21 October to ensure an orderly wind-down of LIBOR. The legislation will grant the FCA new powers to direct the administrator of LIBOR to change the method of calculating LIBOR from a panel of banks to a different method ("synthetic LIBOR"), when LIBOR is judged to be no longer representative of its underlying market, on or after the end of 2021. At that point ("pre-cessation"), the FCA will have the power to prohibit the use of LIBOR by supervised entities in new transactions, but to continue to permit its use in certain legacy transactions.

11 On 18 November, the FCA set out for consultation[10] its potential approach to the use of certain of its proposed new powers under UK legislation to ensure an orderly wind-down of LIBOR. At the conclusion of its consultations, the FCA will set out its approach in the form of public statements of policy. On the same date, ICE Benchmark Administration (IBA) – the administrator of LIBOR – announced that it would consult on its intention that the euro, sterling, Swiss franc and Japanese yen LIBOR panels would, subject to confirmation following the IBA's consultation, cease at the end of 2021. On 30 November, the IBA also announced that it would consult on its intention to cease US dollar LIBOR: one week and two month US dollar LIBOR settings would cease at the end of 2021, and the US dollar panel would cease at the end of June 2023.[11] This accompanied a statement by the Board of Governors of the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency in the US, and the FCA in the UK. (See the Box on page 10.)

12 The proposals for US dollar LIBOR are intended to give a clear message to the market that LIBOR should not be used for new transactions after the end of 2021. They also establish a potential mechanism that can help support the roll-off of a substantial portion of LIBOR-linked legacy contracts. That will help to focus on the remaining legacy exposures that will extend past the mid-2023 date, and especially the tough legacy contracts that after mid-2023 will not have an effective means of transitioning away from LIBOR at its end. The Chairman of the ARRC has said that "the ARRC's proposed legislative solution for these contracts is an essential part of a smooth transition."[12]

13 Whereas the legislation in the UK will give the FCA extra powers to change the method of calculating LIBOR for certain legacy transactions, draft legislative proposals by the ARRC in the US use contractual overrides in order to transition contracts from LIBOR to risk-free rates plus a credit adjustment spread. These different approaches may achieve the same result, though that is not yet clear. In the EU, the Benchmarks Regulation is also expected to be amended to include provisions catering for an orderly wind-down of benchmarks such as LIBOR. Unlike LIBOR, EURIBOR will continue for the time being, though EONIA is being replaced by €STR and more robust fallbacks are being built into new EURIBOR contracts.

14 The introduction of legislation in the UK to increase the FCA's powers to ensure an orderly wind-down of legacy LIBOR contracts is welcome. But there are a number of practical questions which remain to be clarified about how best to make the proposal work, particularly in the bond market:

- It is not yet clear whether synthetic LIBOR will apply to all legacy sterling LIBOR bonds outstanding if and when it is introduced in place of panel-bank LIBOR, or only to some of them. If it does not apply to all legacy bonds outstanding, there will be practical – and may be legal – issues to be considered. Under the UK legislation, this decision will fall to the FCA.
- It needs to be clear whether the market will accept the changed method of calculating synthetic LIBOR, which is currently expected to consist of a term RFR (rather than a compounded RFR) plus a fixed credit adjustment spread, so that synthetic LIBOR can appear on the same screen page as the panel-bank LIBOR it will replace, and so that current bond documentation does not need to change. The

8. Under English law, there are estimated to be over 500 legacy sterling LIBOR bonds maturing beyond the end of 2021, and around 750 taking account of securitisations which have a number of different tranches; and there are estimated to be around 3,400 legacy US dollar LIBOR bonds under English law.

9. The FSB describes tough legacy contracts as "contracts that have no or inappropriate fallbacks, and [which] cannot realistically be renegotiated or amended.": FSB, *Reforming Major Interest Rate Benchmarks,* 20 November 2020.

10. The deadline for responses is 18 January 2021.

11. IBA, 18 and 30 November 2020. The IBA published its consultation, relating to all five LIBOR currencies, on 4 December.

12. Tom Wipf, Chairman of Institutional Securities, Morgan Stanley, Chairman of the ARRC and ISDA Board member: ISDA transcript of webinar: *The Path Forward for LIBOR,* 4 December 2020.

Plans for the orderly wind-down of tough legacy contracts referencing LIBOR

The FCA stated on 18 November: "Under the proposed policy, we would not envisage using our powers where critical benchmarks (such as LIBOR currency-tenor settings) are little used, where the contracts referencing the benchmark can practicably be amended by contractual counterparties without our intervention, or where using the powers would not be necessary to protect consumers or market integrity. Nor would we envisage using the powers where appropriate inputs, as described in the proposed policy, are not available.

If we adopt and apply our proposed policy to the LIBOR settings, there would be, however, a case for using the proposed new powers to require a change to the LIBOR methodology where: LIBOR currency-tenor settings are widely used in outstanding contracts and/or instruments that cannot practicably be transitioned away from the benchmark rate by actions or agreements by or between contract counterparties themselves (often known as "tough legacy" contracts); and using the powers would contribute to protecting consumers or preserving market integrity.

Using the powers would be feasible under our proposed policy if the preferred inputs to a new methodology of the types we have proposed are available to the LIBOR administrator.

Euro and Swiss francs

On the basis of the policy proposed and currently available evidence, it appears unlikely that the conditions and inputs for use of our powers to require continued publication of euro and Swiss franc LIBOR will exist at the time these panels are proposed to cease.

Sterling

Conversely, forward-looking SONIA term rates are available and tough legacy contracts exist in significant amounts in the sterling market. So, at least the most heavily used sterling currency-tenor settings would seem likely to meet these conditions when publication of sterling LIBOR on the basis of a representative panel is proposed to cease.

Japanese yen

In relation to yen LIBOR, we will continue to assess whether it might be necessary and feasible to use the proposed powers in the case of more heavily used yen settings as transition progresses."

US dollars

On 30 November, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency stated that they "encourage banks to cease entering into new contracts that use US dollar LIBOR as a reference rate as soon as practicable and in any event by 31 December 2021, in order to facilitate an orderly – and safe and sound – LIBOR transition."[13]

They also said that "extending the publication of certain US dollar LIBOR tenors until 30 June 2023 would allow most legacy US dollar LIBOR contracts to mature before LIBOR experiences disruptions. Failure to prepare for disruptions to US dollar LIBOR, including operating with insufficiently robust fallback language, could undermine financial stability and banks' safety and soundness."[14]

On 30 November, the FCA stated: "We welcome and support the extension by panel banks and IBA, together with the proposal to consult on a clear end date to the US dollar LIBOR panel, following discussions with the US dollar LIBOR panel banks. This will incentivise swift transition, while allowing time to address a significant proportion of the legacy contracts that reference US dollar LIBOR."

The FCA added: "We also welcome the supervisory guidance in relation to limiting new use of US dollar LIBOR after end-2021 from the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency. We will coordinate with the US authorities, and relevant authorities in other jurisdictions, to consider whether and, if so, how most appropriately to limit new use of US dollar LIBOR, consistent with our objectives of protecting consumers and market integrity."

The FCA noted: "We will continue to consider evidence and views on whether it would be both necessary and feasible for us to use any proposed new powers under the Financial Services Bill to support any "tough legacy" contracts in the case of more heavily used US dollar LIBOR settings as transition progresses."[15]

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13. 2021 related to market-making for legacy (pre-2022) instruments and hedging or reducing client or bank exposures, but the message overall is that people should not expect much new activity in US dollar LIBOR after 2021.": ISDA transcript of webinar: *The Path Forward for LIBOR,* 4 December 2020.

14. 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.

15. FCA, 18 and 30 November 2020.

FCA is expected to consult the market before making a decision.

- Legislation in the UK provides that synthetic LIBOR for legacy transactions can continue for up to 10 years, but with annual reviews by the FCA. This is because the authorities' objective is to wind down legacy contracts rather than allowing them to continue indefinitely. In the bond market, some legacy bonds have a maturity longer than 10 years.
- The market implications of the different dates for the cessation of panel-bank LIBOR in US dollars and other LIBOR currencies need to be considered. If at the end of 2021 sterling LIBOR is declared unrepresentative of its underlying market, the method for computing sterling LIBOR for legacy transactions is expected to change, but in the period between the end of 2021 and the end of June 2023 the method for computing LIBOR for legacy US dollar transactions is expected to continue to be representative and not expected to change.[16] The FCA has stated: "The proposed extension to US dollar does not change the proposed end date for other currencies. We do not see a need to continue the sterling panel beyond end-2021, and we do not think the US dollar extension means the same is appropriate for sterling."[17]
- The interaction between the proposed UK, US and EU legislative solutions for "tough legacy" contracts is still uncertain. International alignment between the different legislative solutions is important for the international bond market. It is desirable, for example, that the rate for legacy dollar bonds issued under English law and the rate for legacy dollar bonds issued under New York law should be the same.

FSB recommendations to the authorities globally

15 The FSB and the BCBS have issued a report[18] setting out a number of recommendations to the authorities globally under three heads: identification of transition risks and challenges; facilitation of LIBOR transition; and coordination.

- *Identification of transition risks and challenges:* Authorities and standard-setting bodies should issue public statements to promote awareness and engage with trade associations and other authorities to undertake regular surveys of LIBOR exposure and to request updates from financial institutions.
- *Facilitation of LIBOR transition:* Authorities should establish a formal transition strategy supported by adequate resources and industry dialogue. Supervisory authorities should consider increasing the intensity of supervisory actions when the preparatory work of individual banks is unsatisfactory.
- *Coordination:* Authorities should promote industry-wide coordination, maintain dialogue on the adoption of fallback language, consider identifying legislative solutions where necessary, and exchange information on best practices and challenges.

Global preparations needed by firms

16 On 16 October, the FSB also published a global transition roadmap[19] for the transition away from LIBOR, and the FSB noted that individual regulators may require firms to move faster in some instances. The key steps in the timetable include the following:

Preparations needed already

- Firms should already at a minimum have Identified and assessed all existing LIBOR exposures, including an understanding on which LIBOR settings they have a continuing reliance after end-2021, by currency and maturity; and the fallback arrangements which those contracts currently have in place.
- They should have identified other dependencies on LIBOR outside of its use in financial contracts: for example, use in financial modelling, discounting and performance metrics, accounting practices, infrastructure, or non-financial contracts (eg in late payment clauses).
- They should have agreed a project plan, including specific timelines and resources to address or remove any LIBOR reliance identified, so that they can transition in advance of the end of 2021, including instituting clear governance arrangements.
- They should have understood recommended best practices by the industry or regulators in relevant jurisdictions, including timelines for intermediate steps in the transition ahead of end-2021, and built these into their plans.
- They should have assessed the changes that may be needed to supporting systems and processes in order to enable use of alternative reference rates in new and existing contracts,

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16. Edwin Schooling Latter, Director, Markets and Wholesale Policy, FCA: "The FCA would not be welcoming and supporting this proposed extension unless we were confident that representativeness thresholds could be maintained in terms of the number of panel banks.": ISDA transcript of webinar: *The Path Forward for LIBOR,* 4 December 2020.

17. Edwin Schooling Latter, Director, Markets and Wholesale Policy, FCA: ISDA transcript of webinar: *The Path Forward for LIBOR,* 4 December 2020.

18. FSB and BCBS: *Supervisory Issues Associated with Benchmark Transition: Report to the G20,* 9 July 2020.

19. FSB: *Global Transition Roadmap for LIBOR,* 16 October 2020.

including through fallbacks. These may include, for example, treasury management systems and accounting processes. Those who currently provide clients with this infrastructure should have developed alternative solutions or offerings to ensure continuity of provision.

- Those who currently provide clients with products that reference LIBOR should have begun to implement a plan for communicating with end-users of LIBOR referencing products maturing beyond end-2021 to ensure they are aware of the transition and the steps being taken to support moving those products to alternative rates.
- By the effective date of the ISDA Fallbacks Protocol, firms should adhere to the ISDA Protocol, subject to individual firms' usual governance procedures and negotiations with counterparties as necessary. Adherence to the protocol is strongly encouraged and, where the protocol is not used, other appropriate arrangements will need to be considered to mitigate risks.
- Providers of cleared and exchange-traded products linked to LIBOR should also ensure that they incorporate equivalent fallback provisions as appropriate.
- By the end of 2020, lenders should at a minimum be in a position to offer non-LIBOR linked loan products to their customers. This could be done either by giving borrowers a choice in terms of the reference rate underlying their loans, or through working with borrowers to include language for conversion by end-2021 for any new, or refinanced, LIBOR referencing loans, for example if systems are not currently ready.

Preparations needed by mid-2021

- On the basis of a full assessment of their stock of legacy contracts, firms should have determined which of these legacy contracts can be amended in advance of end-2021, and they should have established formalised plans to do so in cases where counterparties agree.
- Where LIBOR-linked exposure extends beyond end-2021, firms should make contact with the other parties to discuss how existing contracts may be affected and what steps firms may need to take to prepare for use of alternative rates.
- Firms should have implemented the necessary system and process changes to enable transition to robust alternative rates.
- Firms should aim to use robust alternative reference rates to LIBOR in new contracts wherever possible.
- Firms should take steps to execute formalised plans, where realistic, to convert legacy LIBOR-linked contracts to alternative reference rates in advance of end-2021.

Preparations needed by end-2021

- Firms should be prepared for LIBOR to cease.
- All new business should either be conducted in alternative rates or be capable of switching at limited notice.
- For any legacy contracts for which it has not been possible to make these amendments, the implications of cessation or lack of representativeness should have been considered and discussed between the parties, and steps taken to prepare for this outcome as needed. The scope and impact of any steps taken by authorities to support tough legacy contracts, if available, should have been clearly understood and taken into account.
- All business-critical systems and processes should either be conducted without reliance on LIBOR or be capable of being changed to run on this basis at limited notice.

ICMA's contribution to the global transition to risk-free rates

ICMA is continuing to contribute to the global transition from LIBOR and the other IBORs to risk-free rates in a number of complementary ways:

ICMA is participating in the Sterling Working Group on Risk-Free Rates and chairing the Bond Market Sub-Group. ICMA is also participating in the Euro Risk-Free Rate Working Group (as an observer) and the Swiss National Working Group; and ICMA is in regular contact with the FRN Group Chair on the Alternative Reference Rates Committee in the US and with national working groups in Asia.

ICMA has set up a risk-free rate webpage on the ICMA website with hyperlinks to official publications and speeches globally, as well as to ICMA's own work and joint work with other trade associations.

ICMA has published regular updates on the transition to risk-free rates in the ICMA Quarterly Report.

ICMA has held regular calls to brief members on progress in the transition to risk-free rates.

And ICMA has moderated official sector panels on the transition to risk-free rates for each of the last three years. The 2020 official sector panel was held in virtual form and recorded for members. The panel included senior representatives from the UK FCA, the Federal Reserve Bank of New York, the European Central Bank, the Swiss National Bank and the European Investment Bank.

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