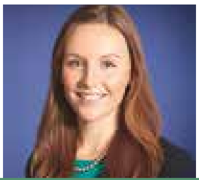
Transition to Risk-Free Rates



by **Katie Kelly and Charlotte Bellamy**

Feasibility of consent solicitation

In April 2021, the Sterling Risk-Free Rate Working Group (RFRWG) updated its top-level priorities, roadmap and target milestones roadmap for the final year of transition to help businesses to finish planning the steps they will need to take in the coming months. One of the key points for the bond market includes "accelerate active conversion where viable (eg consent solicitation mechanisms) to reduce legacy volume", and "complete active conversion where viable" by the end of the third quarter.

In March, the PRA and the FCA sent out a Dear CEO letter reiterating their expectation that all firms meet the RFRWG's milestones (and the targets of other working groups and relevant supervisory authorities as appropriate), stating that "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.".

It is estimated that, as at March 2020, there were approximately 490 bonds[1] linked to GBP LIBOR with a maturity date beyond the end of 2021, of which over 450 are publicly distributed. This equates to approximately 870 individual tranches, with each tranche needing to be transitioned separately, bond by bond, by way of consent solicitation (although a number of different tranches can form part of one consent solicitation exercise). So far, over 50 legacy GBP LIBOR bonds of which we are aware have been converted from GBP LIBOR to SONIA through consent solicitation, with a value of over £33 billion, in all cases to amend the interest rate or reset rate provisions of the legacy GBP LIBOR bonds directly, so that they reference an alternative rate or mid-swaps rate going forward.

The Dear CEO letter states: "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". But there are a number of factors which may affect the feasibility of more consent solicitations being undertaken at the pace required, and in the time given.

A consent solicitation takes at least two months from start to finish[2]. Timings of certain steps are enshrined in bond documentation and may not be circumvented, but a significant amount of time and effort is also required for discussions between the parties on the rationale for the transition, and respective expectations with respect to pricing methodologies to ensure no value transfer. It can be costly to undertake a consent solicitation, and as the cost is usually borne by issuers, they will want to ensure that, before incurring such costs, the consent solicitation will be successful. But there is no guarantee of this. A few consent solicitations have not been successful.

The consent solicitation process works well, but some operational inefficiencies were highlighted at a recent workshop held to discuss measures to help ease the process; this includes, in particular, difficulties in the location of bondholders and the requisite cascade of information and communications between the parties, which can be compounded if there are different ownership structures in place. Much of the operations process is conducted manually, which not only takes up a lot of time in an already compressed time frame, but can also lead to significant extra work for the parties involved. Technical innovation and automation may be helpful, but this is unlikely to be achieved in any meaningful way in the time given this year.

1. Floating rate notes and securitisations.
2. See the typical consent solicitation overview timeline in ICMSA Bulletin 200610/50.

There are also transaction-specific challenges to consider, such as investor engagement, and the migration of holdings in transactions to different jurisdictions, which renders their holders ineligible to vote in a consent solicitation. And for securitisations, there is a need to ensure that the various different instruments which together make up the securitisation (swaps, liquidity facilities and other credit enhancement arrangements) all transition at the same time and in line with the bond itself, and that there is no impact on the rating of the bonds issued as part of the securitisation.

All these factors could become exacerbated if large volumes of consent solicitations were to be undertaken within a relatively short time frame. But time is very much of the essence; as the Dear CEO letter states: "As the time for remaining action is short and reducing in every LIBOR currency, action needs to be front-loaded to deliver demonstrable progress against a risk-based prioritisation of contracts."

@ **Contact: Katie Kelly**
katie.kelly@icmagroup.org

Successor rate recommendation for bond fallbacks

Certain contractual fallbacks from GBP LIBOR to risk-free rates in bond documentation typically envisage an issuer appointing an independent adviser to select (or to advise the issuer in the selection of) a successor rate on the basis of (a) any formal recommendations made by a relevant nominating body or (b) if no such recommendations have been made, customary market practice. This is the case for fallbacks on cessation of the original rate and certain other triggers, including a prohibition or restriction on use (so called "Type 2" fallbacks) and upon an announcement of "unrepresentativeness" (so called "Type 3" fallbacks). "Type 1" fallbacks do not anticipate a successor rate as, in the event of a permanent cessation of LIBOR, the rate in effect for the last preceding interest period will be applied to every interest period for the remaining life of the bond.

A successor rate formally recommended by a relevant nominating body would remove the need for the issuer or independent adviser to exercise discretion in determining the successor rate in transactions containing the relevant fallback language.

If no successor rate were recommended by a relevant nominating body, then according to the definitions typically used, the successor rate would be one which is "customarily applied for the purposes of determining rates of interest". The absence of a recommendation in this case could lead to uncertainty and potential ambiguity over what successor rate is customarily applied for these purposes. The issuer or independent adviser would have to make this determination, which could potentially expose them to litigation risk in the event that the rate they determine is challenged.

According to definitions typically used in the context of SONIA in the bond market, the Sterling Risk-Free Working group (RFRWG) is recognised as one of a number of potential relevant nominating bodies. So the RFRWG carried out a *Consultation on Successor Rate to GBP LIBOR in Legacy Bonds Referencing GBP LIBOR.* The summary of responses to the consultation concluded that it would be helpful for the RFRWG, in its capacity as a relevant nominating body, to make a recommendation on the successor rate to GBP LIBOR for the purposes of the operation of Type 2 and Type 3 fallbacks in bond documentation, and that the recommended successor rate should be overnight SONIA, compounded in arrears.

The RFRWG, the Bank of England, and the FCA made clear in a statement published on 11 January 2021, that, in future, they anticipate that the large majority of sterling markets will be based on overnight SONIA, compounded in arrears, to provide the most robust foundation for the overall market structure, and one of the RFRWG's 2021 Top Level Priorities, as set out in the updated April 2021 updated Working Group Roadmap, has been to: "Continue to enable and promote widespread use of SONIA compounded in arrears throughout wholesale sterling markets". A formal recommendation by the RFRWG of SONIA, compounded in arrears, as a successor rate for the purposes of the operation of fallbacks in bond documentation, would certainly assist with that ambition.

Type 2 and Type 3 fallbacks also envisage an issuer appointing an independent adviser to select (or to advise the issuer in the selection of) a credit adjustment spread methodology to be applied to the successor rate. The RFRWG made a recommendation on a credit adjustment spread in September 2020 following a similar consultation process. Together with a recommendation on the successor rate, this should allow the Type 2 and Type 3 fallbacks to operate in accordance with their terms.

@ **Contact: Katie Kelly**
katie.kelly@icmagroup.org

Future cessation and loss of representativeness of the LIBOR benchmarks

On 5 March 2021, an important suite of statements by the FCA, Bank of England and ICE Benchmarks Administration (IBA) relating to the future cessation and loss of representativeness of all LIBOR benchmarks was issued. This included:

(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.

It is important that bond market participants with outstanding LIBOR bonds that will mature beyond the end of 2021 and contain fallbacks that cater for the permanent cessation of LIBOR (with either "cessation" or "pre-cessation" triggers) review the precise drafting of those fallbacks and consider the potential impact of these announcements.

On 8 March 2021, the US Alternative Reference Rates Committee (ARRC) confirmed that in its opinion the announcements by IBA and the FCA constituted a "Benchmark Transition Event" with respect to all USD LIBOR settings pursuant to the ARRC recommendations regarding more robust fallback language for new issuances or originations of LIBOR floating rate notes, securitisations, syndicated business loans, and bilateral business loans. The ARRC also published *ARRC FAQs Regarding the Occurrence of a Benchmark Transition Event*.

In addition, 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.

@ **Contact: Charlotte Bellamy**
charlotte.bellamy@icmagroup.org

LIBOR-related legislative developments

There have been several recent legislative developments related to the wind-down of LIBOR.

In the US, the New York State Senate & Assembly passed NY State Senate Bill S297 relating to LIBOR discontinuation. It was signed by Governor Andrew M. Cuomo on 7 April, meaning that the Bill is part of New York State law. This development was endorsed by the Alternative Reference Rates Committee. For a high-level overview of the New York, and other legislative initiatives, please see *Tough Legacy Legislative Proposals: A Snapshot*, ICMA, October 2020.

In the UK, changes to the UK Benchmarks Regulation to allow the FCA to direct IBA to publish "synthetic LIBOR" are being considered as part of the Financial Services Bill. In February, HM Treasury published a consultation on the introduction of contract continuity and safe harbour provisions to support the introduction of synthetic LIBOR. The ICMA response to the consultation supported the introduction of such provisions. In particular, ICMA raised the following key points:

- It is important to include explicit and clear continuity of contract and safe harbour provisions in primary legislation to reduce market uncertainty and the risk of litigation to the greatest extent possible.
- Both continuity of contract and safe harbour provisions are needed. Continuity of contract provisions need to provide that legacy contracts referencing panel bank LIBOR should be read as – or "deemed to be" – references to "synthetic LIBOR" as determined by the FCA. A "deeming" provision like this is particularly important in cases where LIBOR is specifically described in legacy contracts by reference to its current features.
- The continuity of contract provision needs to be accompanied by a safe harbour against the risk of litigation. This should provide that relevant parties would not be able to sue each other as a result of the changes to LIBOR.
- The continuity of contract and safe harbour provisions need to be drafted as broadly as possible to include not only supervised entities using LIBOR under the UK Benchmarks Regulation (UK BMR), but also non-supervised entities, where the exposure and risk may be greater.
- The ARRC has already proposed continuity of contract and safe harbour provisions under New York law. The

continuity of contract and safe harbour provisions under English law should be designed to align internationally with the ARRC proposal, while being adapted to the provisions of the UK BMR. This is particularly important given the large volume of legacy US dollar LIBOR contracts governed by English law.

In a House of Lords debate on 24 March 2021, a UK Government Minister noted that the Government is committed to ensuring that an appropriate framework is in place for the orderly wind-down of LIBOR and takes this matter very seriously. The Minister also highlighted that the industry had indicated, including through its responses to the consultation, that it is supportive of the approach set by the Government in the HM Treasury consultation. However, the Government will not be deciding on the appropriate next step in time for contract continuity and safe harbour provisions to be included in the Financial Services Bill and so any such provisions will need to be included in another Bill in the future if they are to be passed into UK law. This is an important point for the bond market and ICMA will continue to engage with the UK authorities on this matter on behalf of its members.

In the EU, the European Commission published on 23 March 2021 a targeted consultation on the designation of a statutory replacement rate for CHF LIBOR under the EU BMR. This appears to relate primarily to 3-month CHF LIBOR mortgages, consumer credit agreements and small business loans and so is not a core area of focus for ICMA.

Contact: Charlotte Bellamy
charlotte.bellamy@icmagroup.org