Consultation on successor rate to GBP LIBOR in legacy bonds referencing GBP LIBOR

The Working Group on Sterling Risk-Free Reference Rates

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Foreword

The overall objective of the Working Group on Sterling Risk-Free Reference Rates (the "Working Group") is to catalyse a broad-based transition to SONIA by the end of 2021 across the sterling bond, loan and derivative markets, in order to reduce financial stability risks arising from the widespread reliance on GBP LIBOR.

The Bank of England and the Financial Conduct Authority ("FCA") are each ex-officio members of the Working Group. The views and outputs set out in this Consultation Paper do not constitute guidance or legal advice from the Bank of England (including the Prudential Regulation Authority ("PRA") or the FCA and are not necessarily endorsed by the Bank of England (including the PRA) or the FCA.

This Consultation Paper is addressed to bond market participants who are considering the operation of fallbacks in their contracts which will be triggered in the event of the permanent cessation of GBP LIBOR (a "permanent cessation event"), or on an announcement of the non-representativeness of GBP LIBOR by the supervisor of the administrator of LIBOR (a "pre-cessation event"). The active conversion of legacy GBP LIBOR bonds to reference SONIA is discussed briefly but is outside the scope of this Consultation Paper.

Subject to its consideration of the feedback received pursuant to this Consultation Paper and any other relevant factors, the Working Group expects to recommend a fallback successor rate for use in the bond market upon the occurrence of a permanent cessation event, or upon the occurrence of a pre-cessation event, which will ultimately assist the objective of the Working Group of facilitating a smooth transition away from GBP LIBOR to SONIA.

This Consultation Paper was considered at the meeting of the Working Group on 26 January 2021 where it was agreed to be published. The Working Group is particularly grateful to the Bond Market Sub-Group, chaired by Paul Richards of the International Capital Market Association, for having developed this Consultation Paper.

Section 1: Executive summary

Background

Used globally, LIBOR is very widely referenced in derivative, floating rate note ("FRN"), loan and securitisation documentation, and in a range of consumer lending instruments, such as mortgages and student loans. Following a July 2017 speech[1] by Andrew Bailey, the then Chief Executive of the FCA, about the uncertain future of LIBOR, there has been an increased focus in the financial markets on the need to transition away from LIBOR and to include more robust fallbacks in contracts referencing LIBOR that will mature after the end of 2021 (as the FCA has indicated that the LIBOR benchmark may cease to be published after this point). ICE Benchmark Administration (IBA), the administrator of LIBOR, has since published a consultation on its intention to cease the publication of all tenors of GBP LIBOR (and certain tenors of other LIBORs) after 31 December 2021.

For the purpose of this Consultation Paper, FRNs and securitisations are referred to as "bonds"[2].

Certain types of fallbacks in bond contracts referencing LIBOR that will mature after the end of 2021 are intended to operate such that upon the occurrence of a permanent cessation event or a pre-cessation event, an issuer would appoint an independent adviser to select (or to advise the issuer in the selection of) (a) a **successor rate** and (b) a **credit adjustment spread** to be applied to such a successor rate, in each case on the basis of (i) any **formal recommendations** made by a relevant nominating body or (ii) if no such recommendations have been made, **customary market practice**.

Whilst there has thus far been no recommendation of a successor rate by a relevant nominating body for the purposes of these fallbacks, working groups in the LIBOR currency jurisdictions have recommended their preferred risk free rates ("RFRs") for LIBOR. In the sterling market, the Working Group's preferred RFR for GBP LIBOR is SONIA. SONIA is an overnight rate, which is capable of being constructed for use in bonds in different ways: in particular compounded in arrears, or as a component of a term rate.

As regards the credit adjustment spread, SONIA is not economically equivalent to GBP LIBOR, and so needs to be adjusted to account for: (i) the fact that SONIA is an overnight rate and not a term rate; and (ii) the various premia included within GBP LIBOR (i.e. a term liquidity premium and a bank credit risk element). The credit adjustment spread methodology for use with SONIA-based rates was the subject of a recommendation by the Working Group (as a relevant nominating body) in September 2020.[3]

If no successor rate is recommended by a relevant nominating body, according to the definitions typically used, the rate to be used would be that which is *customarily applied for the purposes of determining rates of interest*. This requires the exercise of discretion by an issuer or independent adviser in determining the appropriate rate.

Purpose of this Consultation Paper

The purpose of this Consultation Paper is to seek feedback on whether it would be helpful for the Working Group to make a recommendation on a successor rate to GBP LIBOR for bonds upon the occurrence of a permanent cessation event or a pre-cessation event, and to seek feedback on the successor rate to be recommended.

Successor rates and potential considerations

The different successor rates proposed in this Consultation Paper are (i) overnight SONIA, compounded in arrears and (ii) term SONIA. Readers of this Consultation Paper are directed to Section 5 (Description of the successor rates), in particular: "*Potential considerations relevant to recommending overnight SONIA, compounded in arrears as the successor rate", and* "*Potential considerations relevant to recommending a term SONIA rate as the successor rate"* and to Section 6 (Potential considerations common to both rates).

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[1] The Future of LIBOR, speech by Andrew Bailey at Bloomberg London.
[2] This may also include, but is not limited to, covered bonds, capital securities and structured products.
[3] Recommendation of a credit adjustment spread methodology.

By way of summary, potential considerations which should be taken into account include (but are not limited to):

- the stages of development of each of the rates, and their current usage (in the case of overnight SONIA, compounded in arrears) and expected use cases (in the case of term SONIA) in the SONIA-linked bond market;
- alignment with the existing SONIA-linked bond market, the derivatives and loan markets;
- the economic, operational and contractual implications of each of the rates; and
- the implications for global consistency of approach for fallbacks across different IBORs.

Application of results of this Consultation Paper

This Consultation Paper will remain open until 16 March 2021. The Working Group strongly encourages market participants to respond to this Consultation Paper. It hopes to receive feedback from as broad a range of market participants as possible, including from different sectors and product categories.

The results of this Consultation Paper will not be binding on bond market participants or the Working Group. However, subject to its consideration of the feedback to this Consultation Paper and any other relevant factors, the Working Group expects to recommend a successor rate based on such feedback in order to assist the intended operation of existing fallbacks which reference successor rates.

Section 2: Scope of this Consultation Paper

Products in scope

This Consultation Paper focuses on the recommendation of a successor rate for the GBP LIBOR bond market, including (but not limited to) FRNs, securitisations, covered bonds, capital securities and structured products. It is not intended to apply to bonds which directly reference SONIA.

It is not considered to be appropriate at present to make a recommendation on a successor rate for the loan market. As a result of the conclusions of the Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives published by the Working Group (January 2020), some loans may require the flexibility to transition to a range of different rates, and a recommendation towards a particular successor rate for the loan market might therefore impede loan market participants' ability to use a different rate.

LIBOR currencies in scope

This Consultation Paper focuses only on GBP LIBOR and successor rates derived from SONIA.

Other currency working groups are also separately considering the issue of successor rates for their respective IBORs and separate announcements are expected on this issue from those currency working groups in due course.

Types of bond fallbacks

There are three broad categories of contractual fallbacks in bond documentation[4]:

(a) "Type 1" fallbacks[5], which typically are intended to fall back to the last published LIBOR rate for the remaining life of the bond, which means that they effectively will become a fixed rate on the cessation of GBP LIBOR (and do not anticipate falling back to a successor rate plus a credit adjustment spread);

(b) "Type 2" fallbacks[6], which typically are intended to operate such that upon the occurrence of a permanent cessation event, the fallback will be to a successor rate plus a credit adjustment spread; and

(c) "Type 3" fallbacks[7], which typically are intended to operate such that upon the occurrence of a pre-cessation event, the fallback will be to a successor rate plus a credit adjustment spread.

Fallbacks in scope

This Consultation Paper considers what the successor rate should be in respect of: (i) Type 2 fallbacks which are intended to operate *upon the occurrence of a permanent cessation event*, and (ii) Type 3 fallbacks which are intended to operate prior to the cessation of LIBOR, *upon the occurrence of a pre-cessation event.*

Active transition out of scope

This Consultation Paper does not consider the successor rate to be used by market participants who wish to actively convert LIBOR-linked bonds to a SONIA-derived rate at an earlier stage than on the trigger of the relevant fallbacks in the bond documentation. Respondents are directed to the Working Group's Paper Active transition of GBP LIBOR referencing bonds (September 2020) for further information on the active transition of GBP LIBOR referencing bonds.

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[4] References to Type 1, 2 and 3 fallbacks are for convenience only. This categorisation is not referred to in the contractual documentation and there may be overlap between each "Type" of fallback, which varies in detail from issuer to issuer. Additionally, the alternative fallbacks contained in some regulatory capital securities are stated to be subject to compliance with any regulatory requirements.

[5] The Working Group understands that is widely considered that "Type 1" fallbacks comprise the majority of legacy GBP LIBOR bonds

[6] The Working Group understands that "Type 2" fallbacks tend to be more common in bond documentation drafted after Andrew Bailey's speech in July 2017; The future of LIBOR.

[7] The Working Group understands that "Type 3" fallbacks tend to be more common in bond documentation drafted in 2019 *et seq.*

Section 3: Consultation process

Responses

Responses to this Consultation Paper should be sent to the RFR Secretariat (RFR.Secretariat@bankofengland.co.uk) by 16 March 2021.

Information provided in response to this Consultation Paper, including personal information, may be subject to publication or release to other parties or disclosure in accordance with access to information regimes including under the Freedom of Information Act 2000 or data protection legislation, or as otherwise required by law or in discharge of statutory functions. Respondents should indicate if they regard all, or some of, the information provided in response to this Consultation Paper as confidential. If a request for disclosure of this information is received, respondents' indications will be taken into account, but no assurance can be given that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by a respondent's IT system on emails will not, of itself, be treated as constituting notice that such respondent regards any information supplied as confidential.

By responding to this Consultation Paper, respondents provide personal data to the Bank of England and the FCA as the RFR Secretariat. This may include a respondent's name, contact details (including, if provided, details of the organisations respondents work for), and opinions or details offered in the response itself.

For details on how the Bank of England or FCA deal with personal data, rights of respondents in this connection or to get in touch, please visit https://www.bankofengland.co.uk/legal/privacy or http://www.fca.org.uk/privacy, respectively.

Process for publishing results

The Working Group will discuss all feedback and publish an aggregated and anonymised summary of responses received. The summary published will not contain any information that could be used to attribute a particular response or position to an individual respondent. If the responses received are not conclusive, the Working Group retains the right to issue a follow-up consultation.

Competition law notice

By participating in this Consultation, you agree to act in full compliance with applicable competition law requirements. The Working Group has taken and will continue to take appropriate safeguards to ensure that the conduct of this Consultation complies with applicable competition laws.

Section 4: Background on the need for a successor rate

Categories of bond fallbacks

Bond documentation typically contains fallbacks which are intended to operate in the event that a particular benchmark or interest rate is no longer available. There are three broad categories of fallbacks which are typically seen in most bond documentation and which address non-availability of the reference rate, a permanent cessation event and/or a pre-cessation event (although there may be others)[8]:

(i) "Type 1" fallbacks[9], which typically provide that if *the relevant reference rate is not available at the relevant time*, then the party responsible for determining the rate (usually an agent of the issuer) must request quotes from a certain number of major banks in the interbank market (known as "reference banks") and use the quotes provided to determine a rate. If the agent cannot obtain a certain number (or any) quotes from reference banks, then the rate used will be the rate in effect for the last preceding interest period. It is considered unlikely that, in the event of a permanent cessation of LIBOR, reference banks would provide quotes for any length of time if at all. Therefore, absent any other intervention[10], the majority of legacy bonds that reference LIBOR and contain Type 1 fallback provisions could effectively become fixed rate instruments in the event of a permanent cessation of LIBOR, because the rate in effect for the last preceding interest period will be applied to every interest period for the remaining life of the bond.

(ii) "Type 2" fallbacks[11], which, *on the permanent cessation of the relevant reference rate*, typically envisage (broadly) the issuer appointing an independent adviser to select (or to advise the issuer in the selection of)[12] an alternative or replacement rate and adjustment spread to be applied to such rate, in each case, on the basis of (a) any recommendations made by relevant nominating bodies (see below) or (b) if no such recommendations have been made, customary market practice.

(iii) "Type 3" fallbacks[13], which, *on the announcement of "non-representativeness" of the relevant original benchmark by the supervisor of the administrator of the benchmark*, typically envisage (broadly) the issuer appointing an independent adviser to select (or to advise the issuer in the selection of) an alternative or replacement rate and adjustment spread to be applied to such rate, in each case, on the basis of (a) any recommendations made by relevant nominating bodies (see below) or (b) if no such recommendations have been made, customary market practice.

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[8] References to Type 1, 2 and 3 fallbacks are for convenience only. This categorisation is not referred to in the contractual documentation and there may be overlap between each "Type" of fallback, which varies in detail from bond contract to bond contract. Additionally, the alternative fallbacks contained in some regulatory capital securities are stated to be subject to compliance with any regulatory requirements.

[9] The Working Group understands that it is widely considered that "Type 1" fallbacks comprise the majority of legacy GBP LIBOR bonds

[10] Such as the legislative solution proposed by HMT, by way of amending the UK Benchmarks Regulation to enhance the toolkit of the FCA to deal with the wind-down of LIBOR.

[11] The Working Group understands that "Type 2" fallbacks tend to be more common in bond documentation drafted after Andrew Bailey's speech in July 2017; The future of LIBOR.

[12] There is a degree of variation in the fallback language and in particular regarding whether the issuer makes the determination of the replacement rate (having been advised by the independent adviser) or the independent adviser makes the determination. This may depend upon the nature of the issuer, for example it might be more appropriate for financial institution issuers to make the determination, whereas it might be less so for a corporate issuer.

[13] The Working Group understands that "Type 3" fallbacks tend to be more common in bond documentation drafted in 2019 *et seq.*

Effect of nominating a successor rate

The effect of recommending a successor rate for bonds containing the Type 2 and Type 3 fallbacks would be to direct the determination of the successor rate in bonds containing the relevant fallback language.

If there is no recommended successor rate for either the Type 2 or the Type 3 fallbacks, the fallback would be to an alternative rate. According to the definitions typically used, this would be the rate which is *customarily applied for the purposes of determining rates of interest*.[14] 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.

Relevant nominating bodies

In the case of Type 2 and Type 3 fallbacks, according to definitions typically used in the bond market[15], the relevant nominating body would be EITHER: (i) the Bank of England; OR (ii) the Financial Conduct Authority OR (iii) the Working Group.

The Working Group, in its capacity as a relevant nominating body, made a formal recommendation in respect of the credit adjustment spread[16].

[14] Overnight SONIA, compounded in arrears, has become the *de facto* rate which is customarily applied for the purposes of determining rates of interest in sterling. See further Section 5 (Description of successor rates).

[15] See Annex for a description of relevant bond provisions and defined terms.

[16] Recommendation of a credit adjustment spread methodology.

Section 5: Description of successor rates

This Section outlines potential options for the successor rate and highlights some important potential considerations for each approach. These are provided for information only. They are not intended to be comprehensive and the Working Group makes no representation as to the accuracy or applicability to the particular circumstances or contracts of an individual market participant. Readers are strongly encouraged to formulate their own views regarding the potential considerations applicable to each approach, taking into account their particular circumstances and contracts, and to consult with their own professional advisers in doing so. This Consultation Paper does not consider any accounting, tax, legal, regulatory or listing implications that may arise.

In particular, readers should consider the scope of this Consultation Paper (as outlined in Section 2 (Scope of this Consultation Paper), and the questions outlined in Section 8 (Questions for consultation), when considering these options.

Option 1 - Overnight SONIA, compounded in arrears, as the successor rate

Description:

Interest on bonds is typically payable periodically (i.e. monthly, or quarterly). But as SONIA is an overnight rate which is published the following day, that daily SONIA rate must be aggregated in some way over the relevant period to determine the interest amount for the period. In the SONIA-referencing bond market, the convention has been to aggregate the daily SONIA rates on a compounded basis.

Potential considerations relevant to recommending overnight SONIA, compounded in arrears as the successor rate:

- As at the date of this Consultation Paper, at least 215 public SONIA-linked bond transactions have been issued in the sterling market[17]. All of these transactions have been issued using the overnight SONIA, compounded in arrears rate, and none have been issued using any alternative SONIA-based rate. This prevalent use of overnight SONIA, compounded in arrears indicates a certain degree of familiarity and existing infrastructure for this methodology to continue to be used, and may reduce the risk of liquidity fragmentation in the SONIA-referencing bond market.

- Overnight SONIA compounded in arrears aligns with the conventions already used in the SONIA swap market. It also aligns with the fallback rate for derivatives included in the ISDA Fallbacks Protocol and ISDA Fallbacks Supplement, which, following a series of industry consultations, specify that the applicable fall back rate for GBP LIBOR derivatives will be SONIA compounded over the relevant IBOR period (and a spread adjustment added to the compounded rate). Consistency and alignment between the bond market and the derivatives market is considered desirable[18] and should give rise to fewer instances in which instruments used to hedge bonds need to be amended or excluded from the ISDA Fallbacks Protocol (where the parties to the hedge instrument have both adhered to the ISDA Fallbacks Protocol) in order to minimise basis risk. Bond products that are currently unhedged would secure similar benefits from having consistency with the methodology in the derivatives market were they to be hedged in future (and the hedge agreement incorporates the ISDA Fallbacks Supplement).

[17] Source: Bloomberg.

[18] The Statement on SONIA conventions and summary of responses on Conventions for referencing SONIA in new contracts (August 2019) states that "*in respect of the SONIA-referencing bond market, the majority of respondents agreed a consensus was developing towards the conventions of compounding in arrears … It was recognised that this approach has alignment with the existing operational processes in the floating rate note market and with conventions in the SONIA swap market, which uses compounded in arrears. The alternatives… are considered less aligned (and would therefore make hedging more difficult), as well as being more difficult to implement in systems*". This Statement later states that: "*The alignment of conventions between the derivative market and the cash market is considered necessary to have more effective pricing and hedging models*".

- The Working Group has consistently been encouraging the use of overnight SONIA, compounded in arrears, for some time. For instance, the paper on Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives published by the Working Group (January 2020) confirmed that: "*The prevailing view of the Working Group is that overnight SONIA, compounded in arrears, will and should become the norm in most derivatives, bonds and bilateral and syndicated loan markets given the benefits of the consistent use of benchmarks across markets and the robust nature of overnight SONIA*". This paper recognised that a forward-looking term rate may be needed to support the transition of certain legacy contracts, but also stated that: "*where possible, parties are encouraged to transition to overnight SONIA compounded in arrears*".

- Most recently, one of the Working Group's 2021 Top Level Priorities, as set out in the January 2021 updated Working Group Roadmap[19], has been to: "*Continue to enable and promote widespread use of SONIA compounded in arrears throughout wholesale sterling markets*".

- With respect to the offering of non-LIBOR loans products by the end of Q3 2020 in the loan market, the Working Group has stated in the Recommendations for SONIA Loan Market Conventions that: "*SONIA remains the Working Group's recommended alternative to Sterling LIBOR, implemented via a compounded in arrears methodology, and loan markets should now move consistently towards this*". Although the loan market is out of the scope of this Consultation Paper, consistency of approach as between loans, bonds and derivatives is desirable[20].

- From an economic perspective, use of overnight SONIA, compounded in arrears as the successor rate would mean that the interest rate and amount would not be known at the start of the interest period. This may have implications for cash flow planning.

- From an operational perspective, there are likely to be additional practical steps that would need to be taken to reflect the fact that the interest rate and amount can only be determined towards the end of the interest period[21]. However, it is understood that a number of market participants' systems have already been adjusted to cater for bonds referencing overnight SONIA, compounded in arrears.

- In the UK, the basis for any change in methodology of LIBOR (which may be directed by the FCA pursuant to the proposed legislative solution[22] for tough legacy transactions) may differ to that of overnight SONIA, compounded in arrears.

Option 2 - Term SONIA as the successor rate

Description:

LIBOR is a forward-looking or "term" rate quoted for five currencies and seven tenors[23], and because it is forward-looking, the LIBOR-linked term interest rate payable is known at the start of the relevant interest period. Term SONIA rates have been developed by three administrators (FTSE Russell, ICE Benchmark Administration and Refinitiv), of which some are now available for live use. There are methodological differences across the three administrators' approaches, meaning that the rates produced are marginally different. All three are currently authorised benchmark administrators and expect to produce IOSCO-compliant rates.

[19] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfr-working-group-roadmap.pdf
[20] See Statement on SONIA conventions and summary of responses on Conventions for referencing SONIA in new contracts.
[21] Typically, 5 days before the end of the interest period.
[22] https://questions-statements.parliament.uk/written-statements/detail/2020-06-23/HCWS307
[23] USD, GBP, CHF, JPY and EUR in overnight/spot, one week, one month, two months, three months, six months and 12 months. In the international bond market, the most commonly used tenors are three months and six months.

Potential considerations relevant to recommending a term SONIA rate as the successor rate:

- From an economic perspective, use of a term SONIA rate would mean that parties would know the interest amount at the start of the interest period (as they do now, with LIBOR), which some might find beneficial from a cash flow planning perspective, and which may give rise to limited practical operational implications. However, it is worth noting that the determination of the interest rate and amount towards the end of the interest period is not considered to be significantly problematic in the new SONIA bond market.

- Term SONIA does not align with the conventions already used in the SONIA swap market, nor does it align with the fallback rate for derivatives included in the ISDA Fallbacks Protocol and ISDA Fallbacks Supplement. This could lead to more instances in which instruments used to hedge bonds need to be amended or excluded from the ISDA Fallbacks Protocol (where the parties to the hedge instrument have both adhered to the ISDA Fallbacks Protocol) in order to minimise basis risk between overnight SONIA, compounded in arrears, and a term SONIA rate.

- The Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives provided that a forward-looking term rate may be needed for certain users and sectors "*of the loan market"* or to "*support the transition of certain legacy contracts"*. It concluded that, although "*bond issuance, including securitisation, was initially seen as a potential use case for a [term SONIA reference rate]…this market had demonstrably adopted overnight SONIA, compounded in arrears for all new GBP issuance over the last year*".

- The paper also stated that "*while compound in arrears rates will be available in all currencies where an RFR rate is available, term rates may not be made available in all currencies. Using compounding in arrears therefore supports multi-currency borrowers to apply a consistent approach where possible.*" This is expected to be the case, for instance, in the case of SARON (the RFR for CHF LIBOR), where the National Working Group on Swiss Franc Reference Rates has concluded that it is unlikely that a robust derivatives-based term fixing is feasible[24].

- In 2018, the Financial Stability Board emphasised that although there are limitations to RFR-derived term rates which may mean that there are limited instances (likely outside of the international bond market) where a forward-looking term rate is required, term rates can be valuable to some market participants who want or need to plan cash flow to make interest or coupon payments based on a forward-looking rate[25].

- Term SONIA rates have been developed by three administrators (FTSE Russell, ICE Benchmark Administration and Refinitiv), of which some are now available for live use. There are methodological differences across the three administrators' approaches, meaning that the rates produced are marginally different. Given these differences, it could take some time for the market to understand the different nuances between them and to coalesce on one particular term rate.

- As noted in a statement published on 11 January 2021, the Working Group, the Bank of England, and the FCA have made clear that, in future, they anticipate that the large majority of sterling markets will be based on SONIA compounded in arrears, to provide the most robust foundation for the overall market structure. The Working Group has engaged closely with the FICC Markets Standards Board ("FMSB") to support development of a market standard for FMSB members in relation to an appropriately limited use of Term SONIA Reference Rates, consistent with the Working Group's objectives and existing recommendations on use cases of benchmark rates. The proposed FMSB standard was under review by key stakeholders during January 2021 and is expected to be released for public comment in February 2021.

[24] NWG on Swiss Franc Reference Rates, Further FAQ

[25] https://www.fsb.org/wp-content/uploads/P120718.pdf

Section 6: Potential considerations common to both rates

International consistency:

In general there may be benefits to consistency across the application of IBOR fallback rates globally, which potentially impacts the recommendation of the successor rate to GBP LIBOR for bonds. In the case of USD LIBOR legacy bonds, it is worth noting that, in the ARRC's recommended fallback language[26], the first step in the waterfall of fallbacks is to a term SOFR rate, if such a rate becomes available. If USD LIBOR legacy bonds fall back to a term SOFR rate, this could create inconsistency if the successor rate to GBP LIBOR is overnight SONIA, compounded in arrears, particularly for issuers who issue in different currencies and use different reference rates and for whom global consistency is desirable.

Securitisations – treatment of underlying assets:

For securitisations, consideration would need to be given to whether the reference rate for the underlying assets in the securitisation would switch to the same rate as the bond or not, and the implications of that for cashflows.

Contractual issues:

From a contractual perspective, issuers, paying agents and (where applicable) trustees may need to make adjustments to certain elements of contracts that are designed to work with LIBOR. In the case of overnight SONIA, compounded in arrears, this will include reflecting the fact that the interest rate and amount can only be determined towards the end of the interest period. In the case of term SONIA, this may require adjustments to the definition of the relevant screen page, the fallbacks and other terms of the bonds and ancillary contractual documentation. The Working Group understands that English law-governed bond documentation containing the Type 2 and Type 3 fallbacks generally caters for amendments of this kind to be made without recourse to bondholders being needed.

[26] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/FRN_Fallback_Language.pdf

Section 7: Overall summary of considerations highlighted in this Consultation Paper

The various potential considerations set out in relation to the two options presented in this paper may be summarised as follows:

Alignment with other products:

As set out above, use of compounded in arrears SONIA as a successor rate (Option 1) would be consistent with existing market conventions in a wide range of products in sterling markets, including all SONIA-linked bonds issued to date, the SONIA swaps market and the new ISDA fallbacks for LIBOR-linked swaps. By contrast, use of a term SONIA rate (Option 2) may be more consistent with the ARRC recommended fallbacks for legacy bonds linked to USD LIBOR, if a USD term rate becomes available. In the case of securitisations, consistency of rates between the underlying assets and the bond may also be a relevant factor.

Overall market structure:

As noted in its statement published on 11 January 2021, the Working Group anticipates that the large majority of sterling markets will be based on SONIA compounded in arrears, to provide the most robust foundation for the overall market structure, and has been working with the FMSB to support development of a market standard for FMSB members in relation to an appropriately limited use of Term SONIA Reference Rates. The proposed FMSB standard is expected to be released for public comment in February. Once available, respondents may wish to take into account the proposed FMSB standard when considering their preferred potential successor rate for sterling bonds.

Implementation:

As described above, respondents may wish to take into account the degree to which the potential forms of a successor rate are compatible with the existing design of contracts and processes, as changes are likely to be required under both of the available options. Greater similarity in the structure of term SONIA rates relative to LIBOR under Option 2 may allow for these changes to be limited, including in relation to firms' approaches to cash flow planning, while use of SONIA compounded in arrears (Option 1) may require more change relative to legacy processes but provide greater alignment with established processes for newly issued bonds in respect of which the determination of the interest rate and amount towards the end of the interest period is not considered to be significantly problematic.

Section 8: Questions for consultation

Questions for consultation:

1. Do you consider that it would be helpful for the Working Group, 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:

   (i) Type 2 fallbacks in bond documentation, where the relevant fallback triggers are intended to operate upon the occurrence of a permanent cessation event, and

   (ii) Type 3 fallbacks in bond documentation, where the relevant fallback triggers are intended to operate upon the occurrence of a pre-cessation event?

2. Do you consider that the recommended successor rate to GBP LIBOR for Type 2 fallbacks and Type 3 fallbacks should be overnight SONIA, compounded in arrears (Option 1)?

3. If you answered "no" to question 2, do you consider that the recommended successor rate to GBP LIBOR for Type 2 fallbacks and Type 3 fallbacks should be term SONIA (Option 2) or any other SONIA based methodology? Please explain your answer.

4. Do you consider that details regarding further conventions to be used to accompany the successor rate, such as use of observation lag or shift,[27] should be left to the issuer to agree on a case by case basis?

[27] See further Statement on bond market conventions: Use of the SONIA index, and weighting approach for observation periods

Annex: Relevant bond provisions and defined terms

The following defined terms are based upon an example of standard English law fallback provisions and may need to be adjusted for alternatively-drafted fallback provisions. Conceptually however, it is understood that the relevant provisions are broadly consistent.

"**Successor Rate**" means a successor to or replacement of the Original Reference Rate which is formally recommended by any Relevant Nominating Body.

"**Alternative Rate**" means an alternative benchmark or screen rate which the [Issuer following consultation with the Independent Adviser]/[Independent Adviser] determines in accordance with Condition [X](*B*) is customarily applied in [international] debt capital markets transactions for the purposes of determining rates of interest (or the relevant component part hereof) in the same Specified Currency as the Notes.

"**Relevant Nominating Body**" means, in the bond market, in respect of a benchmark or screen rate (as applicable):

(i) the central bank for the currency to which the benchmark or screen rate (as applicable) relates, or any central bank or other supervisory authority which is responsible for supervising the administrator of the benchmark or screen rate (as applicable); or

any working group or committee sponsored by, chaired or co-chaired by or constituted at the request of (a) the central bank for the currency to which the benchmark or screen rate (as applicable) relates, (b) any central bank or other supervisory authority which is responsible for supervising the administrator of the benchmark or screen rate (as applicable), (c) a group of the aforementioned central banks or other supervisory authorities or (d) the Financial Stability Board.