Active transition of GBP LIBOR referencing bonds

The Working Group on Sterling Risk-Free Reference Rates

September 2020

Contents

Foreword **3**

Introduction **4**

Section 1: Why the need to transition to risk-free rates now? **5**

Section 2: Why the need to transition Legacy Transactions now? **7**

Section 3: How to transition Legacy Transactions by way of consent solicitation **7**

Amending the interest rate provisions directly 8

Amending the Type 1 fallbacks 8

Cash credit spread adjustment 8

Securitisation-specific issues with consent solicitation 8

Section 4: Challenges with consent solicitation **9**

Regulatory issues 9

Hedging risk 10

International approach 10

Participation of investors 10

Annex 1: Legacy Sterling LIBOR Bond Fallbacks **11**

Foreword

The overall objective of the Working Group on Sterling Risk-Free Reference Rates (the "Working Group") is to enable a broad-based transition to SONIA (Sterling Overnight Index Average) by the end of 2021 across the sterling bond, loan and derivative markets.[1] This will reduce the financial stability risks arising from widespread reliance on GBP LIBOR, which in the years since the financial crisis has been based on relatively few underlying transactions.[2]

This paper sets out how issuers might consider transitioning existing bonds from a LIBOR-based benchmark to a risk-free rate. In the sterling bond market, the recommended risk-free rate is SONIA. It draws upon recent examples of such transitions which have already taken place using the market-based solution of consent solicitation.

The Working Group is particularly grateful to the Bond Market Sub Group and Cash Market Legacy Transition Task Force for having developed this paper.

The Bank of England and FCA are each ex-officio members of the Working Group. The views and outputs set out in this paper do not constitute guidance or legal advice from the Bank of England (including the Prudential Regulation Authority ("PRA")) or the FCA or the Working Group and are not necessarily endorsed by the Bank of England (including the PRA) or the FCA. In addition, this paper is not intended to impose any legal or regulatory obligations on market participants. This paper has been prepared for the purpose of highlighting to market participants some of the potential considerations. It does not constitute a comprehensive outline of all relevant considerations. Market participants should seek their own advice in relation to their legal, regulatory, tax and other obligations and as to any other considerations or risks that may arise or be relevant.

---

[1] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr-terms-of-reference.pdf

[2] This was particularly evident during the period of disruption brought on by COVID-19 in March 2020 the limited market transactions underpinning GBP LIBOR benchmarks fell away leaving them almost entirely reliant on expert judgment. Additionally, during this period, LIBOR rates – and hence costs for borrowers – rose as central bank policy rates fell and underlying market activity was low. This has reinforced the importance of completing the transition to alternative rates by end-2021. For more on this please refer to the Bank of England's May 2021 Financial Stability Report: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/may-2020.pdf

Introduction

1. The authorities have continually highlighted that LIBOR will come to an end, and have stressed the importance of transitioning as much as possible as soon as possible away from LIBOR to risk-free rates so as to reduce dependence on, and risks arising from, LIBOR.[3]

2. While considerable progress has already been made in relation to GBP LIBOR with the adoption of SONIA in new public issues of sterling floating rate notes (FRNs), covered bonds and securitisations,[4] there are a number of FRNs, covered bonds, capital securities and securitisations (all of which are herein referred to as "bonds") that reference LIBOR, or which reset to or otherwise reference a change in interest based on LIBOR, LIBOR-based swaps or any other LIBOR-based derivative, and which are due to mature beyond the end of 2021[5].

3. Many of these bonds contain fallbacks which typically would result in the bond falling back to the rate in effect for the last preceding interest period, which will be applied to every interest period for the remaining life of the bond; this would de facto result in a bond falling back to a fixed rate on the permanent cessation of LIBOR (herein referred to as "Type 1 fallbacks"[6]). Some of these bonds may contain no fallbacks at all, meaning there is no default position on the permanent cessation of LIBOR. Sterling bonds governed by English law which reference LIBOR, which are due to mature beyond the end of 2021, and which contain Type 1 fallbacks or no fallbacks at all are herein referred to as "Legacy Transactions".

4. The Working Group released a Paper on the identification of Tough Legacy issues (the "Tough Legacy Paper"), which proposed that the UK Government "consider legislation to address tough legacy exposures in contracts governed by English law that reference at least GBP LIBOR, and ideally other LIBOR currencies, that are still in operation when LIBOR is expected to cease on or after the end of 2021".

5. In response to the Tough Legacy Paper, in June 2020, Her Majesty's Treasury announced by way of a written statement that "It is in the interests of financial markets and their customers that the pool of contracts referencing LIBOR is shrunk to an irreducible core 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", and that "the Government recognises, however, that legislative steps could help deal with this narrow pool of 'tough legacy' contracts that cannot transition from LIBOR."

6. In order to deal with these 'tough legacy' contracts, which may include Legacy Transactions, the Government intends to legislate to amend and strengthen the Benchmarks Regulation 2016/1011 as amended by the Benchmarks (Amendment) (EU Exit) Regulations 2018, rather than directly to impose legal changes on LIBOR-referencing contracts that are governed by English law. In its

[3] For example, Andrew Bailey, Chief Executive, FCA: "discontinuation of LIBOR should not be considered a remote probability 'black swan' event. Firms should treat it is as something that will happen and which they must be prepared for", Interest rate benchmark reform: transition to a world without LIBOR.

[4] SONIA-linked FRN and securitisation issuance amounts to over £90bn since June 2018, and public issuance of LIBOR-linked FRNs and securitisations with a maturity beyond the end of 2021 has all but ceased. Source: Bloomberg.

[5] Estimates suggest over 870 individual tranches over approximately 490 issuances, with an estimated total outstanding volume of £110bn. Source: HSBC and NatWest Markets.

[6] Further background on Type 1 fallbacks and other sterling bond fallbacks is included in Annex A.

written statement, the Government stated that "the legislation will ensure that, by the end of 2021, the FCA has the appropriate regulatory powers to manage and direct any wind-down period prior to eventual LIBOR cessation in a way that protects consumers and/or ensures market integrity" which would include the FCA being able to direct a methodology change used for a critical benchmark (such as LIBOR) in circumstances where the regulator has found that that benchmark's representativeness will not be restored.

7. However, the authorities consider that the best and smoothest transition from LIBOR will be one in which contracts that reference LIBOR (including Legacy Transactions) are replaced or amended before the fallback provisions are triggered.[7] In its written statement, the Government stated that "active transition of legacy contracts remains of key importance and provides the best route to certainty for parties to contracts referencing LIBOR. Parties who rely on regulatory action, enabled by the legislation the Government plans to bring forward, will not have control over the economic terms of that action. Moreover, regulatory action may not be able to address all issues or be practicable in all circumstances, for example where a methodology change is not feasible, or would not protect consumers or market integrity".

8. In many cases, active transition can be achieved by way of consent solicitation: a market-based process which enables an issuer to amend bond conditions by way of bondholder consent.[8]

9. As at the date of this paper, a number of Legacy Transactions (in the form of FRNs, covered bonds and securitisations) have already been the subject of successful consent solicitation processes undertaken in order to transition the relevant Legacy Transactions from LIBOR to SONIA (plus a spread adjustment) ("Transitioned Legacy Transactions").

10. The Working Group released a Statement on the "Progress on the Transition of LIBOR-referencing Legacy Bonds to SONIA by way of consent solicitation", which draws upon practices used in the Transitioned Legacy Transactions and includes considerations for the conduct of future consent solicitations. It is hoped this will encourage other market participants to engage with the task of transitioning as many Legacy Bond contracts as possible by way of consent solicitation.[9]

Section 1: Why the need to transition to risk-free rates now?

11. The impending cessation of LIBOR is a clear reason to transition to risk-free rates as soon as possible. For instance, the Bank of England's May 2020 Financial Stability Report observed that "LIBOR rates — and hence costs for borrowers — rose as central bank policy rates fell, and underlying market activity was low. This has reinforced the importance of completing the transition to alternative rates by end-2021." GBP LIBOR is now based on very few underlying transactions and is therefore an unreliable benchmark of the cost of borrowing.

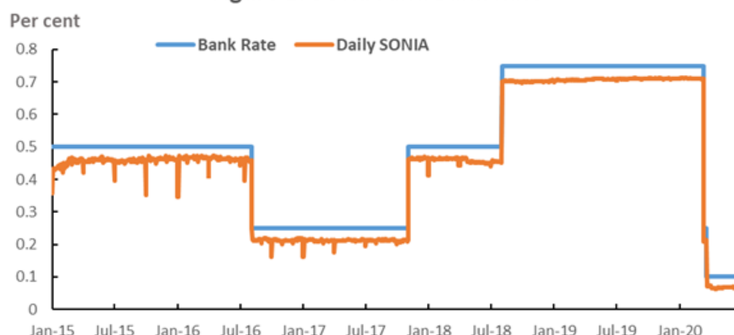
---

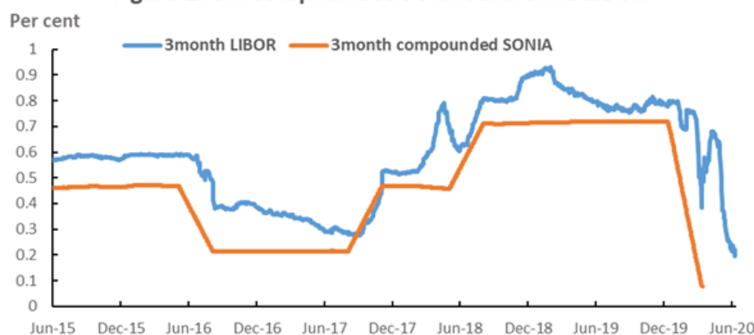
[7] For example, Edwin Schooling Latter, Director of Markets and Wholesale Policy, FCA: LIBOR transition and contractual fallbacks.

[8] For further details, please see ICMSA paper The discontinuation of LIBOR/IBORS – timeline of a consent solicitation.

[9] While the Transitioned Legacy Transactions are helpful in providing direction for the conduct and outcome of consent solicitations, each issuer and each Legacy Transaction is unique. Market participants should therefore carefully consider the suitability of consent solicitation as an appropriate course of action in respect of each relevant Legacy Bond, in all cases assessed on its own merits.

12. Unlike GBP LIBOR, SONIA is robust as it is anchored in an active and liquid underlying market and reflects the average of the interest rates that banks pay to borrow sterling overnight. SONIA, which is administered by the Bank of England, also tracks the Bank of England Bank Rate very closely (*see figure 1*) and is comparatively stable and predictable (*see figure 2*).





Source: Bank of England website, Bank of England calculations, and Bloomberg data.

13. As the end of 2021 draws closer, the risks of continuing to rely on agreements that reference LIBOR after that date will increase due to the uncertainty around the continued existence of LIBOR after that point, whether the rate will be declared to be non-representative, as well as how the volatility of LIBOR and depth of liquidity in LIBOR instruments may change.

14. Successful transition away from GBP LIBOR to SONIA should also, amongst other things:

   a. Increase certainty for corporate borrowers wanting to lock in a fixed credit component at the time bonds are originated,

   b. Allow market participants to take or hedge risk related to the evolution of monetary policy rates through swaps and other instruments without unintentionally introducing a variable credit component,

   c. Incentivise the development of new products, such as swaptions based on risk-free rates, allowing more efficient hedging of interest rate volatility, either on their own or as part of structured products, and

   d. Help to develop liquidity in SONIA-referencing markets even further, resulting in potential for concentrating sterling liquidity into a single interest rate curve referencing compounded overnight SONIA.

15. It would also provide an opportunity to modernise the technology and infrastructure supporting sterling SONIA markets. Firms that do not press ahead with their transition efforts risk finding themselves using LIBOR-linked systems and obligations that are no longer fit for purpose.[10]

16. The risk-free rates, including SONIA, are different to LIBOR, and will take time to fully develop in the bond market. Those who transition early to the risk-free rates will be able to help establish conventions around the use of the rates rather than having to accept conventions that are developed without their input.

---

[10] Andrew Hauser, Executive Director, Markets, Bank of England: [Join the revolution! Why it makes business sense to move on from LIBOR]().

Section 2: Why the need to transition Legacy Transactions now?

17. On the permanent cessation of LIBOR, Legacy Transactions could fall back to a fixed rate due to the operation of a Type 1 fallback (as further described in paragraph 3), which is not likely to have been the longer term permanent commercial expectation or intention of the parties. This could mean that Legacy Transactions would cease to perform the economic function for which they were originally intended, which could lead to a risk of market disruption and could potentially impact financial market stability.

18. Transition of Legacy Transactions from GBP LIBOR to SONIA in a considered and sustainable manner, preferably before fallback provisions are triggered would help to reduce market participants' exposure to GBP LIBOR risks, and would reduce the risk of disorderly adjustment closer to the end of 2021. Removing as much LIBOR risk from the financial system as possible, as soon as possible, would also reduce market disruption when LIBOR is permanently discontinued.

19. The transition to risk-free rates will require significant time and resource, such as legal expertise, investor engagement and discussion with systems providers. Given the number of Legacy Transactions (see paragraph 2 above) which need to be transitioned to risk-free rates, these resources may become more limited as the end of 2021 approaches.

Section 3: How to transition Legacy Transactions by way of consent solicitation

20. A bond is a contract between an issuer and bondholders (and the Trustee for the bond, where relevant), which can only be amended with consent of the parties, in accordance with the bond's terms and conditions.[11]

21. In order to effect a transition from GBP LIBOR to SONIA and thereby avoid the potential consequences of permanent cessation of LIBOR, an issuer would have to amend the terms and conditions of the bonds by way of consent solicitation.

22. Consent solicitation operates such that an issuer can initiate a proposal of certain amendments to the terms and conditions of a bond.[12] If the necessary quorum and/or consent thresholds set out in the terms and conditions are reached, then the proposed amendments will be made to the terms and conditions of the bond and will bind all holders of the bonds, irrespective of whether they voted in favour of the amendments or not.

23. Under English law[13], amendments to interest rate provisions in bond terms and conditions typically require a quorum of two-thirds or 75% of holders of the outstanding principal amount of

[11] Bonds cannot be amended wholesale by way of an amending protocol, such as is used in the derivatives market.

[12] Generally, the terms and conditions of all English law bonds allow for the bonds to be amended by way of consent solicitation.

[13] There is a significant number of US dollar-denominated bonds governed by US securities laws which reference LIBOR, which are due to mature beyond the end of 2021 and contain Type 1 fallbacks. But under New York law, consent thresholds of 100% are common.

bonds, of which 75% of votes cast have to be in favour of the extraordinary resolution to amend the relevant terms and conditions.[14]

24. A consent solicitation exercise is undertaken only in respect of an individual bond, or series of bonds (made up of one or more tranches of bonds, forming part of the same series of bonds). It follows that a separate consent solicitation process would be required to be undertaken in order to transition each relevant Legacy Transaction from GBP LIBOR to SONIA, bond by bond.

25. In the UK and European securitisation market, the Association for Financial Markets in Europe has developed a simplified consent mechanism (so-called "negative consent" wording): if holders representing at least 10% of the aggregate principal amount outstanding of the securitisation have notified the trustee that they do not consent to the amendment, then it will not be made (although the issuer can subsequently undertake a full consent solicitation exercise).

Amending the interest rate provisions directly

26. Issuers may undertake a consent solicitation exercise to amend the interest rate provisions directly of Legacy Transactions so that they reference an alternative rate going forward. The issuers in each of the Transitioned Legacy Transactions undertook a consent solicitation exercise on this basis to transition from GBP LIBOR to SONIA.

27. Because each Legacy Transaction would have to be amended individually, this would result in Legacy Transactions transitioning to SONIA over a period of time, depending on when the consent solicitation exercise is undertaken.

Amending the Type 1 fallbacks

28. As an alternative, issuers may consider undertaking a consent solicitation exercise in order to amend the Type 1 fallbacks in their Legacy Transactions so that they fall back to SONIA rather than to the fixed rate upon the occurrence of a specific event, such as the permanent cessation of LIBOR, or the declaration by the regulator that LIBOR is no longer representative.

Cash credit spread adjustment

29. SONIA is an overnight rate which is near risk-free, whereas GBP LIBOR incorporates a bank credit risk premium. While it might not be possible to replicate this factor, a spread adjustment could be applied to SONIA as a rough proxy.

30. Given the complexities, the proposed methodologies for calculating a spread adjustment may be subject to further market-wide discussion but this may not determine a single specific solution. As the appropriate credit spread adjustment will always be subject to bilateral agreement, transition should not be delayed by waiting for any future suggested standard.

Securitisation-specific issues with consent solicitation

31. A securitisation may comprise different classes of notes (or tranches), as part of one transaction (or series), some of which may be in different currencies and linked to different underlying rates, or IBORs. Consent solicitation will therefore need to be analysed on a tranche-by-tranche basis.

---

[14] For an adjourned meeting, a quorum of one-third or 25% of holders of the outstanding principal amount of bonds is typically required (if the first meeting was adjourned for want of quorum), of which 75% of votes cast have to be in favour of the extraordinary resolution to amend the relevant terms and conditions.

32. It may be possible to group together series of securitisations when voting on an extraordinary resolution to amend the relevant terms and conditions, but given the significance of a change to the interest rate, the changes will need to be voted on tranche-by-tranche. Holders of each tranche will need to approve the changes to their own tranche and each other tranche in the structure, unless the relevant note trustee agrees otherwise.
33. As a matter of market practice, any consent solicitation proposal for securitisations would need to include a confirmation that the ratings on the relevant securitisation were unaffected, or otherwise that the rating agencies had reviewed the relevant amendments and that the rating impact had been assessed.
34. The directors of the special purpose vehicles (the issuers of securitisations) and their originators and sponsors may need to decide who will bear the associated costs.

Section 4: Challenges with consent solicitation

Regulatory issues

35. A question arises as to whether the amendment to the interest rate provisions of Legacy Transactions would be treated as so material as to result in the Legacy Transactions, in their amended form, being designated as "new" instruments instead of existing issuance. This is important for a number of reasons:
    a. Designation as a "new" instrument may result in de-recognition of hedging instruments,
    b. Eligibility of the Legacy Transactions as "capital" under the Capital Requirements Regulation may need to be reassessed,
    c. For non-UK supervised firms, the requirement to insert relevant contractual terms under regional legislation for bank resolution and recovery may be triggered,
    d. Amended Legacy Transactions will have to comply with offering requirements in all jurisdictions in which they are held, and
    e. Existing securitisations that have been "grandfathered" (as applicable regulations have changed over the years) could lose this protection.
36. It is however widely considered that an amendment to a transaction with the sole purpose of transitioning away from LIBOR should not be considered as a material amendment, nor that it should designate a transaction a "new instrument".[15]

[15] https://www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-on-libor-and-resolution. See also the Basel Committee on Banking Supervision (BCBS), which has clarified that, under the Basel Framework, amendments to capital instruments pursued solely for the purpose of implementing benchmark rate reforms will not result in them being treated as new instruments for the purpose of assessing the minimum maturity and call date requirements or affect their eligibility for transitional arrangements of Basel III. Moreover, the international law firms who are most active in the securitisation market consider that, according to the English law analysis, an amendment to just the IBOR provisions of a securitisation would not constitute a new instrument; rather, it would constitute an amended instrument. This would not give rise to any problems in terms of loss of the grandfathering treatment of securitisations; and would therefore not give rise to any sanctions for non-compliance under the Securitisation Regulation.

Hedging risk

37. Bond issuers will need to consider if existing hedging arrangements need to be changed to align with the new rate and its methodology following a successful consent solicitation, in the event of adherence to the ISDA protocol implementing fallbacks in derivatives contracts for the associated hedge products.[16]

International approach

38. Some international issuers, issuing in a number of different currencies, might for practical reasons prefer only to transition Legacy Transactions denominated in different currencies at the same time. It is therefore optimal for many market participants that there is a convergent, international approach to amendment of Legacy Transactions. But it is important to note that this is not always going to be possible.

39. In the US, the terms and conditions of New York law-governed bonds which fall back to a fixed rate on the permanent cessation of LIBOR, or where there are no fallbacks (in other words, akin to Legacy Transactions), could theoretically be amended by way of consent solicitation. But typically, consent would be required from each bondholder; while this might be possible in isolated cases, it is unlikely to be workable for many bonds with a large number of holders. Therefore, unlike in the UK, the US authorities are not actively encouraging market participants to transition as many bond contracts as possible by way of consent solicitation.

40. A likely outcome of this is that upon the permanent cessation of LIBOR, there would be a significant volume of New York law-governed bonds that fall back to a fixed rate. Therefore, in March 2020, the Alternative Reference Rates Committee (ARRC) in the US released details of a Proposed Legislative Solution to Minimise Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition for New York law-governed transactions, which would require the use of the ARRC recommended benchmark replacement instead of falling back to a fixed rate on the permanent cessation of LIBOR, and in contracts where there are no fallbacks[17].

Participation of investors

41. Please note that the market infrastructure may not support the mass transition of bonds to new terms by way of consent solicitation. If large volumes of consent solicitations are taking place at the same time, the requirement under English law to obtain the necessary approval from (typically) 75% of bondholders may pose a significant logistical challenge. Such engagement / approval may be even more challenging if a particular issue being transitioned is widely held by a large number of investors. Issuers should therefore plan to approach bond holders on changing bond terms in good time and well ahead of the relevant transition target milestones established by the Working Group.[18]

---

[16] ISDA has consulted on fallbacks which would apply if certain key IBORs are permanently discontinued, or on a regulatory announcement that certain key IBORs are declared unrepresentative. In almost 90 percent of respondent rankings, the compounded setting in arrears rate was selected as the top preference for the adjusted RFR. The results of this (and associated) consultation are expected tobe reflected in protocols which will facilitate multilateral amendments to include the agreed fallbacks in legacy derivative contracts. The fallbacks are also expected to be included in new transactions that incorporate the 2006 ISDA Definitions.

[17] Where the fallback provisions are discretionary, the legislation also proposes a safe harbour which is intended to encourage the selection of the ARRC recommended benchmark replacement.

[18] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfr-working-group-roadmap.pdf. Please see slides 3 and 4 which refer to cash products, bonds and securitisations.

Annex 1: Legacy Sterling LIBOR Bond Fallbacks

It is important to understand the different fallback language typically seen in most bond terms and conditions, which is characterised and categorised below, and how it affects Legacy Transactions.

Type 1 fallbacks - Traditional fallback provisions

Bonds issued prior to Andrew Bailey's July 2017 speech[19] typically include "traditional" fallback provisions which, in summary, provide that:

a. If the relevant reference rate is not available at the relevant time, then the party responsible for determining the rate must request quotes from a certain number of major banks in the interbank market ("reference banks") and use the quotes provided to determine a rate, or

b. If quotes cannot be obtained from reference banks, then **the rate in effect for the last preceding interest period will be applied to every interest period for the remaining life of the Legacy Transaction.**

It is unlikely that, in the event of a permanent cessation of LIBOR, reference banks would provide quotes for any length of time, if at all. Absent any other intervention, Legacy Transactions which contain Type 1 fallbacks therefore will become fixed rate instruments in the event of a permanent cessation of LIBOR.

Type 2 fallbacks - Alternative fallback provisions

Since Andrew Bailey's July 2017 speech, alternative fallback provisions, which are designed to apply across currencies and in respect of different benchmarks, are now common in EMTN programmes that envisage the issuance of long-dated FRNs in Europe and Asia.

The alternative fallbacks 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 spread adjustment to be applied to such rate, in each case, on the basis of (a) any recommendations made by 'relevant official bodies' or (b) if no such recommendations have been made, customary market practice.

Type 3 fallbacks - Latest fallback provisions

Subsequent statements and publications in 2018/19 have further informed appropriate fallback drafting principles. In some cases, fallbacks have started to include the concept of a pre-cessation trigger based upon a statement of "unrepresentativeness" of the relevant original benchmark by the regulator of the administrator of the benchmark.

[19] Andrew Bailey: *The Future of LIBOR*.