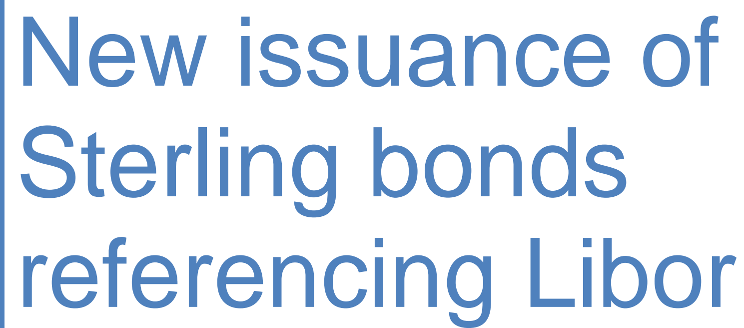


New issuance of Sterling bonds referencing Libor

The Working Group on Sterling Risk-Free Reference Rates

July 2018

Foreword

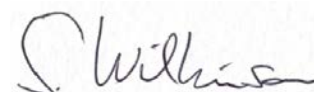
The overall objective of the Working Group on Sterling Risk-Free Reference Rates (the 'Working Group') is to catalyse a broad-based transition to SONIA by end-2021 across sterling bond, loan and derivative markets, in order to reduce the financial stability risks arising from widespread reliance on Libor.[1]

This paper is addressed to bond market participants who are continuing to issue, offer and purchase new Sterling bonds referencing Libor, in particular where those bonds mature beyond the end of 2021 when Libor may cease to be available (which we refer to in this paper as 'long-dated').[2]

The Working Group believes that it is important that end users continue to have uninterrupted access to financing and risk management products. Over the near term, Libor usage might continue whilst firms take steps to mitigate the risks of a discontinuation and reduce their dependency on Libor.

This paper is intended to raise market awareness regarding potential risks of continued Libor usage in bond markets to help market participants increase their level of preparedness and forward planning. The Working Group believes, as highlighted in this paper, that the most effective way of avoiding risks related to Libor discontinuation is to transition to alternative benchmarks, in particular SONIA. Where Libor continues to be referenced in new Sterling bonds issued in the interim period before market conventions and infrastructure for referencing alternatives to Libor are fully developed, there are certain steps market participants could take to mitigate some of the risks highlighted in the paper. A key milestone for the Working Group will be communicating best practice for referencing SONIA in bond markets, planned for later this year.

The Working Group is particularly grateful to its Bond Market Sub-Group (the 'Sub-Group'), chaired by Paul Richards of ICMA, for having developed this paper. The paper was discussed at the Working Group's meeting on July 2nd at which it was agreed to publish the paper, and delegate the final steps to the Working Group Chair and Vice-Chairs as well as the Sub-Group Chair.

François Jourdain, Chair Barclays International	Frances Hinden, Vice-Chair Shell International Ltd	Simon Wilkinson, Vice-Chair Legal & General Investment Management
		

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[1] For more information on the Working Group, see https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor

[2] The considerations in this paper are likely to have relevance for issuance of international floating rate bonds in all currencies for which Libor is quoted.

The Bank of England and the FCA are each ex-officio members of the Working Group. Market participants should note that the views and considerations set out in this paper do not constitute guidance or legal advice from the Bank of England (including the PRA), the FCA or the Working Group. Further, the views and considerations set out in this paper are not necessarily endorsed by the Bank of England (including the PRA) or the FCA. This paper has been prepared for the purpose of highlighting to market participants some of the current market uncertainties surrounding issuance of long-dated bonds referencing Libor. This paper does not constitute a comprehensive outline of all relevant considerations in this regard. Market participants should seek their own advice in relation to their legal, regulatory and other obligations and as to any other considerations or risk that may arise or be relevant in this regard.

Background

1. In a speech in July 2017[3], the Chief Executive of the FCA said that the FCA did not intend to use its powers to persuade or compel banks to submit contributions for Libor after the end of 2021; and would not in any case be in a position to compel banks to submit contributions indefinitely under the EU Benchmark Regulation. Work is therefore underway to transition away from Libor and towards risk-free rates across financial markets globally.

2. In the UK, the Working Group has chosen SONIA as the preferred alternative risk-free rate for Sterling.[4] The Working Group is developing market conventions for SONIA-linked bonds.

3. In advance of those, and other, market conventions being determined and infrastructure being developed, market participants are exposed to certain risks when issuing, hedging, selling or purchasing long-dated bonds referencing Libor, given the uncertainty surrounding the discontinuation of Libor and the transition to risk-free rates in the bond market. It is the position of the Working Group that market participants should make themselves fully aware of these risks and should form an understanding of the issues involved, to ensure that the market operates on an informed basis and in compliance with legal and regulatory obligations.

4. This paper sets out some considerations for market participants in relation to the issue, offering and purchase of long-dated floating rate bonds referencing Libor on the basis of current market standard bond documentation.[5] In highlighting the relevant risks, this paper suggests a number of steps market participants may wish to consider taking to mitigate those risks. However, this paper does not set out all potential risks for all market

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3 https://www.fca.org.uk/news/speeches/the-future-of-Libor

4 In addition, SOFR has been identified as the preferred alternative risk-free rate for US Dollar markets, SARON as the preferred alternative risk-free rate for Swiss Franc markets, TONAR as the preferred alternative risk-free rate for Japanese Yen markets and the working group on euro risk-free rates has been established to identify a preferred alternative risk-free rate for Euribor in the euro markets.

5 It should be noted that the focus of this paper is on new issues of bonds referencing Libor and does not address the question of how to deal with 'legacy' bonds referencing Libor.

participants.[6] Market participants should take their own advice and form their own views on the risks applicable to them.

5. It should be noted that developments in this area are many and frequent, with statements being issued by benchmark administrators, regulators in each of the relevant jurisdictions for the main currencies for which Libor is quoted,[7] and industry bodies, as well as the development of new futures markets in the risk-free rates. Therefore, the steps suggested in this paper should be considered and an assessment as to their appropriateness be undertaken, in light of any new developments as and when they occur. Market participants are encouraged to consider the issues highlighted in this paper now, rather than waiting for market solutions to develop over time.

Risks associated with issuing long-dated bonds referencing Libor now

6. Set out below are some examples of the risks associated with issuing, hedging, selling or purchasing long-dated bonds referencing Libor now, which market participants may wish to consider.

The floating rate bond may become fixed if Libor is discontinued

7. The fallback provisions on how to calculate interest in the event that the nominated rate/screen page is unavailable which are contained in traditional market standard bond documentation typically depend on reference banks providing quotes for the relevant rate.[8] In the context of Libor discontinuation, reference banks may not be willing to provide quotations on a voluntary basis. The majority of floating rate bonds also provide that, as an ultimate fallback, where the interest rate cannot be determined through the preceding fallbacks, then the rate defaults to the most recently calculated rate, for an earlier interest period. In the context of a permanent discontinuation of Libor, this would effectively result in the floating rate bonds becoming fixed rate bonds, because the last determined rate would be applied for the remainder of the life of the bond. This may be commercially unacceptable for both issuer and investors. From an investor perspective, such issues may become illiquid and may cease to perform the commercial purpose investors intended for them. From an issuer perspective, those that aim to match liabilities via other instruments may be adversely affected.

A liability management exercise may be required if Libor is discontinued

8. If Libor is discontinued (and neither issuers nor investors wish the bonds to switch to a fixed rate of interest) or if Libor is no longer an acceptable benchmark rate to reference,

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[6] Neither does this paper reference broader issues relating to credit ratings, accounting or tax, all of which may be impacted by a switch to alternatives to Libor.

[7] For further detail see January 2018 IBOR Global Transition Roadmap https://www.icmagroup.org/assets/documents/Regulatory/Benchmark-reform/IBOR-Global-Transition-Roadmap-2018-010218.pdf and the June 2018 IBOR Global Benchmark Transition Report https://www.icmagroup.org/assets/documents/Regulatory/Benchmark-reform/IBOR-Transition-Report-250618.pdf

[8] Note that where ISDA determination is specified as the method for determining the rate of interest, the relevant fallback provisions are those set out in the ISDA 2006 definitions, which as at the date of this paper, stop at requiring the relevant parties to seek quotes from reference banks and do not contain a further automatic fallback to the previous rate of interest.

then the terms and conditions of floating rate bonds will likely need to be amended to provide for an alternative floating rate. For the majority of bonds these amendments to terms and conditions will require bondholder consent by way of bondholder meetings. This is not a quick or easy process, involving formal notice periods and (usually) high consent/quorum thresholds to amend terms relating to interest. Depending on the prevalent interest rate environment, the switch to a fixed rate may create a disincentive to the parties' proposing or agreeing to any changes to the terms of the bonds. Therefore there is no guarantee that any proposed amendments will be accepted. Other liability management exercises (such as cash tender offers or security exchange offers) are alternative options. These can also be costly and time consuming and have unpredictable outcomes.

Hedging arrangements may be impacted

9. If floating rate bonds are issued with the issuer entering into associated swaps (e.g. interest rate swaps but also potentially cross-currency swaps or other hedging arrangements), in the context of Libor discontinuation, the fallbacks for swaps and bonds may operate differently or may be triggered at different times. This may result in mismatches on payments. This may have an impact on an issuer's funding arrangements. Investors in floating rate bonds may also enter into related swaps on an individual or portfolio basis. A mismatch in the operation of bond and swap fallbacks may also have an impact upon the investment strategy of the relevant investor and may impact expected returns. There may also be risks for banks that have offered hedges through swaps if a hedge fails to provide the expected protection.

Market participants may be subject to increased litigation risk

10. If a switch from floating to fixed rate results in a loss to investors, this could expose the issuer and arranging bank(s) to litigation risk. For example, if a bond is marketed and sold today as a 7-year floating rate bond, but (because of its terms and a potential discontinuation of Libor in 2021) that bond operates as a 3-year floating rate bond, switching to a fixed rate for the remaining term, there could be a risk that an investor might claim that it has been mis-sold the product. This may be the case even if the prospectus disclosure accurately describes the operation of the terms and conditions of the bonds which would result in this outcome and clearly sets out the associated risks for investors.

11. A similar litigation risk could arise in relation to Libor based floating rate bonds with alternative fallbacks which anticipate the discontinuation of Libor and attempt to deliver an alternative floating rate. To the extent that any switch to an alternative rate results in a transfer of economic value, it increases the chance of litigation.

Bank capital instruments referencing Libor may not operate as intended

12. In the midst of the current uncertainty, regulated bank issuers will wish to keep their capital requirements in mind, especially if the terms of their capital instruments (which often reference Libor in the context of interest rate resets) do not operate as intended after 2021.

Libor may continue to be published but may be based on submissions from fewer panel banks or a different methodology

13. It is possible that the market might move to referencing a new benchmark rate, while some form of Libor might continue to be published by its administrator, for example based on submissions from fewer panel banks or a different methodology. If this were the case, Libor would continue to be applicable to interest calculations in floating rate bonds which do not have alternative fallback provisions enabling a transition to an alternative rate in these circumstances. Again, this may not be agreeable to issuers or investors.

Libor replacement may impact on the regulatory obligations of certain market participants

14. Certain market participants have regulatory obligations that may be impacted by the current uncertainty surrounding Libor replacement. For example, certain banks acting as manufacturers of floating rate bonds will need to consider their product governance obligations. These obligations require them to design products that meet identified needs, characteristics and objectives of the target market (including the fact that the product's risk/reward profile is consistent with the identified target market) and to ensure that they continue to do so over the life of the relevant products.

15. Credit institutions regulated in the UK will also need to ensure compliance with FCA Principles which require them to pay due regard to the interests of their customers and treat them fairly and to pay due regard to the information needs of their clients and communicate information to them in a way which is clear, fair and not misleading. These principles will apply in relation to contracts that they are entering into or products they are selling and will be relevant in the context of introducing new fallback provisions and ensuring provision of adequate disclosure and communication of pay-out profiles. Similar regulatory obligations in other jurisdictions are likely also to be relevant.

What measures can be taken to mitigate these risks?

16. The most effective way of avoiding risks related to Libor discontinuation in relation to new issues of Sterling bonds would be for new issues of Sterling bonds to reference alternative benchmarks, in particular SONIA[9]. Where Libor continues to be referenced in new Sterling bonds issued in the interim period before market conventions and infrastructure for referencing alternatives to Libor are fully developed, there are certain steps market participants could take to mitigate some of the risks highlighted above. Some suggested steps are set out below. However, it should be noted that, none of these steps, taken in isolation or combined, are sufficient to eliminate all the risks arising from the uncertainty in relation to the discontinuation of Libor and the transition to risk-free rates for the bond market.

[9] For example, the European Investment Bank issued £1 billion Floating Rate Notes due 2023 referencing SONIA in June 2018.

Increased transparency/awareness: Disclosure

17. Given the uncertainty around the future of Libor, market participants should make themselves fully aware of these uncertainties and understand how any bond referencing Libor may operate post 2021 (or whenever Libor ceases to exist or ceases to be an appropriate benchmark rate to reference). It is also appropriate to include detailed risk factors relating to Libor discontinuation (and interest rate reform generally) in debt prospectuses. Investors should be informed and understand how the bond they hold may operate if Libor is discontinued, including how any alternative rate might be determined. (It should be noted, however, that a prospectus provides disclosure in a new issue context and may be less effective in relation to secondary market investors.) It may also be prudent to examine how products are labelled and marketed. Given the evolving nature of developments in this area, it may be the case that prospectus disclosure might not have contemplated a particular subsequent development or its impact on the bonds.

Incorporating alternative fallbacks which attempt to provide the means by which a future alternative rate might be identified

18. Terms of long-dated bonds referencing Libor could include an alternative fallback to specifically address discontinuation (or the market generally moving away from use) of a benchmark and attempt to provide the means by which a future replacement benchmark could be applied in specific circumstances. This would not require consent of bondholders as it would be contemplated within the terms of the bonds themselves. However, the efficacy of these provisions will depend upon it being possible to select and apply an alternative rate and calculate any necessary adjustment spread at the relevant time in accordance with the relevant provisions of the bond. Given the current uncertainty surrounding each of these aspects, alternative fallback provisions may not operate as expected in the event of Libor discontinuation. Market participants may find that the return on a bond might be significantly different to what they expected once any new rate is applied. However, provisions which contemplate this are already being included in some bond terms and conditions and practice is evolving.[10]

Amending terms of bonds to facilitate easier future amendment of terms

19. Issuers could consider varying the bond terms and conditions to facilitate easier amendments to the interest rate provisions for example by applying a lower bondholder quorum requirement or consent threshold than might otherwise have applied to this type of amendment. This would facilitate easier amendments to be made to the interest terms, once an alternative benchmark for Libor is established. (It may, on the other hand, increase the risk of litigation if a dissenting bondholder considers that it has been unfairly treated.)

20. The securitisation market has developed the concept of "negative consent" to provide for certain changes to be made to bond terms and conditions via a simplified consent

[10] The US Alternative Reference Rates Committee published *Guiding Principles for More Robust LIBOR Fallback Contract Language in Cash Products* to guide the development of U.S. dollar Libor fallback language within its working groups in July 2018; available at: www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-principles-July2018

mechanism with the involvement of the bond trustee. To date such a mechanism has not been seen in the vanilla bond markets, where a trustee may not be a feature of many transactions.

Regulated entities should be mindful of their regulatory obligations

21. Given the uncertainties surrounding the discontinuation of Libor and the alternatives for the bond markets, and the risks consequent upon these uncertainties, regulated entities may wish to take these factors into account when identifying the appropriate target market or investor base for the bonds. In addition, communications with investors relating to benchmark replacement must be fair, clear and not misleading.

22. Senior managers within UK credit institutions may also wish to consider the statutory duty of responsibility requiring them to take reasonable steps to prevent regulatory breaches from occurring, or continuing to occur, in their area of responsibility. It may also be advisable for regulated entities to document the reasons for concluding that the particular floating rate issuance was acceptable for regulatory purposes, at the time of issuance.