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IBOR TRANSITION: BONDS

The transition from IBORs to alternative near risk-free reference rates (RFRs) has continued to progress in 2021. In the bond markets, significant progress has been made in the transition to RFRs for new issues. With the end of LIBOR for most tenors approaching, the focus has been on how to address the issue of tough legacy bonds.

There have been significant volumes of new SOFR and SONIA-linked Floating Rate Notes (**FRNs**) issued in the last year; and new public issuance of sterling LIBOR-linked FRNs and securitisations with a maturity beyond the end of 2021 has all but ceased.

One area that is still being bedded down is the market convention for interest calculation for SONIA FRNs. The convention has typically involved referencing SONIA compounded in arrears over an interest period, with a margin added, and a “lag” in respect of each interest period. However, some issues of FRNs have used a five day observation period “shift” approach (similar to the “lag” approach but the compounding formula weights the SONIA rate to account for calendar days when the SONIA rate is not published according to the observation period (rather than the interest period)). The "shift" approach is compatible with the daily SONIA compounded index published by the Bank of England, therefore, it is possible that the market moves towards using the "shift" approach in time.

Some market participants are embedding the optionality of issuing SONIA FRNs via both the “shift” and “lag” approach in their base documentation to give them flexibility. However, the “lag” and “shift” approach could continue to exist side by side as there is no substantive difference in coupon amount for each approach..

While considerable progress has already been made in relation to transition to RFRs in new issues of FRNs, the issue of existing bonds that still reference LIBOR that are due to mature beyond 2021 that do not contain robust fallbacks (legacy bonds) still remain. The vast majority of these bonds do not contain appropriate fallbacks to cater for permanent cessation (commonly called 'Type 1 fallbacks'). A small number of legacy bonds also contain “Type 2” fallbacks, where an independent financial advisor is appointed to determine a successor rate plus a fixed credit adjustment spread typically on permanent cessation.

For legacy bonds, a transition away from LIBOR 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. However, progress has been limited in this area due to the fact that consent solicitations can be time consuming, costly and, in the case of bonds with high consent thresholds, unsuccessful. It is therefore likely that at the end of 2021, a significant population of GBP LIBOR-linked bonds will remain outstanding and it is for the issuers of these bonds that the UK's legislative solution will be very useful.

The UK legislative solution operates via amendments to the retained EU law version of the Benchmarks Regulation (EU) 2016/1011 (**BMR**), which have been introduced by the Financial Services Act 2021 (**FSA 2021**). The FSA 2021 amends the BMR to enable the FCA to designate a benchmark (such as LIBOR) that is unrepresentative or is at risk of becoming unrepresentative under Article 23A, with the result that its use (as defined in the BMR) is prohibited by virtue of Article 23B, except where legacy use is permitted by the FCA under Article 23C. The Article 23A benchmark may be published under a changed methodology using powers under Article 23D, so-called "synthetic" LIBOR. Synthetic LIBOR will be the sum of (i) the forward-looking term rate for the applicable tenor based on either (a) the ICE Term SONIA Reference Rate provided by IBA, or (b) the Tokyo Term Risk Free Rate provided by QUICK Benchmarks Inc., as applicable; and

(ii) the respective fixed spread adjustment (that is published for the purpose of ISDA's IBOR Fallbacks for the Article 23A LIBOR Versions (as defined below).

In the last quarter of 2021, the FCA has confirmed via various notices that (i) 1m, 3m and 6m sterling LIBOR and all yen LIBOR tenors (the **Article 23A LIBOR Versions**), as "Article 23A" benchmarks (the designation will take effect on 1 January 2022), (ii) the prohibition on new use, under Article 21A of the BMR, of the five continuing USD LIBOR settings from the start of 2022, and the exceptions under which new use is allowed, and (iii) it will permit legacy use of the Article 23A LIBOR Versions by supervised entities in all contracts (including bonds) other than in cleared derivatives.

The decision to grant a broad permission to use synthetic LIBOR has been welcomed by DCM market participants and it is anticipated that most legacy sterling and yen LIBOR bonds (with Type 1 and Type 2 fallbacks) will reference synthetic LIBOR from 2022. From a practical perspective, the market is expecting synthetic LIBOR to be published at the same time and on the same screens as panel bank LIBOR to avoid market disruption.

The FCA has also released a Q&A related to the use of its powers under the BMR, emphasising that the legislative fix is only a "bridging solution" to the tough legacy issue. The length of availability of synthetic LIBOR is likely to be a concern for the bond market given the challenges faced so far in active transition. For all legacy sterling LIBOR bonds referencing synthetic LIBOR, it will be important that the FCA gives market participants sufficient notice before synthetic sterling LIBOR ceases to be published. For synthetic yen LIBOR, publication is due to cease at the end of 2022.

Whilst the legislative solution has been welcomed by the market, the authorities still consider that the smoothest transition from LIBOR will be one in which contracts that reference LIBOR are replaced or amended before the fallback provisions are triggered. This was recognised by the RFRWG in its paper on active transition of GBP LIBOR-Referencing Bonds published in September 2020.

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