# The transition from LIBOR in the bond market: progress and remaining steps

by **Paul Richards**


## Summary

Very considerable progress has been made in the transition from LIBOR to risk-free rates, including in the bond market. This assessment considers: the changes to LIBOR at the end of 2021; the reasons for the smooth transition at the end of 2021; the remaining challenge in the legacy sterling and US dollar LIBOR bond market; differences in the legislative approach to the transition of legacy LIBOR bonds; and the remaining steps needed in the legacy sterling and US dollar LIBOR bond market under English law.


## Introduction

1 The authorities have for some time planned the permanent cessation of LIBOR,[1] on the grounds that LIBOR poses clear risks to global financial stability, as the market for unsecured wholesale term lending between banks is no longer sufficiently active to support such a widely used reference rate as LIBOR.[2] Instead, the authorities have encouraged the market to adopt near risk-free reference rates, where the volume of underlying market transactions is greatest.

2 This assessment considers: the changes to LIBOR at the end of 2021; the reasons for the smooth transition at the end of 2021; the remaining challenge in the legacy sterling and US dollar LIBOR bond market; differences in the legislative approach to the transition of legacy LIBOR bonds; and next steps. While the assessment sets out the overall context, the focus of the assessment is on progress to date and the remaining steps needed in the legacy sterling and US dollar LIBOR bond market under English law.

## The changes to LIBOR at the end of 2021

3 The main changes to LIBOR at the end of 2021 can be summarised as follows:

- 24 of the 35 LIBOR settings in the five LIBOR currencies ceased permanently, including all euro LIBOR and Swiss franc LIBOR settings, and some sterling, yen and US dollar settings.[3]
- In the case of outstanding legacy LIBOR contracts for one, three and six month sterling and yen LIBOR settings, except cleared derivatives, the methodology changed from panel bank LIBOR to synthetic LIBOR.[4]

1. In July 2017, the Chief Executive of the FCA, the regulator and supervisor of the IBA, the administrator of LIBOR, announced that the FCA would no longer persuade or compel banks to submit quotations for LIBOR after the end of 2021.

2. See the FSB Global Transition Roadmap, 2 June 2021. This problem was illustrated during the market turmoil at the start of the COVID-19 pandemic in March 2020, during which LIBOR rates rose when central bank policy rates fell. See the FSB *Statement on the Impact of COVID-19 on Global Benchmark Reform,* July 2020.

3. The overnight/spot next, one week, two month and 12 month sterling and Japanese yen LIBOR settings; and the one week and two month US dollar LIBOR settings.

4. Synthetic LIBOR consists of a term risk-free rate plus a fixed spread. The remaining yen settings will cease permanently at the end of 2022.

- In the case of the remaining five – overnight, one, three, six and 12 month – US dollar LIBOR settings, new transactions are no longer permitted, with very limited exceptions.[5] In the case of legacy US dollar LIBOR contracts using these settings, panel bank US dollar LIBOR submissions will continue only until the end of June 2023.

4 In place of LIBOR, the authorities have encouraged the market to adopt near risk-free rates: SOFR in US dollars; SONIA in sterling; €STR in euro; SARON in Swiss francs; and TONA in Japanese yen:[6]

- In each case, the most robust risk-free rates are overnight rates, which are measured by the volume of overnight transactions and do not depend on any use of expert judgment. To take account of local market conditions, risk-free rates in some currencies are based on secured transactions and in others on unsecured transactions.
- Overnight risk-free rates compounded in arrears have the highest volume of transactions. In the UK, for example, overnight SONIA compounded in arrears is now fully embedded across sterling markets. In the sterling bond market, new floating rate notes (FRNs) and securitisations have been referencing compounded SONIA for some time. The FCA estimates that SONIA FRN issuance since 2018 exceeds £120 billion.[7]
- Although the authorities prefer the market to use overnight risk-free rates, wherever practicable, because these rates are the most robust, they also recognise the need for the market to use forward-looking term risk-free rates in some limited cases. In particular, the authorities in the US and the UK want the market to avoid the use of credit-sensitive rates, which they consider would run similar risks in the future to those experienced in the past with LIBOR.[8]

## The reasons for a smooth transition at the end of 2021

5 The changeover at the end of 2021 went smoothly. Sterling markets, for example, navigated the transition at the end of 2021 on time and with minimal disruption, in support of global transition efforts towards alternative risk-free rates.[9] There are two main reasons for this.

6 First, the changeover was well organised and coordinated:

- The authorities and market participants worked closely together at national level through Risk-Free Rate Working Groups, and they were coordinated at global level by the FSB Official Sector Steering Group. The official sector in different jurisdictions kept in regular contact with each other internationally. In addition to the official sector, the Risk-Free Rate Working Groups and their Sub-Groups included representatives of the market as a whole. For example, the UK Bond Market Sub-Group, chaired by ICMA, has included representatives of issuers, banks, asset managers and investors, service providers, relevant trade associations and law firms, all working together with the FCA and the Bank of England.
- The changeover was carefully planned by the authorities in consultation with the market. Roadmaps were agreed by the authorities with the market in advance with clear deadlines, clearly communicated across the market as a whole. This message was reinforced by speeches from senior officials and Dear CEO letters from bank supervisors, which were designed to reinforce the message to senior management in market firms about the need to transition from LIBOR to risk-free rates.
- The authorities encouraged market participants to stop referencing LIBOR in new transactions and start referencing risk-free rates as early in the transition process as possible (eg by coordinating the SONIA First and SOFR First initiatives). This helped to build liquidity in the market for risk-free rates and also helped to reduce the stock of legacy LIBOR contracts outstanding at the end of 2021, as legacy transactions matured.
- The authorities also encouraged market participants actively to transition legacy contracts from LIBOR to risk-free rates in advance, where feasible, as well as to include robust fallbacks to risk-free rates in legacy contracts, where feasible, as a backstop: in particular through the ISDA Fallback Protocol for OTC derivatives and through conversion weekends for cleared derivatives organised by ICE and LCH. This further reduced the stock of legacy contracts and the scale of the conversion risk at the end of 2021.

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5. The FSB and IOSCO agreed on 2 June 2021 to stop the use of LIBOR in new transactions, including in US dollars, by the end of 2021, with very limited exceptions.

6. In the euro area, on 4 January 2022, EONIA was replaced by €STR. EURIBOR continues to be published and there has been no announcement indicating that it will cease.

7. Bank of England, FCA and RFRWG: *Finalising LIBOR Transition – Achievements in Sterling Markets and What Remains to be Done,* 9 February 2022.

8. See also the IOSCO *Statement on Credit Sensitive Rates,* 8 September 2021.

9. Bank of England, FCA and RFRWG: *Finalising LIBOR Transition – Achievements in Sterling Markets and What Remains to be Done,* 9 February 2022.

7 Second, the UK authorities took a number of decisions that were critically important to the sterling bond market, where legacy contracts referencing LIBOR need to be transitioned bond by bond (rather than through a protocol), and where the normal market process – consent solicitation – is time-consuming and difficult to achieve in some cases owing to high consent thresholds. All these decisions by the UK authorities were taken in consultation with the market:

- The use of synthetic LIBOR (ie term SONIA plus a spread) for "tough legacy" sterling contracts[10] which had not been able actively to transition was critically important in preventing a large number of legacy sterling LIBOR bonds outstanding at the end of 2021 from falling back from a floating rate to a fixed rate.
- Synthetic LIBOR was made available for all legacy sterling LIBOR bonds in the relevant one month, three month and six month settings, not just some of them, to avoid legal and practical problems.
- The Critical Benchmarks Act was introduced by HM Treasury to ensure continuity of contract in law between panel bank LIBOR and synthetic LIBOR.

## The remaining challenge in the legacy sterling and US dollar LIBOR bond market

8 While the changeover at the end of 2021 was smooth, this is not the end of the transition process away from LIBOR to risk-free rates in the bond market. Taking account of the lessons learned from the changeover in the run-up to the end of 2021, there are remaining challenges in cash markets, and in particular in the bond market, in both sterling and US dollars.

9 Although significant progress has already been made on active transition of legacy contracts in the sterling bond market, the remaining challenge is to transition synthetic legacy sterling LIBOR bonds still outstanding to compounded SONIA plus a spread through consent solicitation, where feasible. To encourage active transition, the UK authorities have emphasised that synthetic LIBOR is a bridging solution, not a permanent solution: it cannot last longer than ten years, and may last less, as it is subject to annual review. The UK authorities have also made it clear that some settings may be retired before others.[11] In particular, the FCA has stated that it will seek views on retiring one month and six month synthetic sterling LIBOR at the end of 2022, and on when to retire three month synthetic sterling LIBOR.[12]

10 In the case of the US dollar floating rate bond market, the US and UK authorities have stressed the importance of using SOFR for new transactions, not credit-sensitive rates, which they consider run the same risks as LIBOR. The remaining issue relates to the transition of US dollar legacy LIBOR bonds to SOFR plus a spread. There are large numbers of legacy US dollar LIBOR bonds outstanding, many of which are not due to mature until after 30 June 2023, under both a law of the US and English law.

11 In that context, the Chair of the US Alternative Reference Rates Committee (ARRC) has stated: "Here lies the challenge: Some legacy contracts cannot be amended. While a substantial portion of legacy contracts will no longer be outstanding by the mid-2023 cessation date set by the FCA and IBA, there will still be a tail of contracts that will mature after that, including those that have no effective means to replace LIBOR upon its cessation. We believe legislation to address these contracts specifically is critical."[13] On 15 March 2022, federal US legislation was signed into law.[14] The legislation is designed to "minimise legal and operational risks and adverse economic impacts associated with the transition".[15]

## Differences in the legislative approach to the transition of legacy LIBOR bonds

12 The US and UK approaches to the transition of legacy LIBOR bonds have a common objective, which is to end the use of LIBOR and transition to risk-free rates as soon as possible. But although they have a common objective, the UK and the US authorities have so far adopted different legislative approaches to the transition of legacy LIBOR bonds:

- One difference is that active transition[16] of legacy sterling LIBOR bonds has demonstrated that consent solicitation is feasible under English law in some cases, though not in others. The UK authorities stated on 4 January 2022:

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10. See Charlotte Bellamy: *"Tough Legacy" Bonds,* ICMA Quarterly Report, First Quarter 2022.

11.Edwin Schooling Latter, FCA: "It is worth noting that the case for three month sterling LIBOR [is] stronger than for one month or six month. When outstanding contracts that still reference a particular LIBOR setting have reduced significantly, it may no longer be proportionate for the FCA to require continued publication of that setting on a synthetic basis.": 8 December 2021.

12. Bank of England, FCA and RFRWG: *Finalising LIBOR Transition – Achievements in Sterling Markets and What Remains to be Done,* 9 February 2022.

13. Tom Wipf, Chair of the ARRC, 3 February 2022.

14. The US Adjustable Interest Rate (LIBOR) Act was signed by the President into law on 15 March 2022.

15. ARRC Welcomes Passage of Federal LIBOR Transition Legislation in Omnibus Spending Package, 15 March 2022.

16. See Katie Kelly: *Continued Active Transition of Sterling LIBOR-linked Legacy Bonds,* ICMA Quarterly Report, First Quarter 2022.

"firms should now focus on converting their legacy US dollar LIBOR contracts by mid-2023".[17] But active transition is not expected in general to be feasible for US dollar LIBOR bonds governed by a law of the US, as consent thresholds are commonly 100%.

- The other difference is that the UK has kept the same LIBOR benchmark for legacy sterling LIBOR contracts but the FCA has compelled the IBA to change the methodology for the benchmark from panel bank LIBOR to synthetic LIBOR, whereas the US has introduced federal legislation to change the benchmark by overriding contractual references from LIBOR to a SOFR-based rate chosen by the Federal Reserve Board.[18] There is a time limit on the FCA's statutory power to compel the IBA to publish synthetic LIBOR of a maximum of 10 years, with annual reviews in the meantime, but there is no time limit on the contractual override provided by federal US law.[19]

13 The implication is that, in the US, on 30 June 2023, when panel bank US dollar LIBOR is due to cease, legacy US dollar LIBOR bonds governed by a law of the US are expected to fall back to a floating (SOFR-based) rate under federal US legislation. In the UK, it is not yet clear what approach the UK authorities will take for legacy US dollar contracts under English law. If panel bank US dollar LIBOR ceases permanently on 30 June 2023, most US dollar LIBOR bonds governed by English law would be expected to fall back to a fixed rate at that point. But if the UK authorities decide to introduce synthetic US dollar LIBOR for legacy US dollar LIBOR contracts (in the same way as for sterling), legacy US dollar LIBOR bonds governed by English law would continue to reference a floating rate until synthetic LIBOR is withdrawn subsequently, when most of them would be expected to fall back to a fixed rate.

14 The deadline for the end of panel bank US dollar LIBOR – ie 30 June 2023 – is later than for sterling, as SONIA has been in market use for much longer than SOFR. This interval until 30 June 2023 should give time: for the legacy stock to be reduced as LIBOR bonds mature; to transition as many as possible of the remainder, where feasible; and to work out the implications of the different legislative approaches to the common objective, and to resolve any outstanding issues.

## Next steps

15 In a statement on 9 February 2022, the Bank of England, FCA and Sterling Risk-Free Rate Working Group (RFRWG) said that the RFRWG had met its objective to "catalyse a broad-based transition to SONIA across sterling derivative, loan and bond markets". They also said that "there remains further work to be done to finalise the transition from LIBOR, primarily to support the continued active conversion of legacy sterling LIBOR-linked bonds and loans that are dependent on temporary synthetic LIBOR; and to consider any implications of non-sterling LIBOR transition in UK markets. The RFRWG will therefore be moving forwards in an amended form and with new objectives, and with continued support from the Bank of England and the FCA."[20]

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17. FCA, *Change to LIBOR as of End-2021,* 4 January 2022.

18. Adjustable Interest Rate (LIBOR) Act, 8 March 2022. Separately, on 22 December 2021, the European Commission announced plans to adopt implementing acts to designate statutory replacement rates for certain sterling and Japanese yen LIBOR settings. It is also possible that the European Commission will designate statutory replacement rates for US dollar LIBOR settings in due course.

19. Another difference is that the contractual obligation for dealer polls on bonds before they fall back to a fixed rate at the permanent cessation of LIBOR is no longer required as a result of legislation under New York law, but not covered in legislation under English law. Instead, the UK authorities are following a voluntary approach under which banks are invited to state that they will not respond to requests for dealer polls.

20. Bank of England, FCA and RFRWG: *Finalising LIBOR Transition – Achievements in Sterling Markets and What Remains to be Done,* 9 February 2022.