LLOYDS BANK

# IBOR TRANSITION NEWSLETTER

Edition 18: June 2021

COMMERCIAL BANKING

## FULL STEAM AHEAD

Welcome to our Newsletter. This is our eighteenth edition providing an update on the transition away from the London Interbank Offered Rate (LIBOR) and other Interbank Offered Rates (IBORs). There are a number of important topics this month, which include:


- **STOPPING USE OF USD LIBOR TAKES CENTRE STAGE**
- **STERLING SUCCESS, 'TOUGH LEGACY' AND LIQUIDITY**
- **CONTINUED SUPPORT FOR STERLING TRANSITION**
- **THIRD SOFR SYMPOSIUM**
- **FSB GLOBAL TRANSITION ROADMAP**
- **OTHER NEWS**
- **A CLOSER LOOK: TOUGH LEGACY**


Please contact your Relationship Team if you have any questions or queries on the contents.

## STOPPING USE OF USD LIBOR TAKES CENTRE STAGE

Leveraging an already well-established framework for LIBOR transition, the official sector and industry have provided additional support and guidance to the market over the past month. Due to the widespread use of US dollar LIBOR worldwide, a key area of focus has been on the requirement for any new use of US dollar LIBOR to stop before the end of this year. Emphasising this message, the International Organisation of Securities Commissions (IOSCO) issued a statement on 2 June 2021 encouraging discontinuation of US dollar LIBOR use as soon as practicably possible; the message was welcomed by the Financial Stability Board (FSB), who offered encouragement to national authorities to set globally consistent expectations on ceasing the new use of US dollar LIBOR, regardless of where those trades are booked.

The IOSCO statement resonates with earlier messages from the International Swaps and Derivatives Association (ISDA) who published an article on 22 April 2021 noting that whilst it may be tempting to look at the 30 June 2023 date, set for the cessation of most US dollar LIBOR settings, as an 18-month delay, the reality is "that firms need to prepare to use alternative reference rates for most new trades from the start of next year, irrespective of which LIBOR they use." US regulators have been very clear that US-supervised entities should stop using US dollar LIBOR for new trades after the end of 2021.

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## STERLING SUCCESS, 'TOUGH LEGACY' & LIQUIDITY

In sterling markets, recent focus has been in two key areas: one has been how to deal with those 'tough legacy' contracts that are truly unable to convert from LIBOR ahead of cessation, and the other to support liquidity in Sterling Overnight Index Average (SONIA) exchange-traded derivatives. The latter was the subject of a statement of support from the Financial Conduct Authority (FCA) and Bank of England (BoE) issued on 13 May 2021 encouraging market users and liquidity providers in the sterling exchange traded derivatives market to switch the default traded instrument to SONIA instead of LIBOR from 17 June 2021.

An overview on recent developments around tough legacy is provided in this month's *A Closer Look* section. In many respects the "fine-tuning" of a tough legacy solution actually highlights how much progress has been made in terms of active transition to date. At the third SOFR Symposium (links to agenda and webcast) held on 8 June 2021, Edwin Schooling Latter, Director of Markets and Wholesale Policy at the FCA, reflected on headway made towards transition in the context of the successful 'SONIA First' initiative launched back in October 2020, pointing out that:

- 70% of all new sterling derivatives activity is now SONIA-denominated. Adjusted for products that will not exist after 2021, this figure moves closer to 90%.
- Nearly 100% of sterling bonds are now SONIA-denominated.
- Effective 31 March 2021, almost 100% of new loans are SONIA-denominated.
- From 30 June 2021, the FCA expects non-linear derivatives activity in LIBOR to cease with almost 100% activity in SONIA.

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## CONTINUED SUPPORT FOR STERLING TRANSITION

The Loan Market Association (LMA) has been particularly busy during the past month, publishing a new suite of documentation on 28 May 2021. These documents are intended to further facilitate the syndicated loan market's transition from LIBOR to compounded risk-free rates. In addition, the LMA has updated its RFR documentation to reflect changes to the post-Brexit bail-in provisions and take into account the recent recommendations of the Working group on Euro Risk-Free Rates around the Euro Interbank Overnight Rate (EURIBOR) fallback trigger events and the Euro Short-Term Rate (€STR) based EURIBOR fallback rates. We covered this topic in more depth in our May 2021 newsletter.

Further support for transition in sterling markets was also provided by ICE Benchmark Administration (IBA), who on 17 May 2021 announced the publication of daily indicative SONIA Spread-Adjusted ICE Swap Rate 'Beta' settings for an initial testing period. The settings are designed to support the market in transitioning non-linear derivatives, structured products and cash market instruments that currently reference the sterling LIBOR ICE Swap Rate.

Then, on 19 May 2021, the Working Group on Sterling Risk-Free Reference Rates (BoE WG) published a statement recommending the use of overnight SONIA compounded in arrears as the successor rate to sterling LIBOR in fallbacks in bond documentation that envisages the selection of a recommended successor rate.

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## THIRD SOFR SYMPOSIUM

Many of the developments in the US dollar LIBOR markets over the past month have revolved around the discussions happening at the second and most recently the third SOFR Symposium, where the main topic on the agenda was transition in the derivative markets. Timed to coincide with the event, the Commodity Futures Trading Commission's (CFTC) Market Risk Advisory Committee (MRAC) published a recommendation that from 26 July 2021 interdealer brokers replace the trading of LIBOR linear swaps with the trading of Secured Overnight Financing Rate (SOFR) linear swaps. Dubbed "SOFR First", the initiative is seen as an important step in increasing overall SOFR swap volumes, thereby contributing to a smooth transition of liquidity towards SOFR. It was welcomed by the Alternative Reference Rates Committee (ARRC), and is modelled on the sterling "SONIA first" initiative introduced on 27 October 2020.

Meanwhile, progress towards establishing a forward-looking SOFR based term rate was made after the ARRC announced it will recommend Chicago Mercantile Exchange Rate Group (CME) as the administrator of the rate. On 21 April 2021, the CME had announced the publication of term SOFR reference rates for 1-month, 3-month and 6-month tenors. These rates are being published for the time being on an unendorsed basis. The ARRC has emphasised that it will make its official recommendation only once its market indicators for the term rate, published on 6 May 2021, are met. Similar to term SONIA, the use of term SOFR is expected to be on a limited basis only.

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## FSB GLOBAL TRANSITION ROADMAP

The FSB issued a series of statements on 2 June 2021 which included an updated Global Transition Roadmap providing a useful overview of transition priorities across all currencies and jurisdictions. In addition, the FSB released a paper examining overnight risk-free rates and term rates, and a note supporting the use of the ISDA spread adjustments in cash products.

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## OTHER NEWS

Elsewhere news has centred on the Asia-Pacific region. On 29 May 2021, the Bank of Japan (BoJ) and the Japanese Financial Services Agency (JFSA) published the results of their joint survey of LIBOR usage by financial institutions - including banks, securities companies and insurance companies. The reference date of the survey is end-2020 and it provides an invaluable resource for statistics on LIBOR usage across the different currencies, not just Japanese yen.

On 4 June the Reserve Bank of Australia (RBA), the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) issued a joint statement that they expect all market participants to adhere to the deadline of end-2021 for ceasing issuance of new LIBOR contracts, and also accelerate the active conversion of legacy LIBOR contracts.

Lastly, in a speech on 9 June 2021 the BoJ emphasised that with limited time left before the cessation of JPY LIBOR, the success of the orderly transition is reliant upon market participants proceeding with their own LIBOR transition plan in a steady and swift manner using the tools available to them, and that there will be no last minute reprieve.

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## A CLOSER LOOK: 'TOUGH LEGACY'

On 29 April 2021, the Financial Services Bill received royal assent and became the Financial Services Act 2021. The Act makes extensive amendments to the legislative and regulatory framework of the UK's post-Brexit financial services landscape. Of relevance to LIBOR transition are amendments to the on-shored UK Benchmarks Regulation which provides the FCA with additional powers to manage an orderly wind-down of a critical benchmark (such as LIBOR) and extends the transitional period for third country (non-UK) benchmarks. These powers include the ability to designate a "synthetic" LIBOR for use in "tough legacy" cases.

Back in early March 2021, the FCA issued a statement of policy on how it intends to exercise some of its powers under the Benchmarks Regulation. At the time, the FCA promised to consult on the requirement for the continued publication of a small number of LIBOR settings, including 1, 3 and 6-month sterling LIBOR, on a non-representative 'synthetic' basis. This was because they recognised that there are some existing LIBOR contracts which are particularly difficult to amend, often known as 'tough legacy'. However, tough legacy is not a way for market participants to transition to risk-free rates; the FCA is very clear that the permitted use of any synthetic LIBOR rate is expected to be limited.

Furthermore, the FCA emphasised that any synthetic LIBOR setting will not be deemed to be representative and therefore is not to be used in new contracts. It is intended for use in tough legacy contracts only.

Subsequently, on 20 May 2021, the FCA published a consultation on its proposed policy framework for exercising two of the new powers introduced by the Financial Services Act 2021 which relate to the use of critical benchmarks that are being wound down. It sets out: 1) which factors the FCA thinks are relevant in deciding what legacy use of a permanently non-representative benchmark, such as any synthetic LIBOR, it will permit to continue and; 2) the FCA's proposed approach to using its power to prohibit new use of a critical benchmark which is ending. The consultation will close on 17 June.

Once this consultation is complete, there will be a further FCA consultation in Q3 2021 on 1) what legacy use will qualify for any synthetic sterling and yen LIBOR, and 2) how it might restrict new use of LIBOR rates, including US dollar LIBOR. Final decisions are then to follow, as soon as practicable, in Q4 2021.The FCA once again took the opportunity provided by the consultation to remind market participants that any permitted use of synthetic LIBOR would not be a permanent solution and parties will need to continue their efforts to amend their contract post LIBOR cessation.

As the market awaits further clarity on how the FCA's new powers will be applied, on 21 April the BoE WG noted the absence of "safe harbour" protection within the Financial Services Bill, asking HM Treasury whether any would be forthcoming. Legislation for a safe harbour as it pertains to LIBOR transition essentially aims to provide legal certainty for contracts that are unable to transition away from LIBOR before cessation.

Reference was also made to the then recently passed New York State LIBOR legislation, which does include a safe harbour provision for contracts governed by New York law. The US Government is now considering similar legislation at a Federal level. In the European Union (EU), a statutory replacement rate mechanism for contracts referencing critical benchmarks that are without appropriate fallbacks was achieved by an amendment to the European Benchmark Regulation on 13 February 2021 and this included a safe harbour provision.

In their response to the BoE WG question, HM Treasury advised that whilst the UK Government does intend bringing forward further legislation to address the issues identified in the consultation, it is their view that "wherever possible, parties should seek to transition contracts away from LIBOR ahead of the end of 2021".

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