

## LIBOR Transition - Impact on Bond and Loan Capital Markets

13 July 2020

As regulators, issuers and underwriters grapple with legal, technical and operational issues as the 2021 Libor transition deadline rapidly approaches, Events Radar's second webinar discussed the key challenges facing market participants during this pivotal period.

- Will the transition deadlines be extended because of covid-19?
- Are markets aligned across jurisdictions and currencies?
- What exactly happens after the deadline has passed? Is this a Y2K issue?

KM Capital Markets founder **Keith Mullin** chaired the timely discussion with panellists **Ian Fox**, **James Eves**, **John Ewan** and **Katie Kelly**.

### ***Has the covid-19 epidemic thrown the transition schedule off course?***

In short, no. "The headline answer is that covid changes nothing," said John Ewan, Director at Benchmark Advisory Services, a group which assists a range of organisations with Libor transition and benchmark regulation. "If anything, the answer has become even more solidified that we need to get this change done by the end of 2021."

The official sector and the groups they endorse, which include the Alternative Reference Rates Committee (ARRC) in the US and the UK's Working Group on Sterling Risk-Free Reference Rates (RFRWG) have been steadfast in their commitment to staying on track for the December 2021 deadline, Ewan added.

Katie Kelly, Senior Director, Market Practice & Regulatory Policy at ICMA, also says the messaging has not changed despite the loss of

three crucial months owing to the pandemic shutdown. But there has been recognition that for corporate issuers, and the loan segment in particular, Q3 2021 might not be a "realistic" deadline.

### ***"The headline answer is that covid changes nothing"***

In a poll conducted at the start of the webinar, 38% of participants agreed that the loan market faces the greatest challenges in switching to the risk-free benchmark, narrowly followed by 35% for derivatives. 20% said bonds was the most concerning sector, and only 7% highlighted retail products.

### ***Are there any realistic alternatives to the RFRs already penned in?***

Again, the consensus is no. "I don't think there are generally widely available alternatives,"

said James Eves, Senior Executive at ConvEx, Europe's largest independent calculation agent.

Notwithstanding bespoke products such as Ameribor, a benchmark used for interbank lending between smaller US regional banks, Eves says the "path towards risk free rates is well set and people are not arguing fundamentally with the foundations, [but rather] how you apply them and the timing of them."

Regulators across jurisdiction are also keen to stress that the likes of 'Term SONIA' and 'Term SOFR' -- forward-looking term reference rates based on the overnight benchmarks -- should be used only for a very strict minority of products. Here though, Eves says it will be "interesting to see how they are used and if they are used more widely."

"There is acceptance that the new RFRs are established in each jurisdiction," said Kelly. "Other than bank-based rates or fixed rates, there is not really an alternative to the [established transition] rates that benefit from ratification and endorsement from the market and the official sector."



**John Ewan,  
Benchmark  
Advisory  
Services**

### ***HMT sharpens focus, raises questions***

Coronavirus may have stalled much of the progress made by market participants and hampered communication channels, but interventions by authorities have served to potentially make the transition easier than the outlook pre-covid.

Coordinated interest rate cuts by central banks in response to the crisis triggered a widening in the Libor to SONIA spread, which "hardened the view of the authorities that [Libor] does not work in the way that was envisaged," according to Ian Fox, Group IBOR Transitions Director at Lloyds Banking Group.

As a solution to the breakdown in communications, on 23 June the UK Treasury granted greater powers to the FCA to direct the administrator, ICE, to itself determine what Libor is and how it should be calculated.

Fox said this removes the risk of creating a so-called "zombie Libor" after 2021 and solved many of the tough legacy issues associated with the move from the scandal-tainted benchmark.

### ***Coronavirus has "hardened the view of the authorities that [Libor] does not work in the way that was envisaged"***

Panellists agreed that the intervention by the Treasury is a positive step in the right direction, but questions still remain, Kelly said. How do counter parties ensure contractual continuity by having modified Libor or would contracts need changing? What about bonds with operable fallbacks, or super-long and perpetual bonds? And what would "synthetic" Libor be based on - term rates, or overnight rates in arrears?

Kelly also drew attention to the fact that New York law contracts in currencies other than dollars may also prove a stumbling block, assuming that the US arrives at a different solution to the legacy issue. And whilst the key message from that is that the market should use the consent solicitation process to transfer as many contracts as possible, this process remains expensive and time consuming.

### **Pressure mounts**

Whilst providing a much clearer timetable for transition, the June announcement is a U-turn on the part of the FCA, which had previously stated that it would not attempt to put a deadline on the end of the use of Libor. With this in mind, issuers should “not be blamed for being hesitant” to make the transition, said Ewan of Benchmark Advisory Services, who took a less positive view on recent policy interventions.

There is still a “grey area” in the June statement because of the possibility that a hypothetical synthetic Libor would exist beyond 2021 which is qualified by unrealistic expectations.

As Ewan put it: “Some of us have been looking for robust inputs for an alternative to Libor for a decade, and if those things genuinely existed...they would be in existence right now!”

This still leaves us with the biggest elephant in the room, which is how a transition to a synthetic alternative might be priced, which was highlighted as the greatest area of concern by the audience. 47% of participants said the “lack of a forward rate curve” is the main stumbling block, followed by 39% who highlighted “contractual issues.”

One suggestion mooted by Ian Fox to address this was so-called ‘Term SONIA’, which is a forward-looking rate based on the overnight SONIA RFR.



**Katie Kelly,**  
ICMA

### **Cross jurisdiction alignment: Work to be done**

Key jurisdictions have a clear picture of what life will look like after Libor, with the majority focused on a risk-free benchmark, and some maintaining interbank rates. There is “reasonable” alignment, said Eves, though work remains to be done in terms of the timeline of transition and how new rates apply to different currencies.

“Alignment is a good ambition... but [full alignment] is not necessarily something that can be achieved through all jurisdictions and across all products,” said Katie Kelly of ICMA.

Different conventions are used not just for each jurisdiction’s respective new risk-free rate, but conventions differ again across the currencies, Kelly added. Whereas the sterling bond market has hosted upwards of 140 SONIA-based transactions based on the same conventions since its adoption in 2018, SOFR transactions in the US “have not coalesced on one particular set of conventions,” she said.

***“Alignment is a good ambition... but [full alignment] is not necessarily something that can be achieved”***

For example, the US market may employ simple averages rather than compounded averages as is customary in Europe. And again, Kelly drew attention to the loan market as the segment where the future is less clear and where different conventions may be adopted to the bond markets of each jurisdiction.

ESTR, the euro area risk-free alternative Euribor, is closely aligned to the SONIA market in the UK, but is “much more of a nascent market,” according to Kelly. According to Bond Radar data, there have been five ESTR-linked transactions eligible for league table inclusion

since the ECB began publishing ESTR in October 2019, all in the SSA sector.

As well as being a newer product, one of the key reasons behind the apparent inconsistencies in the SOFR benchmark is the fact that it has been less than straightforward to publish an index, James Eves of ConvEx said, also highlighting the US derivatives market as another hurdle. By contrast, the Bank of England has announced plans to publish a daily SONIA Compounded Index from 03 August this year.

“Finding an index will help simplify the usage [of RFRs] in the bond markets,” Eves said. A market consensus with respect to SOFR calculations “will be driven largely by the use of the indices,” he added.

“The UK is well positioned to achieve the end of 2021 date, [but] it is far more fragmented in the US,” said Ian Fox of Lloyds Banking Group. “There are different lobby groups and a much boarder set of transactions that are linked to Libor, not least the residential mortgage market.”

The US therefore faces a “much more fragmented post-Libor world,” Fox said. Multiple rates will likely appear for different sectors, for instance “simple SOFR” for the loan market and a daily compounded rate for the international, multi-currency market.

But whilst the US market is currently focused on these conventions, Fox conceded that there is no reason why the conventions listed above could not change.

For this reason, John Ewan cautioned a certain degree of scepticism with respect to the direction of the transition in the US market.

ARRC has long maintained that SOFR is the “anointed successor” to Libor, so its recent indication that it would be willing to endorse any product “consistent with IOSCO principles of financial benchmarks” – which may include

Ameribor or the ICE Bank Yield - suggests that markets are further from reaching a consensus than the headlines indicate.



**James Eves,  
ConvEx**

### ***Are issuers ready?***

None of these technical fundamentals are putting off issuers from raising new debt against SOFR however. The crux is liquidity. “I do not have a conceptual issue with SOFR at all, we are just looking for the market to develop liquidity,” Fox said.

Fox agreed with Kelly that the loan market faces a more urgent challenge than the bond market. But both agreed that that international conversations between various working groups mean that the trajectory is heading in the right direction.

***“Going forward, issuers are ready. Looking backwards towards legacy, it is more wait and see.”***

An example of this is the clearly well-positioned area of FIG issuers in the sterling market, Kelly suggested, despite a slow down since the onset of covid. Nearly GBP23bn of Bond Radar league table-eligible covered bonds has been issued by banks since the adoption of SONIA, which includes issues by Canadian and Australian lenders as well as core UK banks.

“In the corporate world, floating rate issuance is not a very big market anyway,” she noted.



And corporates are justifiably in “wait and see mode” to observe how the SONIA market develops. The key challenge for non-financial companies is legacy transactions, rather than new issuance.

Kelly estimates that there are between four and five-hundred individual legacy sterling bonds that would need to be transitioned from Libor, very few of which were issued by corporates.

“Generally, going forward issuers are ready,” Kelly said. “Looking backwards towards legacy, it is more wait and see.”

For financials, around twenty individual bonds have been converted via consent solicitation, but mainly smaller, illiquid covered bonds. Consent solicitation still has some way to go before becoming the norm, and Kelly estimates that most issuers are waiting for clearer guidelines from legislators before taking the plunge.

Financial institutions are under no illusion that work remains to be done. In an audience poll, in which most participants represented banks, a majority of 55% said their organisation has “a lot of work to do.” 29% said that their preparation is “moderately advanced”, whilst only 13% thought their firm to be “very advanced” in their Libor transition preparations.



**Ian Fox,  
Lloyds  
Banking  
Group**

### ***Libor transition: Much Ado About Nothing?***

The two opposing but concurrent narratives that have driven debate surrounding Libor

transition are the lack of clarity and the necessity for change. Observers have highlighted the problem of the so-called ‘Millennium bug’ analogy for the much-hyped shift from the scandal tainted benchmark. But how accurate is this comparison?

***“If we look back on this in mid-2022 and say ‘nothing happened’, that would be a major result”***

“I think the narrative and necessity for change will continue to evolve,” said Eves at ConvEx. “But you would be neglectful over the next 18 months if, as a market participant, you are not thinking about this issue front and centre.”

The consensus among panellists is that the short transition timeframe, reduced significantly by covid, has amplified the main points highlighted during the discussion.

“My concern with respect to timing is the very significant legacy problem we have,” Katie Kelly concluded. “What I would hope is that there will be a lot of clarity on what the legislative solution might look like.”

Recent developments with respect to tough legacy legislation have made the Y2K analogy more realistic by removing contract risk, Ian Fox at Lloyd Banking Group suggested. Alongside the pricing issues, the main challenge remains the tight twelve-month timeframe until Q3 2021, he added.

“If we look back on this in mid-2022 and say ‘nothing happened’, that would be a major result,” Fox concluded.



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