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STERLING LIBOR TRANSITION – 2020 ROADMAP

The UK regulators, in a series of co-ordinated publications, have stepped up their warnings to market participants to move away from the use of sterling LIBOR. Although there has already been much progress in the markets, this is a clear sign that momentum is expected to increase during the course of 2020 in order for market participants to be ready for the cessation of LIBOR in 2021. In this note, we explore these publications and the time line to 2021.

1. Roadmap for 2020

The Working Group on Sterling Risk-Free Reference Rates (the "**Working Group**") has published a roadmap ("**Roadmap**") setting out key developments, deliverables and targets that are expected to be achieved in 2020. The roadmap reflects the Working Group's top level priorities which include:

- Cessation of issuance of LIBOR referencing cash products maturing beyond 2021 by the end of Q3 2020. Although this is not a new target, the rhetoric is strengthening, presumably to galvanise the markets into working to meet this target.
- Taking steps to promote and enable the widespread use of SONIA compounded in arrears.
- Taking steps to enable a further shift of volumes from GBP LIBOR to SONIA in derivatives markets – from 2 March 2020, market makers are encouraged by the FCA and the Bank of England to change the market convention for sterling interest rate swaps from LIBOR to SONIA.
- Providing market input on issues around "tough legacy" contracts and establishing a clear framework to manage the transition of legacy LIBOR products in order to significantly reduce the stock of LIBOR referencing contracts by Q1 2021.

2. Carrot and stick approach

Further to their "Dear CEO" letters and the associated feedback statement published in June 2019, the FCA and PRA have sent a letter setting out their initial expectations for transition progress during 2020. Although regulators have until now taken the approach of encouraging firms to transition, it is clear that a "stick" approach of the use of "supervisory tools" may be taken if the Financial Policy Committee of the Bank of England determines that there is insufficient progress by mid-2020.

3. Term Rates

The cash markets (particularly loan markets) have long been suggesting that to enable an orderly transition away from LIBOR, forward looking term rates based on risk free rates were necessary. Indeed, many regulators and the FSB indicated that they agreed there was a role for term rates. However, time has moved on. Issuance in SONIA compounded in arrears has become almost the norm for the bond markets. By contrast, in the loan markets, movement away from LIBOR has been slower with greater growth in the bilateral rather than syndicated space. The Roadmap makes it clear that a term rate should be available by mid-Q3, but any hopes of that being the panacea for the transition away from LIBOR in the loan markets are now somewhat limited and it appears that the vast majority of market participants should be looking to the use of SONIA compounded in arrears.

Use cases for term rates are likely to be extremely limited

The Working Group has also published the Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives (the "**Working Paper**"). Given the slower pace of transition in the loan market, the Working Paper largely focusses on that market. Derivatives are not covered – previously there were indications that although a term rate would be inappropriate for most derivative transactions, there may be a use case for the hedging of products which themselves referenced that term rate. It is unclear whether this will continue to be the assumption, but, even if so, the decline in LIBOR derivatives may push up the cost of hedging LIBOR loans.

The task force which put together the Working Paper considered that the use of SONIA compounded in arrears was appropriate and is likely to be operationally achievable for approximately 90% by total loan value of the Sterling LIBOR loan market sampled. This would generally include all sponsor driven/ leveraged loans, loans to mid to large corporates and financial institutions, social housing financing, education/local authority lending, project finance and real estate.

The remaining 10% by total loan value would likely require alternative rates. This 10% consists primarily of lower value loans to a wide range of smaller borrowers for whom simplicity and/or payment certainty is a key factor. However, the figure does include some other products where use of a SONIA compounded in arrears would create operational difficulty – these include trade and working capital facilities, export finance, emerging markets and Islamic facilities.

Barriers to transition

In order to meet the Q3 transition target for cessation of issuance of LIBOR referencing cash products maturing beyond 2021, the Working Paper acknowledges that there are a number of barriers that need to be addressed in the loan market. Surely the most important barrier is the establishment of market conventions for calculating SONIA compounded in arrears – deals based on SONIA cannot be executed in bulk until these are settled. The development of conventions will depend on the completion of more SONIA referencing transactions and associated discussion amongst market participants. However, with interlinking products and multicurrency facilities, this is not something that can necessarily be resolved easily. Markets will operate more smoothly if conventions are similar across currencies and products.

Once conventions are settled, work towards resolution of other barriers such as systems updates and standardised documentation can be accelerated.

4. Legacy transactions

It is a clear intention of the Working Group that market participants should begin the transition away from LIBOR in legacy transactions. Ultimately, for the loan markets, the same issues that face new transactions are also relevant for legacy transactions with the added difficulties of an amendment process.

The Working Group notes that for the bond markets, issuance in SONIA is becoming more common and in a paper highlights the progress made to date on the transition from LIBOR referencing legacy bonds to SONIA referencing bonds by way of consent solicitations. Although market participants are encouraged to consider transitioning further contracts, it is acknowledged that each bond transaction is unique and therefore precedent may be of little value save for the direction of travel.

5. Clear message to move faster

The message from the UK regulators is, therefore, that more must be done to facilitate transition away from LIBOR as soon as possible. In particular, regulated market participants must engage in the process to avoid regulatory sanction. The syndicated loan markets in particular can no longer be reliant on a forward looking term rate based on SONIA to ease movement away from LIBOR and must act to assist in the development of new products and market conventions for loans based on compounded SONIA.

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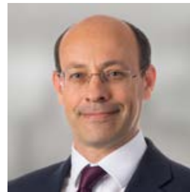

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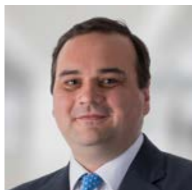

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