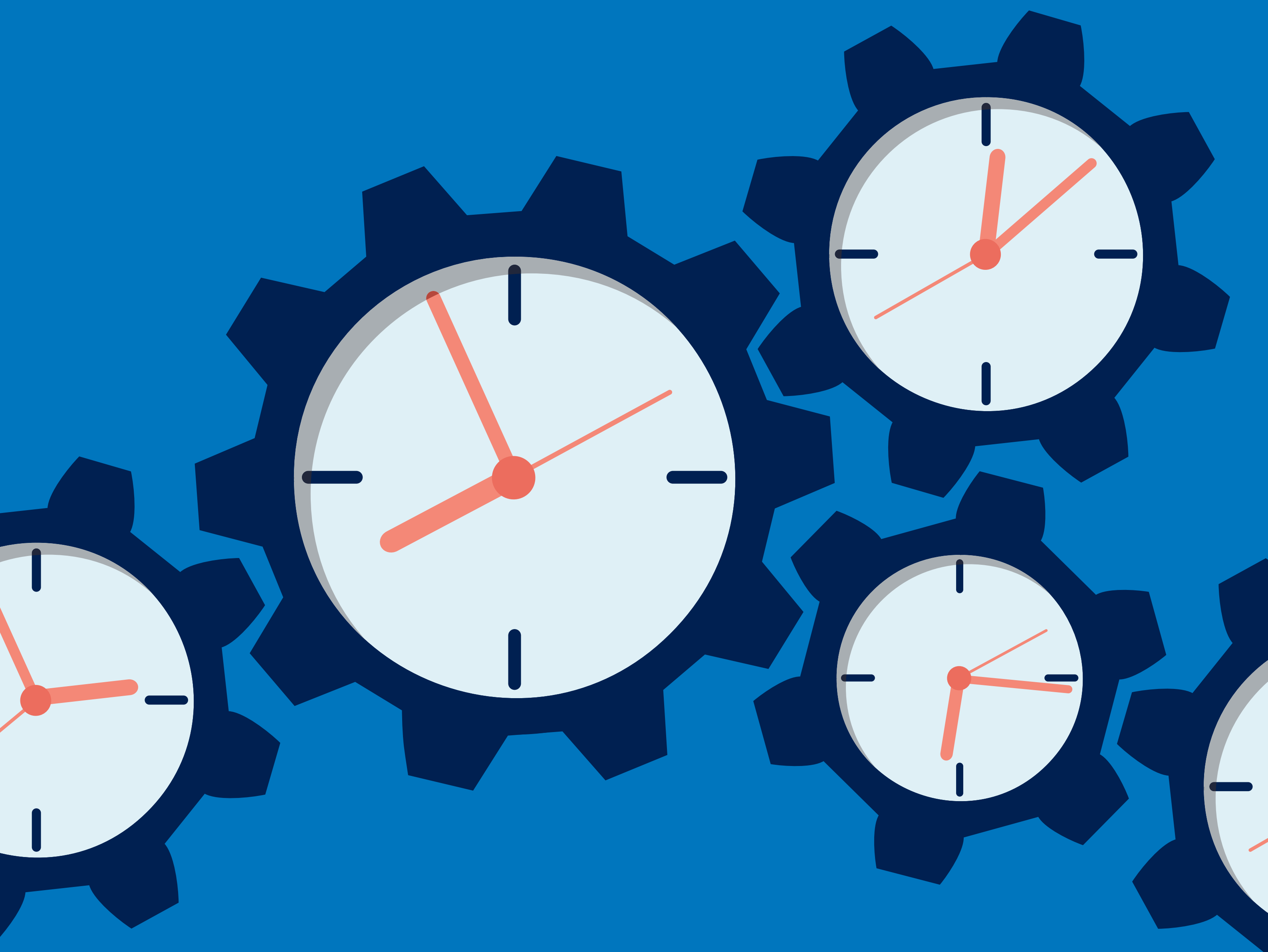
THE INVESTMENT ASSOCIATION

ENCOURAGING TRANSITION OF LIBOR-LINKED BONDS

June 2021



The Investment Association
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BACKGROUND

The Investment Association represents UK investment managers. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.5 trillion for savers and institutions in the UK and beyond. The UK asset management industry is the largest in Europe and the second largest globally.

As investors in LIBOR-linked securities, our members have a keen interest in encouraging active transition away from LIBOR by issuers of LIBOR-linked instruments. From the end of 2021 LIBOR will be phased out by jurisdictions around the world – by that point there should be no further issuance in the UK of LIBOR-linked instruments and all outstanding LIBOR-linked securities should have been transitioned to a new rate. On March 5th, the FCA confirmed the cessation dates for all panel bank LIBOR settings.[1]

However, as of the time of writing there remain a large number of outstanding LIBOR-referencing bonds which have not yet transitioned to a new rate.

This is a matter of serious concern for the industry more widely, and for the buy-side in particular. As noted in the IA's own 'Dear CEO' letter of February 3rd, in which the buy-side called for active transition of GBP-LIBOR referencing bonds, the potential impact of these bonds not being transitioned to the new rate ahead of the deadline is severe, with the risk of significant market disruption and harm to investors if bonds continue to reference a non-representative rate.[2] Ultimately this will harm the end-client – the ordinary people who are hoping to save for the future.

As noted by the Bank of England in its letter to CEOs of March 26th[3], "we have now entered the critical and final phase of the transition from LIBOR to Risk Free Rates (RFRs). It is imperative that the industry continues to build on work undertaken to date, and in some areas, accelerates efforts."

The Bank has stated that it expects firms to intensify efforts to execute plans to transition the stock of legacy LIBOR-linked contracts ahead of confirmed cessation dates of panel bank LIBOR, wherever it is feasible to do so. All legacy sterling LIBOR contracts should, wherever possible, have been amended by end Q3 2021 to include at least a contractually robust fall-back that takes effect upon an appropriate event, or, preferably, an agreed conversion to a robust alternative reference rate.

[1] https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf
[2] https://cdn.roxhillmedia.com/production/email/attachment/840001_850000/b74d0ee90dade381f9c9ccbd2704661f31767790.pdf
[3] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2021/march/transition-from-libor-to-risk-free-rates.pdf?la=en&hash=28D5CAB6CE11D930906FAEE35C86982FE159375E

ROLE OF THE BUY-SIDE IN ENCOURAGING TRANSITION

The IA's members have been strong supporters of the LIBOR transition process throughout, and have demonstrated that support through a number of initiatives. These include:

PUBLICATION OF EDUCATIONAL MATERIAL AND GUIDANCE

The IA has produced educational material for its members guiding them through the transition process, including the 2019 LIBOR Transition Roadmap for Investment Managers[4], and the 2020 report 'Time To Act Now: LIBOR Transition for Investment Managers'.[5] In addition the IA has hosted educational webinars and roundtables on the topic.

We are also aware that many of our members have also produced their own educational material, aimed at guiding their clients, as well as the issuers in which they have invested, through the LIBOR transition process.

ENGAGEMENT WITH WORKING GROUPS

The IA and a number of its members sit on the Working Group on Sterling Risk Free Reference Rates[6], established to support the transition of LIBOR to SONIA. Likewise, the IA and many of its members also sit on many of the Working Group's sub-groups, focused on specific areas of the LIBOR transition process – these include Bonds, Derivatives and Loans.

The IA has also established its own internal LIBOR Transition Working Group, providing a forum for investment managers to discuss and address LIBOR transition issues.

COMMUNICATION WITH ISSUERS AND PUBLIC CALLS FOR TRANSITION

Investment managers have looked to engage directly with issuers to encourage active transition, contacting them to urge them to put in place transition plans and to express support for the transition process. At the behest of its members, the IA published an open letter[7] in February to issuers of LIBOR-linked GBP bonds, calling on issuers to initiate transition plans as soon as possible, and to highlight investor support for past LIBOR transition consent solicitation processes. This letter was positively received and has led to further conversations with issuers.

SUPPORT FOR LIBOR TRANSITION CONSENT SOLICITATIONS

As noted above, in the IA's February open letter to issuers of LIBOR-linked GBP bonds, the IA highlighted members' past support of LIBOR transition consent solicitations, seeking to alleviate issuer reluctance to launch such proposals on the grounds that they may not be successful. Investment managers have repeatedly supported such proposals where they have been appropriate, and have waived the consent fees normally payable as part of such processes in order to further encourage issuers to transition.

[4] https://www.theia.org/sites/default/files/2019-04/20190221-liborroadmap.pdf
[5] https://www.theia.org/sites/default/files/2020-07/20200729-LIBORreport.pdf
[6] https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor/working-group-on-sterling-risk-free-reference-rates
[7] https://cdn.roxhillmedia.com/production/email/attachment/840001_850000/b74d0ee90dade381f9c9ccbd2704661f31767790.pdf

LIBOR CONSENT SOLICITATIONS – THE FRAMEWORK FOR SUCCESS

Issuers and sell-side representatives have noted that it would be helpful to have a guide as to the key features the buy-side expects a LIBOR transition consent solicitation to have, to ensure that such proposals are acceptable to investment managers and to maximise the chance of them being successful.

The IA and its members note that a common framework for such proposals has begun to develop over the last year or two as more such consents are brought to market. In particular, the IA would encourage issuers and their sell-side advisers to incorporate the following features:

REGULATORY AND INDUSTRY BODY ANNOUNCEMENTS:

Issuers and sell-side advisers should be aware of the regulatory and policy announcements that have already been made laying out regulators' and other industry bodies' expectations as to the LIBOR transition. For example, these include:

- The ISDA IBOR Fallbacks Protocol – ISDA's IBOR Fallbacks Protocol, which came into force in January 2021, provides strong fallback provisions to be applied on LIBOR's cessation, including the use of a historical five-year median spread adjustment methodology when calculating the credit adjustment spread which should then be applied to the risk free rate chosen or recommended to replace GBP LIBOR (in this case, SONIA).[8]

  The FCA's March 5th announcement on the cessation of LIBOR locked in the credit adjustment spread, which has been posted by Bloomberg.[9]
- Successor Rates – Issuers should take account of the Risk-Free Rate Working Group's May 2021 recommendation that overnight SONIA, compounded in arrears, be used to replace GBP LIBOR for the purposes of the operation of fallbacks in bond documentation that envisage the selection of a recommended successor rate.[10]
- Consent solicitations – Issuers may wish to consider the Risk-Free Rate Working Group's considerations for the use of consent solicitations to transition English-law legacy bond contracts from LIBOR to SONIA.[11]

FOCUS ON TRANSITION AWAY FROM LIBOR:

In order to meet the guided timelines of transition ahead of cessation, the sole focus of any issuer proposal must be limited to the transition away from LIBOR, as any effort to include additional elements may have a material impact on the ability to conclude this process in a timely manner.

NO CONSENT FEES:

It is now commonly accepted that investors should waive any expectation of consent fees, in order to encourage active transition from LIBOR.

TIMING:

Investment managers have a fiduciary duty to their clients to carefully and methodically consider all consent solicitations before deciding on a voting decision. In order to ensure this is possible, issuers should ensure they allow investors sufficient time to review the proposals before reaching a decision. In particular, issuers should consider the possibility that there may be delays in notices and documentation being delivered to investment managers, which may mean investment managers have less time to review the proposals than might be expected. The IA encourages all parties in the chain to pass on notices and documentation as quickly as possible.

DOCUMENTATION:

Standardisation of documentation will minimise the time necessary to review documentation and help investors make their investment decisions in a timely manner. Issuers should consider how to align the language in their consent solicitation documentation with the precedents set by previous consents.

In the interest of allowing investors to quickly review proposals, issuers should also consider including a simple summary of the proposed changes, such as a comparison between LIBOR and the new rate.

ENGAGEMENT:

Investment managers have noted that bilateral engagement with issuers on LIBOR transition is made more difficult by relevant regulation requiring material information to be made public. In order to facilitate open dialogue between an issuer and investors regarding the terms of the consent solicitation, the issuer may consider it appropriate to pre-announce a consent solicitation by way of an RNS announcement.

[8] https://www.isda.org/protocol/isda-2020-ibor-fallbacks-protocol/
[9] https://assets.bbhub.io/professional/sites/10/IBOR-Fallbacks-LIBOR-Cessation_Announcement_20210305.pdf
[10] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/wgrfr-statement-recommendation-of-successor-rate.pdf
[11] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/lessons-learned-from-recent-conversations-of-legacy-libor-contracts.pdf

OTHER TOOLS FOR TRANSITION

The IA and its members note that consent solicitations may not be suitable in all cases, particularly where identifying the required supermajority of bondholders in order to garner their support is challenging. The IA notes that tools other than consent solicitations are available for transition away from LIBOR. These include tender offers, bond repurchases or exchanges, or the exercise of call options.

ROLE PLAYED BY OTHER MARKET PARTICIPANTS

As this paper has laid out, the buy-side is a strong supporter of the LIBOR transition process, and has taken numerous steps to encourage active transition.

Nonetheless, transition is not a process that can be driven by any one part of the market. It is incumbent on all market participants to consider how they can drive effective transition. We encourage all market participants to actively engage amongst themselves in order to ensure alignment and effective collaboration with the goal of achieving active transition before the deadline.

- **Issuers** – Issuers, of course, are ultimately the ones who must launch transition processes themselves to transition their bonds away from GBP LIBOR. We would encourage issuers to be transparent in their plans for LIBOR transition and to ensure effective communication with their investors. As noted in the Bank of England's Dear CEO letter of March 26th, issuers must ensure that all legacy sterling LIBOR contracts, wherever possible, have been amended by end Q3 2021 to include at least a contractually robust fall-back that takes effect upon an appropriate event, or, preferably, an agreed conversion to a robust alternative reference rate.

- **Benchmark providers** – Early feedback from conversations with benchmark providers suggests non-transitioned bonds will not be removed from their indices. Benchmark providers should consider taking a different approach, in order to help drive active conversion.

- **Banks and advisers** – These market participants play a vital role in shaping consent solicitation processes, and have their own education role to play in ensuring issuers are informed of the importance of early and active transition, particularly non-FCA or PRA regulated issuers over whom these market participants are likely to have significant influence. There is concern that regulated advisers may suffer reputational risks if they are not seen to be reaching out to any non-regulated issuer clients on this matter.

- **Regulators** – It is absolutely critical that all market participants are provided with clarity on the FCA's approach to Tough Legacy and the use of synthetic LIBOR as soon as possible so that they can prioritise transition activity effectively between now and the end of the year. Further guidance on the definition of 'tough legacy' and 'irreducible core' would be gratefully received, as well as the medium-to-long-term application of synthetic LIBOR. There is a concern that confidence in these instruments will be hampered by the fact that the use of synthetic LIBOR remains subject to annual review.

  Additionally, regulators should consider what further steps could be taken to enforce compliance with the deadline if issuers do not take active steps towards transition.

- **Third Party Operational Providers** – Third party operational providers should also be engaging regularly with issuers and other key stakeholders as part of their management of the transition process, and should ensure they are prepared to transact non-LIBOR linked bonds and for the expected uptick in changes of terms of LIBOR bonds.

The IA and its members are keen to continue their engagement with all key stakeholders to ensure effective and rapid transition away from GBP-LIBOR, and would welcome further dialogue with other market participants.

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