Transition from LIBOR in Sterling Structured Products

The Working Group on Sterling Risk-Free Reference Rates

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Foreword

The overall objective of the Working Group on Sterling Risk-Free Reference Rates (the "Working Group")[1] is to enable a broad-based transition to SONIA (the Sterling Overnight Index Average) by the end of 2021 across the sterling bond, loan and derivatives markets, in order to reduce the financial stability risks arising from the widespread reliance of financial markets on LIBOR.[2]

The Working Group has established sub-groups and task forces to provide technical input for the objective of facilitating market-led transition in sterling markets. The role of the Bond Market Sub-Group ("BMSG") is to identify and consult on appropriate solutions to support sterling bond markets, including vanilla floating rate notes, securitisations and regulatory capital securities, in the transition to alternative rates. The Non-Linear Derivatives Task Force ("NLTF") seeks to support transition in the sterling non-linear derivatives markets. The work of both the BMSG and NLTF on behalf of the Working Group is relevant to the sterling structured products market, given the inherent nature of many structured products as pre-packaged structured finance investments with a derivative component.

This paper builds on the work to date on transition in other parts of sterling markets, to describe how a sterling structured products market based on a risk-free rate could potentially be designed using compounded in arrears SONIA, and to set out considerations for the transition of existing sterling structured products from GBP LIBOR to SONIA. It is intended to support market participants in meeting the recommended milestones set out in the Working Group's roadmap and priorities for transition by end-2021.[3]

This paper is intended for all participants in the sterling structured product markets including issuers, manufacturers, distributors and investors.[4] It refers to various types of structured products, including on-balance sheet issuances and repackaging transactions. Please refer to the section titled "How to use this paper" below for further information.

The Working Group is grateful for the significant input received on behalf of the UK Structured Products Association. It is also grateful to the BMSG and the NLTF for having overseen the development of this paper.

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[1] The Bank of England and the Financial Conduct Authority (the "FCA") are each ex-officio members of the Working Group. The views and outputs set out in this document do not constitute guidance or legal advice from the Bank of England (including the Prudential Regulation Authority (the "PRA")) or the FCA and are not necessarily endorsed by the Bank of England (including the PRA) or the FCA. This document is not intended to impose any legal or regulatory obligations on market participants. This document has been prepared for the purpose of highlighting to market participants some of the potential considerations. It does not constitute a comprehensive outline of all relevant considerations. Market participants should seek their own advice in relation to their legal, regulatory, tax and other obligations and as to any other considerations or risks that may arise or be relevant.

[2] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr-terms-of-reference.pdf

[3] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfr-working-group-roadmap.pdf

[4] 'Manufacturers' refers to those firms that create, develop, issue, and/or design investments, including when advising corporate issuers on the launch of new investments. 'Distributors' refers to those firms that offer, recommend or sell investments or provide investment services to clients.

Executive Summary

1. The Working Group's overall objective is to catalyse a broad-based transition from GBP LIBOR to SONIA by end-2021 across sterling bond, loan and derivatives markets. This includes the sterling structured products market, which has links to a number of areas within these broad product categories. The recommended roadmap for transition outlined by the Working Group[5] therefore includes a number of milestones relevant to structured products:

   a. By end-Q1 2021, cease initiation of new GBP LIBOR-linked loans, bonds, securitisations and linear derivatives* that expire after the end of 2021.

   b. By end-Q2 2021, cease initiation of new GBP LIBOR-linked non-linear derivatives* that expire after the end of 2021.

   c. During Q2/Q3 2021, cease initiation of cross-currency derivatives with a LIBOR-linked sterling leg, expiring after 2021*

   d. Progress active conversion of all legacy GBP LIBOR contracts where viable through to completion by end-Q3 2021.

   * Except for risk management of existing positions.[6]

2. Market participants are encouraged to take all necessary steps to complete their operational transition plans for structured products in order to reduce the financial stability risks arising from the widespread reliance on GBP LIBOR and to support an orderly transition ahead of end 2021. To assist with this, it may be beneficial for participants to consider issuing new structured products based on compounded in arrears SONIA. The Working Group anticipates that a functioning sterling structured products market using compounded in arrears SONIA as the primary vehicle is not only feasible, but could also benefit from the consistency in use of compounded in arrears SONIA across markets.

3. The customary convention for new issuance in the sterling bond and securitisation markets to date is for use of compounded in arrears SONIA for the purposes of interest determination, and the Working Group anticipates that this will readily apply to new structured product issuance too. Where such structured products have a derivative-linked payout or coupon, the development of a new structured products market would be inherently linked to a compounded in arrears SONIA derivatives market. Levels of liquidity in interest rate swaps based on compounded in arrears SONIA are already strong[7], following a move to SONIA in interdealer conventions in October 2020 and the milestone noted above to cease most new issuance of GBP LIBOR-linked linear derivatives by the end of March 2021. In respect of non-linear derivatives, such as caps and floors, a common set of conventions and trading practices has been established[8] and liquidity is expected to develop based on compounded in arrears SONIA as the market nears the end-Q2 2021 milestone.

4. The Working Group encourages market participants to amend their legacy GBP LIBOR referencing structured products now where it is feasible to do so. Taking an active approach to review transactions and form a remediation strategy in good time enables market participants to take

[5] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfr-working-group-roadmap.pdf

[6] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/the-path-for-derivatives-transition-including-exceptions-for-risk-management-purposes.pdf

[7] As shown in the video presentation found in this LinkedIn post from the Working Group:
https://www.linkedin.com/posts/working-group-on-sterling-risk-free-reference-rates_uk-rfr-working-group-sonia-first-quoting-activity-6782352129186119680-DG3q

[8] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/transition-in-sterling-non-linear-derivatives.pdf

control over the terms and impact of the inevitable transition. Consent solicitation or other forms of liability management could be a means to accelerate active transition away from GBP LIBOR, where it is viable to do so. To help drive momentum, the Working Group also encourages market participants to consider publicly disclosing, where appropriate, transactions referencing compounded in arrears SONIA (together with any disclosable information around the transition mechanisms).

How to use this paper

5. This paper seeks to build on the work to date by the Working Group in areas relating to the bond market and the derivatives market, to support the transition for structured products. It is intended that this paper is used by structured products issuers, manufacturers, distributors and investors in their plans to meet the recommended milestones referred to above. In the context of transition to compounded in arrears SONIA, firms will need to consider other matters, in particular governance (including product governance[9] for manufacturers and distributors), conduct and communications.[10]

6. Section 1 of this paper details some key considerations for new issuances in structured products referencing compounded in arrears SONIA. Section 2 of this paper provides high-level views to support the transition of legacy GBP LIBOR structured products.

7. Unless indicated otherwise, references to structured products in this paper are intended to cover both balance sheet structured products and repackaging transactions. In both cases, GBP LIBOR is commonly used as the reference rate when determining the payout. Given the breadth and variety of products in the market, the terms 'balance sheet structured product' and 'repack securities' as used here do not have a strict legal or technical definition.

    a. Balance sheet structured products: This paper refers to what the Working Group understands would generally be considered by the market as 'structured products'. Broadly, these are securities which provide a (non-traditional) structured payout based on the performance of underlying assets or rates. The exposure to these underlying assets or rates is created using a derivative, and there may also be other embedded derivatives to structure the relevant payout further. They are often (but not necessarily always) issued from the balance sheet issuance programmes of financial institutions and may be in the form of notes, warrants, certificates and other types of transferable securities.

    b. Repack securities: Broadly, repackaging transactions (also referred to as "repack securities") are securities which are backed by (and generally secured on) another security or other asset. Cash flows on the underlying asset are often channeled through a swap to generate the return on the repack security, and may include other embedded derivatives to structure the payout further to meet the specific requirements of end investors. Repack securities are often (but not necessarily always) issued in the form of notes by special purpose vehicles in transactions arranged by financial institutions. Given the various elements and transaction parties to a repackaging transaction, an illustration of a typical repackaging transaction is provided for reference in *Appendix 1*.

8. Although this paper does not seek to cover other types of products (including for example, securitisation transactions, structured loans and structured deposits), market participants may find the considerations herein to be useful in other circumstances in their planning to meet the Working Group's recommended milestones.

[9] For example, market participants may need to consider the Product Intervention and Product Governance Sourcebook (PROD): https://www.handbook.fca.org.uk/handbook/PROD.pdf

[10] For example, market participants may need to consider the following:
https://www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition
https://fmsb.com/wp-content/uploads/2020/06/libor-transition-case-studies-for-navigating-conduct-risks.pdf

Section 1: Key considerations for new issuances of structured products referencing SONIA

1.1 Use of compounded in arrears SONIA

9. The prevailing view of the Working Group is that compounded in arrears SONIA will and should become the norm in most sterling derivatives, bonds, and bilateral and syndicated loan markets given the benefits of the consistent use of benchmarks across markets and the robust nature of SONIA as a reference rate. As such, the Working Group anticipates that a functioning sterling structured products market using compounded in arrears SONIA as the primary vehicle for new deals is not only feasible, but could also benefit from the consistency in use of compounded in arrears SONIA across markets.

10. Operationally, it may be relatively straightforward for structured products to reference compounded in arrears SONIA as the basis for conventional interest determination. Compounded in arrears SONIA is now the customary convention for new issuance in the sterling bond market (including securitisation markets), so it is anticipated by the Working Group that this will readily apply to new structured products issuance as well for the purposes of interest determination.

11. New structured products referencing compounded in arrears SONIA that have a derivative-linked payout or coupon (for example, a product featuring a payout with a cap or a floor) would be inherently linked to the corresponding derivatives markets based on compounded in arrears SONIA. In the linear derivatives market, there are already strong levels of liquidity in swaps based on compounded in arrears SONIA, with trading in GBP LIBOR having reduced in line with the Working Group's recommended milestone at the end of Q1 2021 to cease initiation of new GBP LIBOR-linked linear derivatives expiring after the end of 2021 (except for transactions entered into for risk management of existing positions).[11]

12. In respect of the non-linear derivatives market, the recommended milestone is to cease initiation of new GBP LIBOR non-linear derivatives expiring after the end of 2021 (except for risk management of existing positions) by the end of Q2 2021. As the market nears this milestone, a common set of conventions and trading practices has been established and liquidity is expected to develop for non-linear derivatives based on compounded in arrears SONIA, supporting in turn the development of a new structured products market on this basis. Specific steps supporting this have included:

    a. <u>Conventions for non-linear derivatives</u>: In November 2020, the Working Group published its paper on Transition in Sterling Non-Linear Derivatives[12] which provided guidance to market participants on how key non-linear derivatives can be structured using compounded in arrears SONIA. This guidance is relevant to issuers and manufacturers of structured products with similar derivative-linked payouts too.

    b. <u>Infrastructure</u>: The findings of a survey of non-linear derivatives dealers conducted on behalf of the Working Group highlighted that most had processes in place to make markets in derivatives based on compounded in arrears SONIA.[13] To support end-users in non-linear derivatives, the Working Group understands that much of the market infrastructure for non-

[11] As shown in the video presentation found in this LinkedIn post from the Working Group: https://www.linkedin.com/posts/working-group-on-sterling-risk-free-reference-rates_uk-rfr-working-group-sonia-first-quoting-activity-6782352129186119680-DG3q

[12] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/transition-in-sterling-non-linear-derivatives.pdf

[13] https://www.bankofengland.co.uk/-/media/boe/files/minutes/2020/rfr-december-2020.pdf

linear derivatives that reference compounded in arrears SONIA, for example in swaptions and caps/floors, has been made available in Q1 2021 as well.[14]

c. Fixing of credit adjustment spreads for ISDA fallbacks: The FCA announcement on 5 March 2021[15] relating to the future cessation and non-representativeness of certain LIBOR rates resulted in the fixing of the credit adjustment spread for all tenors of GBP LIBOR for the purposes of the ISDA 2020 IBOR Fallbacks Protocol (the "ISDA Protocol")[16] and IBOR Fallbacks Supplement.[17] This is expected to assist the market in developing pricing and trading conventions for non-linear derivatives.

13. Further, the FCA surveyed participants in the non-linear derivatives market, including liquidity providers, buy-side firms and interdealer brokers, and identified strong support to change market standard trading conventions to a SONIA basis from 11 May 2021. The FCA and the Bank of England have encouraged[18] all participants in the sterling non-linear derivatives market to take the steps necessary to prepare for and implement these changes to market conventions on 11 May and shift liquidity away from GBP LIBOR to SONIA.

14. Issuers and manufacturers of structured products should consider the way in which compounded in arrears SONIA is referenced. For certain products, issuers and manufacturers may wish to consider referencing the SONIA Compounded Index[19] published by the Bank of England as opposed to a formula-based compounding calculation in issuance documentation. From a presentational perspective this may be more in keeping with existing documentation for certain structured products, and thereby aid investor familiarisation. Section 1.2 (*Calculation conventions for compounded in arrears SONIA*) below details further considerations here.

15. The economic profile of particular product types will also be relevant when choosing to reference compounded in arrears SONIA. For example, the NLTF has noted that caps and floors which reference compounded in arrears SONIA are different in terms of optionality than caps and floors which reference GBP LIBOR (due to the difference in the point of time at which the reference rate is fixed for such products).[20]

16. The Working Group and UK authorities have set out a clear view[21] that a broad-based transition to compounded in arrears SONIA will provide the most robust foundation for sterling interest rate markets, and as noted above this has become the norm in many areas. Where market participants wish to consider a different approach, proposed industry guidance is available describing areas

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[14] https://www.bankofengland.co.uk/-/media/boe/files/minutes/2021/rfr-january-2021.pdf

[15] https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf

[16] ISDA 2020 IBOR Fallbacks Protocol published on October 23, 2020 by the International Swaps and Derivatives Association, Inc. (ISDA).

[17] https://www.isda.org/a/y3ZTE/A43681587-v7.0-04032021_ISDA-Guidance-on-FCA-announcement_LIBOR-Future-Cessation-and-Non-Representativeness.pdf

[18] FCA website: https://www.fca.org.uk/news/statements/fca-and-bank-england-encourage-market-participants-switch-sonia-sterling-non-linear-derivatives

Bank of England website: https://www.bankofengland.co.uk/news/2021/march/fca-and-boe-encourage-market-participants-in-sonia-switch-in-sterling-non-linear-derivatives-market

[19] https://www.bankofengland.co.uk/boeapps/database/FromShowColumns.asp?Travel=&searchText=sonia+compounded+index

[20] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/transition-in-sterling-non-linear-derivatives.pdf

[21] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/statement-welcoming-proposed-market-standard-on-use-of-term-sonia-march-2021.pdf

where use of alternatives such as a Term SONIA Reference Rate ("TSRR") may be more or less appropriate. For example, the draft standard on use of TSRRs[22] produced by the FICC Markets Standards Board, open for public comment until 28 May, recognises the conduct and systemic risk advantages associated with a broad-based adoption of compounded in arrears SONIA and considers selected use cases for TSRRs where there is a robust rationale to meet specific needs. The Working Group has noted this is broadly consistent with its own conclusions on Use Cases of Benchmark Rates,[23] which estimated that use of compounded SONIA would be appropriate and likely to be operationally achievable for around 90% of the sterling loan market by value.

1.2 Calculation conventions for compounded in arrears SONIA

17. In certain transactions (for example, repack securities), payments may be determined by reference to SONIA at several layers, including at the level of: (i) the underlying collateral assets; and (ii) any derivatives entered into by the hedge provider internally or with any third-party entities. When adopting compounded in arrears SONIA for new issuances of structured products, issuers and manufacturers may want to take into account that (as at the date of this paper), across markets, there are several conventions currently in use.

18. Issuers and manufacturers should consider which conventions would minimise basis risk between any amounts payable to investors under the terms of the instrument, as well as between the issuer and the derivative provider. This could be achieved if identical or closely matching conventions are used across the different layers of a structured product, particularly between the bond and derivative where the choice of convention for the structured product may be driven by the extent to which the instrument does or does not rely on the derivative element. In collateralised structures such as repack securities, the compounding convention used under the terms of any underlying collateral asset may also play a role.

19. A summary of some of the key considerations for the structured products market when selecting a compounding convention (as at the date of this paper) is shown below. It is anticipated that ISDA will publish a Supplement to the 2006 ISDA Definitions setting out a new, modular approach to documenting derivatives referencing new floating rate options for overnight risk-free rates ("RFRs"), including SONIA. ISDA's new modular approach is expected to provide issuers and manufacturers with standardised provisions for the most commonly used compounding methodologies (including "observation shift", "observation lag" and "lock-out") as at the date of this paper.

Compounding convention[24]	**Where it is currently used**	**Considerations for a structured products market**
Five Banking Days Lookback without Observation Shift (also known as "observation lag")	Over 230 SONIA-linked floating rate notes ("FRNs") and securitisations with a total nominal value of approximately £105 billion were issued by mid-March 2021.	As at the date of this paper, both of these compounding methodologies are being used in sterling FRNs. **If the role of the derivatives element is relatively limited, it may be**

[22] https://fmsb.com/wp-content/uploads/2021/03/FMSB-Term-Rate-Standard_TRANSPARENCY-DRAFT_Final.pdf

[23] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/use-cases-of-benchmark-rates-compounded-in-arrears-term-rate-and-further-alternatives.pdf

[24] For guidance on loan market conventions: https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/best-practice-guide-for-gbp-loans.pdf

Five Banking Days Lookback with Observation Shift (also known as "observation shift")	Some recent issuances of sterling FRNs have begun to utilise this in order to, amongst other reasons, facilitate reconciliation of interest amounts between market counterparties.	**more appropriate to follow the applicable FRN convention at the time.**
No observation lag or observation shift	Market standard sterling SONIA swaps	**If the derivative is driving the structured product pay-outs, for example where the issuer hedges by way of SONIA swaps, it may be more appropriate to follow the more commonly used convention in the derivatives market.**

1.4 Credit adjustment spread

20. Interest payments in new issuance in existing SONIA-referencing products generally comprise a fixed spread in addition to the floating rate, in a similar manner to GBP LIBOR-referencing transactions. While an additional 'credit adjustment spread' is typically used when converting existing transactions from GBP LIBOR to SONIA, to account for structural differences between the rates, in new issuance these differences are typically accounted for as part of the single fixed spread.

1.5 Fallbacks

21. The overnight SONIA rate is anchored in an active and liquid underlying market and based on a significant volume of transaction data. Nevertheless, market participants should consider whether they need to ensure they have robust contractual fallbacks for SONIA in accordance with the EU Benchmarks Regulation or UK onshored version of this regulation (together, the "BMR"), and in line with the IOSCO Statement on Matters to Consider in the Use of Financial Benchmarks.[25] The BMR requires that supervised entity users of all benchmarks must produce and maintain robust written plans setting out their planned course of action in the event of cessation or material change of a benchmark. This point is discussed in the Working Group's Discussion Paper: Conventions for referencing SONIA in new contracts.[26]

22. With issuers starting to incorporate SONIA-linked provisions into their structured products programmes in the last twelve months, there are some themes developing in fallbacks to SONIA which could form the basis of a standard approach going forward – see *Appendix 2* for more details on this. Market participants may want to consider the benefits of aligning SONIA fallbacks in structured products with SONIA fallbacks in other asset classes at an early stage to avoid any potential disconnect, i.e. to seek consistency between the conventions and fallbacks used in the securities and the derivatives or (for repack securities) underlying collateral. Market participants will have to consider their own needs to determine the appropriate fallback contractual language for new SONIA structured product issuances, but may want to take the following into account:

[25] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD589.pdf

[26] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/discussion-paper-conventions-for-referencing-sonia-in-new-contracts.pdf

a. SONIA-specific/hard-wired fallbacks: The approach taken by ISDA will be of particular relevance given the overlap between these asset classes. Market participants may therefore wish to include cessation triggers and fallbacks for SONIA that are aligned with the ISDA Protocol and IBOR Fallbacks Supplement[27], and the triggers and fallbacks for SONIA to be included in ISDA's 2021 Interest Rate Derivatives Definitions.[28]

b. Subsequent fallbacks allowing discretion: Market participants may wish to include fallbacks in the sequence of fallback provisions which permit the issuer or calculation agent to follow guidance published by a relevant nominating body as to how the SONIA rate (or any rate that is to replace the SONIA rate) is to be determined. This may also include, in some cases, market consensus as to what the appropriate fallback may be or any transaction-specific considerations. The intention of setting the parameters in which the issuer or the calculation agent must exercise discretion is not only to increase the likelihood of an outcome that is in line with market expectation, but also to limit the scope for conflict and challenge. Such a fallback could be broadly aligned with the concept of a GBP Recommended Rate in the ISDA Protocol and IBOR Fallbacks Supplement or the concept of an Alternative Post-nominated Index in ISDA's Benchmarks Supplement.[29]

   Although the Working Group considers it unlikely in the context of SONIA markets, it may be the case that some market participants also want to address a potential situation where there is no clear fallback rate or associated published guidance. The ISDA Protocol and IBOR Fallbacks Supplement cover this by including an additional fallback. Outside of derivatives that incorporate the IBOR Fallbacks Supplement, this could alternatively be addressed as an additional fallback provision permitting wider issuer or calculation agent discretion coupled with a discretion to make related adjustments to the terms of the securities that the issuer or the calculation agent determines are appropriate. In doing so, market participants may also wish to have such a fallback broadly aligned with the concept of a Calculation Agent Nominated Replacement Index in ISDA's Benchmarks Supplement and as an ultimate or penultimate fallback provision (e.g. ahead of the last preceding rate) in the sequence of fallback provisions. If derivatives incorporate the IBOR Fallbacks Supplement as well as ISDA's Benchmarks Supplement, then the IBOR Fallbacks Supplement would apply in priority to the Calculcation Agent Nominated Replacement Index.

c. Administrator/Benchmark Event trigger: Whilst unlikely to be key in the context of central bank administered rates such as SONIA, for consistency with fallbacks for non-central bank rates and to cater for any change in administrator, market participants may wish to consider the benefits of including a trigger and fallbacks aligned with the Administrator/Benchmark Event

[27] Supplement number 70 to the 2006 ISDA Definitions.

[28] Whilst we note that the ISDA 2020 IBOR Fallbacks Protocol and Supplement address fallbacks for IBORs, including GBP LIBOR, the sequence of fallback provisions for GBP LIBOR also includes fallbacks for SONIA. Supplement 55 to the ISDA 2006 Definitions (Amended Floating Rate Option definition "GBP-SONIA-COMPOUND", updated for the SONIA benchmark reforms, published April 23, 2018) does not include fallbacks for SONIA but ISDA have included fallbacks for RFRs in more recent Supplements (for example, Supplement 57 (USD-SOFR-COMPOUND, published May 16, 2018) and fallbacks for SONIA are expected to be included in the context of 2021 ISDA Interest Rate Derivatives Definitions and also in the overnight GBP-SONIA Floating Rate Option expected to be published as a Supplement to the 2006 ISDA Definitions, in each case expected to be finalised later this year.

[29] ISDA's Benchmark Supplement was published in 2018 and is available on ISDA's website here:

https://www.isda.org/book/isda-benchmarks-supplement/

Note that the concept of "GBP Recommended Rate" in ISDA's 2020 IBOR Fallbacks Supplement is closely aligned with the definition of "Alternative Post-nominated Index" in ISDA's Benchmarks Supplement so if including the GBP Recommended Rate as a hard-wired fallback, market participants may wish to consider whether it is necessary to also include a fallback akin to the Alternative Post-nominated Index.

in ISDA's Benchmarks Supplement addressing the risk that any party is not able to use SONIA to perform its obligations. In this regard, market participants may also want to take into account the approach taken in ISDA's 2021 ISDA Interest Rate Derivatives Definitions (when published) in relation to this trigger for SONIA.

Section 2: Key considerations for the transition of legacy GBP LIBOR structured products

2.1 Contractual fallback language and potential steps to facilitate transition

23. There has been a significant degree of variation across fallbacks in structured products programmes, particularly over the last 3-4 years in response to the evolving regulatory landscape and developments related to IBOR transition. Whilst some programmes, mainly off-balance sheet repackaging programmes, contain fallback provisions that are highly bespoke, the trend for most structured products programmes has been to include some or all of the broadly defined *Type 1, 2* or *3* categories of fallbacks[30] described in *Appendix 3* to this paper. Within each type, additional variations are common based on the internal policies of individual issuers. Programmes may also include features that affect outcomes under Type 2 and Type 3 fallbacks in particular, such as restrictions on the amount of time the issuer or the calculation agent has to determine a replacement rate and provisions envisaging that one or more replacement rates may have been specified in the issue terms.

24. Under the Working Group's roadmap and priorities for transition by end-2021, market participants are recommended to have completed 'identification of all legacy GBP LIBOR contracts expiring after end 2021 that can be actively converted' by the end of Q1 2021 and to proactively review transactions and form a remediation strategy in good time. The high-level steps set out below may assist in the identification and development of a strategy:

    a. Reviewing and categorising existing LIBOR issuances, particularly for GBP LIBOR issuances containing Type 1 fallbacks;

    b. Identifying key risks which may arise in relation to different remediation strategies (for instance, risks relating to use of discretionary rights to effect modifications) and any mitigants at an early stage;

    c. For Type 2 and Type 3 fallbacks, assessing:

        i. the relevant triggers for each issuance in light of the FCA's announcement of 5 March 2021 on the future cessation and loss of representativeness of the LIBOR benchmark. Issuers should consider what trigger events may already have been fulfilled under legacy issues and the timeframe for any action to be taken;

        ii. how the potential recommendation to a fallback successor rate arising from the Working Group's Consultation on a successor rate to GBP LIBOR in legacy bonds[31] may assist transition in the context of specific fallbacks; and

        iii. how the Working Group's September 2020 Recommendation of Credit Adjustment Spread Methodology for fallbacks in cash market products referencing GBP LIBOR[32] may assist in the context of GBP LIBOR contracts that contain contractual fallbacks and replacement of screen rate provisions which result in the selection of a spread-adjusted SONIA rate as a fallback;

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[30] Note that the categorisation of Type 1, Type 2 and Type 3 fallback has also been used by the Bond Market Sub-Group to describe floating rate note fallbacks. Fallbacks used in floating rate notes are similar, but not exactly the same as the types of fallbacks typically appearing in structured products.

[31] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/consultation-on-successor-rate-to-gbp-libor-in-legacy-bonds-referencing-gbp-libor.pdf

[32] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/recommendation-of-credit-adjustment-spread.pdf

d. Assessing operational and systems readiness and agents' requirements for implementation of SONIA arrangements.

25. The following may also be useful for market participants to factor into their remediation strategies:

    a. Transitioning legacy products based on ISDA fallbacks: The structure of certain legacy products may limit the feasible transition options available to issuers and, in particular, mean that transitioning products with GBP LIBOR-linked payouts so as to achieve alignment with the treatment of equivalent derivatives (where relevant) under the ISDA Protocol is not the preferred outcome.

       Range accrual products, for example, may require particular consideration. Although a GBP LIBOR-linked range accrual product may operate from a mechanical perspective if transitioned to compounded in arrears SONIA on the basis set out in the ISDA Protocol, its economic profile could be materially different from its original intended form. For products such as these, issuers and manufacturers may want to consider a range of available approaches to transition, including transition on the basis set out in the ISDA Protocol, to determine the appropriate approach for individual products and investor classes. For example, issuers may seek to restructure legacy products so they reference compounded in arrears SONIA in the same way that a new issuance would. In determining the appropriate course of action, issuers and manufacturers will need to consider alignment with associated hedges and the possibility of value transfer.

    b. Transitioning legacy products based on GBP swap rates: In respect of legacy derivatives referencing GBP swap rates such as the GBP LIBOR ICE Swap Rate, the Working Group has proposed a replacement rate in its paper issued in February 2021.[33] As of April 2021, the proposed replacement rate is being considered by ISDA for inclusion in its market standard documentation.

    c. Hedging mismatches: Structured products issuers commonly hedge their exposure under the securities, including any GBP LIBOR-based exposure, through OTC derivatives. In a repackaging structure, the issuer of the repack securities will usually enter into a hedging transaction with a bank swap counterparty, which in turn will hedge its obligations in the market (as illustrated in the diagram in Appendix 1 to this paper).

       Structured product programme documentation is not standardised across the market, whereas the market-facing hedging activity will usually be under standardised ISDA documentation. As a result, there is potential for mismatch between the GBP LIBOR fallbacks and triggers applicable to the structured product, which, as discussed in sections 1.5 and 2.1 above, vary widely depending on when they were drafted and the policies of the individual issuer or arranger, and those applicable to the related market-facing hedging derivatives.[34]

       Mismatches could arise in relation to:

        i. the applicable triggers (for example, the market-facing hedge incorporates a pre-cessation trigger whereas the structured product provisions may not);

[33] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/supporting-transition-in-sterling-non-linear-derivatives-referencing-gbp-libor-ice-swap-rate.pdf

[34] Uncleared derivatives may have been amended to embed the standard fallbacks contained in the ISDA IBOR Supplement through adherence to the ISDA Protocol or bilateral negotiation. Cleared derivatives are expected to be amended through changes to clearing houses' rulebooks.

For more background, please see Section 1: Characteristics of 'tough legacy' contracts across asset classes – Derivatives of the Working Group's Paper on the identification of Tough Legacy issues:

https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/paper-on-the-identification-of-tough-legacy-issues.pdf

ii. the timing of any fallback taking effect;

iii. the parameters within which a replacement rate can be determined (for example, the market-facing hedge falls back to an 'all in' screen rate whereas the structured product gives the calculation agent limited discretion to determine the replacement risk-free rate plus a credit adjustment spread); and

iv. the fixing and/or payment date of the replacement compounded in arrears RFR (for example, the market-facing hedge falls back to an RFR with a fixing date falling two business days prior to the related payment date, whereas the ICSDs may require the fixing date under the securities to fall at least five business days prior to the related interest payment date).

Any of these could result in a discrepancy between amounts received by the issuer (or in the case of a repackaging, the swap counterparty) under its market-facing hedge and its corresponding liabilities.

In addition, under a repackaging structure, the underlying collateral securities held by the issuer of the repack securities may themselves reference GBP LIBOR. Any mismatches between the fallbacks in these collateral securities (which are commonly corporate FRNs) and the repackaging derivative between the issuer and the swap counterparty (or in the swap counterparty's own market-facing hedge) may result in (i) the issuer receiving lower interest payments under the collateral securities than the floating rate amounts it is required to pay under the repackaging derivative; or (ii) the swap counterparty receiving lower payments under the repackaging derivative than it is required to pay under its own market-facing hedge. As the issuer of the repack securities has no additional assets from which to fund its liabilities, such a scenario could lead to the issuer defaulting on its payments which could trigger an early redemption of the repack securities.

In view of these points, issuers and manufacturers may wish to consider identifying any areas of potential mismatch that may arise and determine how to minimise or avoid it in the proposed changes to contractual terms and cash flows, ahead of implementing their remediation strategies. ISDA has published template documentation that market participants could use to track the fallbacks in linked products as opposed to the standard fallbacks in the ISDA Protocol and IBOR Fallbacks Supplement.[35]

2.2 Credit adjustment spread

26. As structured products rely on the alignment between the terms of the instruments themselves as well as related derivatives transactions, it is important that the addition of any credit adjustment spread ("CAS") upon transition to SONIA does not disrupt the economics of the product:

    a. <u>Active transition</u>: A structured product may include several references to GBP LIBOR in different parts of its structure, so transition of each of these elements at the same time may help to minimise or eliminate any mismatches. Active transition is the most certain way for firms to retain control over the process and ensure the economic equivalence of their structured products before and after the transition. Due to the variety of products and structures in the market, it is likely that different approaches for determining the CAS may be appropriate depending on the type of both the instrument and the related derivative, and on the timing of the transition.

    In the case of derivatives and FRNs, the "forward approach" is commonly used to determine a CAS for active transition, as a means to take account of variable LIBOR-OIS spreads over

[35] http://assets.isda.org/media/3062e7b4/bf8c96ca-pdf

the period until the end of 2021, when ISDA fallbacks comprising the fixed ISDA spreads will take effect. Application of this approach in the context of structured products may help to maintain consistency and alignment between different parts of the structure. An analysis of options for determining CAS in the context of active transition for loans is set out the Working Group's paper titled "Credit adjustment spread methods for active transition of GBP LIBOR referencing loans"[36], and may also be helpful in the context of structured products. In particular, please see the table set out in paragraph 24 of that paper setting out an analysis of the approaches adopted for different asset classes (including bonds and derivatives).

b. Fallbacks: As noted above, fallback provisions in structured products vary considerably depending on the vintage of the instrument and the policies of the issuer or arranger, and each product needs to be assessed on a case-by-case basis. The Working Group understands that a significant portion of more recently issued structured products confer some level of discretion on the issuer or the calculation agent, allowing them to make certain determinations upon a cessation or pre-cessation event occurring in respect of the relevant benchmark. The discretion given to the issuer or the calculation agent may result in differences of approach to determining the CAS between products.

   The Working Group has recommended the use of the historical five-year median spread adjustment methodology as the preferred fallback for cash products maturing beyond end-2021.[37] This is consistent with the methodology adopted for derivatives under the ISDA Protocol and IBOR Fallbacks Supplement. To the extent that the terms of a structured product grant the issuer or calculation agent discretion relating to the determination of the CAS, such parties may wish to consider adopting the historical five-year median spread adjustment methodology, as recommended by the Working Group and adopted in the ISDA Protocol.

2.3 Consent solicitation

27. The Working Group has welcomed[38] consent solicitation as a way to transition many legacy bonds from GBP LIBOR to SONIA. Given previous coverage from the Working Group,[39] this section does not intend to cover the subject of consent solicitation in-depth, and instead highlights some key points which may be relevant for consent solicitations in the context of structured products:

   a. Sole or limited security holders: Certain structured products have a limited number of investors, which may result in an easier consent solicitation process – for example, repack securities often have a sole securityholder or a few consolidated professional investors[40] as

[36] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/credit-adjustment-spread-methods-for-active-transition-of-gbp-libor-referencing-loans.pdf

[37] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/recommendation-of-credit-adjustment-spread.pdf

[38] https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/active-transition-of-gbp-libor-bonds.pdf

[39] Working Group paper on active transition of GBP LIBOR referencing bonds:

https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/active-transition-of-gbp-libor-bonds.pdf

Working Group paper on progress on the transition of LIBOR referencing legacy bonds to SONIA by way of consent solicitation:

https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/lessons-learned-from-recent-conversations-of-legacy-libor-contracts.pdf

[40] Working Group paper on considerations for the conduct of consent solicitations to transition English law legacy bond contracts from LIBOR to SONIA:

https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/lessons-learned-from-recent-conversations-of-legacy-libor-contracts.pdf

opposed to a wide ranging investor base and thus the process of identifying and communicating with the relevant securityholders is likely to be less burdensome.

b. Intermediated securities: Retail structured products are often 'buy to hold' products held through third party intermediaries (e.g. private banks and wealth managers). Consideration must therefore be given to how best to engage with these intermediaries and the relevant product manufacturers and distributors. Manufacturers and distributors will need to consider their obligations under the FCA's Product Intervention and Product Governance Sourcebook ("PROD")[41] in terms of consideration of crucial events, engagement with end investors, conflicts of interest, stress testing, communications, target market identification and ongoing review as well as any contractual arrangements between the parties, co-manufacturing arrangements or third country elements.

c. Engagement with additional parties: Structured products such as repack securities issued on an off-balance sheet basis often have multi-layered exposure to IBORs (at both the swap and collateral level) which further complicates the consent solicitation process. With additional parties in the transaction structure (e.g. issuer, trustee, calculation agent, swap counterparty, custodian, ICSDs), there is a greater need for coordination. Full engagement by all stakeholders should be prioritised to ensure the relevant voting, quorum and consent thresholds are met in time. Further operational and practical considerations to ease the consent solicitation process are set out in the ICMSA Bulletin 210118/55.[42]

d. Documentation: The standardisation of disclosure in documentation may help to minimise operational inefficiencies and increase the time available to investors to make their investment decisions and subsequent voting elections. As more consent solicitations are undertaken, issuers and manufacturers may want to align language across their consent solicitation documentation as much as possible, for example, language in respect of the rationale for moving away from GBP LIBOR or descriptions of the pricing mechanism. They may want to look to publicly available market precedents when doing this too. Where amendments are proposed to the terms and conditions of a security pursuant to a consent solicitation, attention should be given to whether any consequential amendments are required, including to the underlying hedging arrangements which may fallback to compounded in arrears SONIA in line with the ISDA Protocol and IBOR Fallbacks Supplement.

28. It is recognised that consent solicitations may not be suitable in all cases, for example, where structured products are held by retail investors, and tracing the widespread investors can be challenging. In such circumstances, issuers may opt to consider other forms of liability management, including tender offers, open market repurchases, offering cash or alternative securities in exchange of the legacy bonds or exercising call options where available, or potentially even a security holder meeting to consider an extraordinary resolution.

29. Market participants are therefore encouraged to consider the feasibility of consent solicitation or other forms of liability management to accelerate the active transition of their securities and associated contracts from GBP LIBOR to SONIA, where it is viable to do so. They are encouraged to plan ahead and commence the relevant process in good time, consider operational efficiencies where possible, prioritise full engagement by all stakeholders and avoid reliance on a legislative solution as far as possible.

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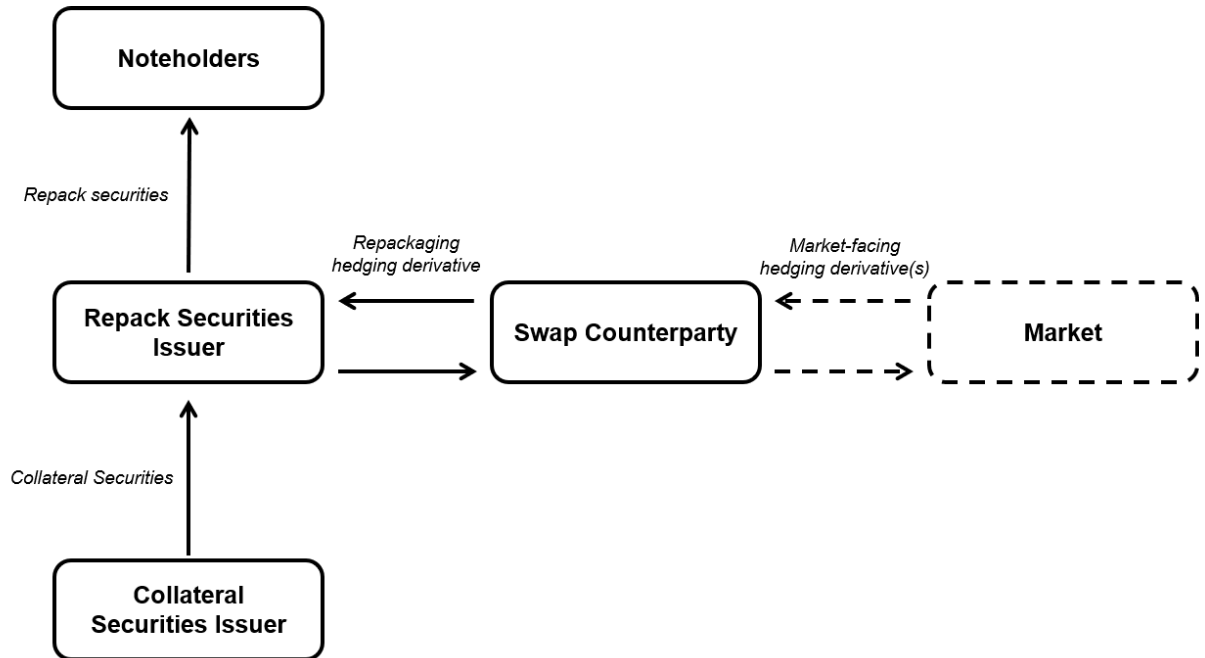
[41] FCA Product Intervention and Product Governance Sourcebook (PROD): https://www.handbook.fca.org.uk/handbook/PROD.pdf

[42] https://icmsa.org/publication/icmsa-bulletin-210118-55-the-discontinuation-of-libor-ibors-operational-and-procedural-considerations-for-consent-solicitations-and-written-resolutions/

Appendix 1: Diagram illustrating a typical repack securities transaction



Appendix 2: Emerging themes for fallbacks in new SONIA-linked issuance

The BMR requires that supervised entity users of all benchmarks must produce and maintain robust written plans setting out their planned course of action in the event of cessation or material change of a benchmark. The Working Group understands that issuers have started to incorporate SONIA-linked fallback provisions into their structured products programmes over the twelve months or so prior to the date of this paper. Developing themes in this area include:

a. General fallbacks for all types of floating rate or benchmark: The latest generation of general fallback provisions sometimes aim to capture not only IBORs as part of the immediate transition, but also replacement rates, including SONIA and other risk-free rates. Examples include 'Benchmark Transition Event' provisions, which often include a sequence of consequences (not all of which would be relevant for a SONIA rate, e.g. interpolation and compounding).

b. SONIA-specific fallbacks: Some issuers are incorporating fallbacks specific to SONIA, whereby if the SONIA rate is not available on the relevant screen page or has otherwise not been published by the relevant authorised distributors, there is a fallback to (i) the sum of the Bank of England's 'Bank Rate' prevailing on the relevant day plus the mean of the spread of the SONIA rate to the Bank Rate, typically over the previous five days on which a SONIA rate has been published (note this has similarities with the ISDA 2020 IBOR Fallback Supplement's GBP LIBOR provisions), or (ii) the rate determined as at the last preceding interest determination date.

c. Discretion: The issuer or calculation agent's discretion frequently appears as the ultimate or penultimate (e.g. ahead of the last preceding rate) limb of fallbacks applicable to reference rates or benchmarks generally. The discretion to select a replacement rate is usually coupled with a discretion to make related adjustments to the terms of the securities that the issuer or the calculation agent determines are appropriate.

d. Allowing for flexibility: Some issuers are including provisions that apply notwithstanding general and SONIA-specific fallbacks, and which allow the calculation agent to follow guidance published by a relevant nominating body at the time and, in some cases, market consensus. In other programmes, the issuer may, when making adjustments to the terms of the instruments, also be required to consider transaction-specific factors such as the issuer's costs and other arrangements (including hedging and/or guarantees).

Appendix 3: Contractual fallbacks in legacy structured products referencing GBP LIBOR

There is a significant degree of variation across fallbacks in structured products programmes, particularly over the last 3-4 years in response to the evolving regulatory landscape and IBOR cessation. Whilst some programmes, particularly off-balance sheet repackaging programmes, contain fallback provisions that are highly bespoke, the Working Group understands that the trend for most structured products programmes has been to include some or all of the Type 1, 2 or 3 fallbacks[43] depending on the vintage.

a. Type 1 fallbacks are generally limited to those under the screen rate or ISDA Determination provisions, triggered by the relevant screen page being unavailable or GBP LIBOR not appearing on the relevant screen page. For screen rate determination, the outcomes may include dealer poll, last preceding rate (effectively meaning notes become fixed rate securities) or as determined by the calculation agent. For ISDA Determination, the outcomes under the ISDA Definitions apply (normally without any supplement following the issue date, i.e. primarily reference dealer determination).

b. Type 2 fallbacks may apply to most types of floating rate, reference rate or benchmark (and where appropriate replacement rates such as SONIA) triggered by (i) actual cessation or (or in some cases anticipatory cessation (i.e. "will cease")) or material change, (ii) statements or publications of information by the administrator of the relevant rate or its sponsor or supervisor announcing actual cessation or material change, or otherwise prohibiting or restricting use, or (iii) it becoming unlawful to use the relevant rate or benchmark. The events are typically contained in "administrator/benchmark event" provisions and, more recently, "benchmark transition event" provisions. The outcomes tend to include (a) in the case of an administrator/benchmark event, calculation agent discretion to substitute or adjust or, failing that, early redemption of the securities and (b) in the case of a benchmark transition event, replacement rate determined by the calculation agent by reference to a hardwired selection (typically featuring an interpolated rate, a risk free rate (on a compounded or term basis), the ISDA rate, a rate recommended by the relevant authority or a rate determined by the Calculation Agent) plus a spread, or an optional or mandatory redemption.

c. Type 3 fallbacks are similar to Type 2 fallbacks, except that the trigger events incorporate a form of pre-cessation trigger (usually a regulator notice that the relevant rate is, or in some cases will become,[44] non-representative at a specified future point).

[43] Note that the categorisation of Type 1, Type 2 and Type 3 fallback has also been used by the Bond Market Sub-Group of the Sterling Risk-Free Reference Rates Working Group to describe floating rate note fallbacks. Fallbacks used in floating rate notes are similar, but not exactly the same as the types of fallbacks typically appearing in structured products.

[44] Whether or not a pre-cessation or cessation trigger is forward-looking is of relevance when considering the impact of the FCA announcement. See: https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf