Active transition of legacy GBP LIBOR contracts

The Working Group on Sterling Risk-Free Reference Rates (the 'Working Group')[1] has published its priorities and roadmap for the final year of transition. For the active transition of legacy GBP LIBOR contracts, across bonds, loans and derivatives, the recommended milestones established by the Working Group are:

- By **end-Q1 2021**, complete identification of all legacy GBP LIBOR contracts expiring after end-2021 that can be actively converted
- By **end-Q3 2021**, complete active conversion of all legacy GBP LIBOR contracts expiring after end-2021 and, if not viable, ensure robust fallbacks are adopted where possible

The Prudential Regulation Authority and Financial Conduct Authority have explicitly supported the Working Group's recommended milestones, including those on active transition, in their March 2021 'Dear CEO' letter.

The Working Group recommends the active transition of contracts ahead of GBP LIBOR cessation as the primary method to ensure contractual certainty and retain economic control. Market participants are strongly encouraged to engage with their financial providers to agree, as soon as possible, when and how their legacy GBP LIBOR contracts will change. This document sets out a range of considerations to help market participants assess and prioritise the active transition of legacy GBP LIBOR contracts to SONIA.

On 5 March 2021, the Financial Conduct Authority announced cessation dates for all panel bank LIBOR settings. ISDA confirmed that the announcement constituted an 'Index Cessation Event' under its IBOR fallbacks, which triggered the fixing of its 'spread adjustments' published by Bloomberg. The Working Group formally recommended the same Credit Adjustment Spread methodology for fallbacks in cash products referencing GBP LIBOR where the relevant language exists.

These developments have increased the sense of urgency to complete the transition away from GBP LIBOR ahead of cessation at end-2021. They have also created a clear economic link between GBP LIBOR and SONIA-referencing contracts, providing clarity and confidence for market participants to engage in discussions on the active transition of legacy GBP LIBOR contracts that expire after the end of 2021. SONIA based products are now being widely used across all core sterling markets, providing a solid and established foundation for legacy GBP LIBOR contacts to be transitioned to. And for those contracts where industry standard recommendations are appropriate (e.g. on spread adjustment), steps to administer the relevant changes are now clearer.

The Working Group encourages market participants to address GBP LIBOR exposures via a risk-based approach, as recommended in the March 2021 'Dear CEO' letter, by prioritising the amendment of contracts which do not contain or have not yet adopted robust fallback arrangements. In many circumstances, this will apply to legacy GBP LIBOR-linked bonds and loans. When transitioning these contracts to a SONIA basis, market participants may wish to consider the potential benefits of active transition to SONIA, rather than via the adoption and execution of contractual fallbacks.

In addition, contracts which already include fallback provisions should be carefully assessed to determine their effectiveness and suitability. In the Working Group's view, existing fallback provisions, unless they are contractually robust and specifically anticipate the envisaged end of GBP LIBOR, should not be relied upon as a primary method of transition from GBP LIBOR to SONIA or alternative reference rates. The Working Group has published papers which provide considerations on the active transition of GBP LIBOR referencing bonds and loans. In particular, for the GBP bond market, issuers and investors should be aware of potentially long lead times in consent solicitations and capacity constraints, and are encouraged to prioritise accordingly. For GBP LIBOR referencing loans, the Working Group has also published a paper to assist borrowers and lenders when they engage and discuss how to approach the differences between GBP LIBOR and SONIA when considering active transition mechanisms.

In the case of derivatives, widespread coverage of ISDA's IBOR fallbacks has provided a safety net for the large majority of GBP interest rate derivative contracts. Nonetheless, market participants are encouraged to make an active and informed decision on how these contracts are transitioned. The Working Group has concluded that there are a number of advantages to transitioning these contracts actively rather than relying on ISDA's IBOR fallbacks, including where they may be directly hedging cash products, but these will vary on a case-by-case basis. Annex 1 provides a comparison across a range of factors between reliance on ISDA's IBOR fallbacks and the active transition of legacy GBP bilateral swap contracts.

Annex 1 – Considerations between reliance on ISDA's IBOR fallbacks and active transition for GBP bilateral swaps

Comparisons made using a RAG (Red-Amber-Green) rating. ***Green*** *– potentially positive consequence;* ***Amber*** *– potentially less positive consequence and/or risk.*

Considerations	ISDA's IBOR Fallbacks	Active Transition
Consistency with existing RFR market conventions vs fallen back trades	Fallbacks employ a 2-day backward shift methodology which is not consistent with current OIS market conventions.	Maintains consistency with current market OIS conventions and allows parties to retain economic control over their contracts.
	Fallen-back trades are not eligible for clearing.	New contracts using the market conventions can be cleared.
Resource requirements	ISDA fallbacks provide an efficient route to amend a large number of contracts at once.	Individual renegotiation potentially time consuming for large portfolios.
	System development may be required to book and value trades.	Consistency with existing OIS trades may minimise system changes.
Operational risk	Reliance on counterparties/third parties, including risk resulting from inadequate or failed processes and systems.	Changes can be implemented over a longer period to test approach.
	A 'big bang' approach means that operational risk may be highly concentrated at or around the Cessation Effective Date (31 December 2021)[2]	Individual amendments can give rise to operational risks, but less so compared to a 'big bang' approach.
Trading cost	The spread component of the ISDA fallback is now fixed. Those who adhered to the ISDA protocol will have their positions converted automatically.	The fixing of the ISDA 'spread adjustment' should reduce bid/offer charges incurred to close and re-book positions
Alignment with hedges	Imperfect alignment as hedges may have different fallbacks (e.g. between asset classes).	Hedges can be renegotiated at the same time to maintain alignment.
Liquidity	Potentially less liquidity for uncleared swaps that are fallen back compared to swaps with standard OIS conventions.	With active transition, the parameters of the trade can align to standard OIS conventions.
		LIBOR liquidity may change as activity shifts to SONIA-referencing markets, which may affect contracts actively transitioning from LIBOR as end-2021 approaches.

Notes

[1] The Bank of England and the Financial Conduct Authority (the "FCA") are each ex-officio members of the Working Group. Market participants should note that the views and considerations 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. In addition, 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] See the Working Group's paper on 'Operational considerations for fallbacks in uncleared linear derivatives' for further details