



Paper on the identification of Tough Legacy issues

The Working Group on Sterling Risk-Free Reference Rates

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Foreword

The Tough Legacy Taskforce (**Taskforce**) was established to deliver one of the key priorities of the Working Group on Sterling Risk-Free Reference Rate (**RFRWG**), namely to provide market input to help identify issues around 'tough legacy'. This is in response to Andrew Bailey's call for a more public debate around the potential outcomes for legacy contracts that prove unable to convert or be amended to include fallbacks ahead of LIBOR discontinuation.¹

As per the Terms of Reference, this paper considers:

- market participants' expectations for the scope of products across markets which may be at risk of forming part of the 'tough legacy' category;
- specific issues which mean certain contracts are less likely to be able to convert;
- the likely market outcomes in relation to those contracts in the event of LIBOR cessation; and
- the range of potential options suggested by market participants for mitigating those outcomes, with consideration of their benefits and risks, and limitations around their effectiveness and feasibility.

The Bank of England and the FCA are each ex-officio members of the RFRWG. Market participants should note that the views and considerations set out in this paper do not constitute guidance or legal advice from the Bank of England (including the PRA) or the FCA nor are they necessarily endorsed by the Bank of England (including the PRA) or the FCA.

Statement on the identification of 'tough legacy' contracts across asset classes

The RFRWG's mandate is to catalyse transition from LIBOR to SONIA in sterling markets, and its **overarching view remains that firms should proactively remove LIBOR dependencies from their contracts before the end of 2021**, after which LIBOR may no longer continue. This may be done through amending a contract to reference a suitable alternative rate, or using a robust fallback that enables the contract to move to a suitable alternative rate upon an appropriate event.

The work of the RFRWG, and its Subgroups and Taskforces, to support active transition of legacy contracts remains of key importance, as reflected in the RFRWG's 2020 priorities. The RFRWG believes that active transition of legacy LIBOR positions is the only way parties can have certainty over both the continued operation and the future economics of their contracts. Any alternative solution, including any proposals discussed in this paper, is not certain to succeed and may not be economically neutral or suitable for particular contracts. Accordingly, the approaches explored in this paper are relevant only for those contracts that cannot be dealt with in any other way (and the scope of "tough legacy" contracts should be understood in this context), given the significant drawbacks of relying on such approach.

To determine the market segments where tough legacy issues may arise, the primary considerations of the Taskforce have been:

- (i) the outcome achieved through existing contractual fallbacks;
- (ii) how practicable it is to amend the contract in question, either to replace LIBOR directly or otherwise to insert a new fallback; and
- (iii) whether there are linkages with other possible tough legacy contracts.

The focus of the Taskforce has been on sterling LIBOR in the first instance, but the group has also considered the exposure of UK and non-UK market participants to LIBOR settings in other currencies under contracts governed by the laws of England and Wales (**English law**).

The Taskforce has concluded that, in their view, there **is a case for action** to consider what can be done to address tough legacy LIBOR exposures in the UK. This case differs by asset class, and is driven by the nature of, and linkages between:

¹ <https://www.fca.org.uk/news/speeches/libor-preparing-eng>

- the contracts involved (and so the ability or otherwise to amend the terms);
- the practical challenge of amending a large number of contracts in a relatively short period of time; and
- the potentially material adverse economic implications should such exposures not have transitioned on or before LIBOR ceases to be published.

In addition, the group considers there is a particular case for action to help ensure fair and consistent outcomes for customers that have tough legacy exposures.

The case for action has been strengthened by the market impact of the COVID-19 pandemic. While the deadline for the market to be ready for the cessation of LIBOR by the end of 2021 remains the same, there is less time available in practice to meet it.

To the extent that action can feasibly be taken, and accepting the challenges and dependencies required in delivering it, the Taskforce proposes that the UK Government considers legislation to address tough legacy exposures in contracts governed by English law that reference at least sterling LIBOR, and ideally other LIBOR currencies, that are still in operation when LIBOR is expected to cease on or after the end of 2021.

The Taskforce has noted, in particular, the proposal for legislative relief under New York law put forward by the ARRC.² The Taskforce considers that a similar approach for contracts governed by English law would, assuming the ARRC work continues, help to bring about international consistency in the treatment of tough legacy contracts. Given the time constraint, the Taskforce considers that any work on an official sector solution would need to begin as soon as possible, and should not wait for the outcome in the US.

However, while the Taskforce has a preference for a legislative solution of some kind, it recognises that there is no guarantee that such a solution will materialise, that it will materialise across all relevant legal jurisdictions, or that it would be available for all products and circumstances (and COVID-19 may well introduce further constraints on this). The Taskforce also recognises that any potential solution will not necessarily be able to deliver the desired economic basis of the contract and should therefore not be relied upon for any contracts which are not genuinely stranded. Consequently, the Taskforce recommends that:

- **Other solutions to the tough legacy problem should be pursued in parallel.** For example, the Taskforce has considered the scenario of LIBOR being stabilised via a so called 'synthetic methodology' for a wind down period following panel bank departure (which is expected to happen at some point after the end of 2021) especially if those departures put LIBOR at risk of being unrepresentative under the EU Benchmark Regulation (**EU BMR**). The Taskforce noted that this scenario would require either an administrator willing to modify the methodology for LIBOR and/or potentially official sector intervention to modify it; and it would be important that the rate could be used in existing contracts without those contracts needing to be changed.
- **In any event, the Taskforce calls on market participants to focus primarily on active transition.** Proactive transition of contracts away from reliance on LIBOR ensures that parties to the transaction have control over the timing and substance of the transition. This is the only way for parties to have certainty over their contracts.

Section 1: Characteristics of 'tough legacy' contracts across asset classes

Derivatives

The Taskforce considers that derivatives contracts **may** be tough legacy contracts, but this position depends of course on the circumstances.

Parties to uncleared derivatives are able to pro-actively negotiate on a bilateral basis or multilateral basis (e.g. through compression) to amend or replace contracts such that their LIBOR-based exposures are changed to an RFR, or other basis. These pro-active approaches are considered a better means for transition compared with the use of a trigger to activate a fallback rate (on LIBOR's

²https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Press_Release_Proposed_Legislative_Solution.pdf

cessation or otherwise). This may be particularly true in relation to certain types of derivatives (such as non-linear products).

Parties to uncleared derivatives are also able to embed new fallbacks via adoption of the expected ISDA IBOR Fallback documents or by means of bilateral negotiation, while the clearing houses have announced their intention (subject, in some cases, to consultation) to incorporate fallbacks for derivatives subject to clearing into their rulebooks, comparable to those published by ISDA.

Parties to derivatives can also use basis swaps, compression and other methods to pro-actively convert LIBOR exposures into RFR exposures.

Therefore, many derivatives **will not** be 'tough legacy' contracts. However, the Taskforce recognises that adoption of the ISDA IBOR Fallback Protocol is voluntary for uncleared derivatives. In addition, the Taskforce considers there are likely to be cases where a derivative is used to hedge an exposure which is itself considered tough legacy or forms part of a more complex structure, where the derivative is subject to the same or similar constraints as the instrument it is used to hedge, thus making the derivative tough legacy as well. In addition, the Taskforce recognises that for non-linear products, fallbacks are quite possible but may require additional amendments to supplement the amendments made by the ISDA IBOR Fallback Protocol.

Accordingly, while the Taskforce considers that the primary mechanism for transition should be for parties to pro-actively amend their derivatives positions and/or adopt suitable fallbacks (via the ISDA IBOR Fallback Protocol or otherwise), it considers there **is a case for action** to address tough legacy exposures in the derivatives market.

Bonds

The tough legacy issues in the bond market are well understood through previous work of the RFRWG's Bond Market Subgroup. The fallback provisions in legacy bonds are problematic because:

- they do not contemplate the permanent discontinuation of LIBOR, and ultimately rely on the application of the last available LIBOR fix for the remaining life of the bond (effectively turning floating rate instruments into fixed rate instruments), which poses a risk of market disruption³;
- they involve the exercise of discretion within certain parameters, which may not be straightforward; or
- in a small number of cases there are no fallback provisions at all.

Consent solicitation has been used to transition a small number of legacy bond contracts, including securitisations, to alternative rates. The RFRWG continues to encourage market participants to transition their legacy bonds actively wherever possible. The Cash Market Legacy Transition Taskforce is producing materials to support this. However, the Tough Legacy Taskforce recognises that the use of consent solicitations to transition the whole of the legacy LIBOR bond market is unlikely to be feasible because it may not always be possible to obtain the requisite consent from bondholders. In addition, it is very unlikely to be possible to transition all affected legacy bonds in the time available, recognising that consent solicitation can be a long and costly process.

In addition, within more complex arrangements (such as securitisations or repackagings), there are additional difficulties where the originator or sponsoring entity no longer exists or is insolvent, or where the economic interest in the transaction has been sold to a third party. This means active transition becomes more difficult as there is no longer a decision maker, nor a party willing to assume the costs of amendment.

The Taskforce considers that there may be some cases within the securitisation or repackaging markets where transition is more straightforward, for example those that have call dates between now and end-2021, more recent transactions which include negative consent language, or in some cases retained transactions. However, the Taskforce also recognises there may be good reasons why, notwithstanding these features, deals with pre-end 2021 call dates are not called, or where negative consent mechanics are unsuccessful – for example where enough investors object to the changes proposed by the issuer and so a full vote is required. Accordingly, the Taskforce considers that there **is a case for action** to address tough legacy exposures in the bond market.

³ Subject to obligations of agents to attempt to obtain quotations, which are unlikely to be provided.

Loans – syndicated and bilateral

In the syndicated loan market, more recent facility agreements have a ‘replacement of screen rate’ clause, which contemplates replacement of the screen rate upon a discontinuation of that rate (with majority lender and borrower consent). However, some older legacy loan documentation does not contemplate replacement of the screen rate and requires all lender and borrower consent to amend the facility agreement to transition to an alternative rate.

If the required consents are not obtained, the ultimate fallback in many syndicated lending agreements is to an individual lender’s cost of funds. The Taskforce has concluded that such fallbacks are likely to be problematic for both lenders and borrowers for a range of reasons (including the difficulty of calculating the relevant cost).

The nature of the bilateral loan market means there is less standardisation of terms, and therefore a very wide variety of fallback language across a high volume of individual loans. This may include the lender’s cost of funds as the ultimate fallback. For a large number of bilateral loans provided on standard (short) form documentation, there is no fallback and consent of both borrower and lender is required to amend those contracts. The borrowers are typically less sophisticated in the bilateral market and, in general, they are less attuned to LIBOR transition. This may create an additional challenge when seeking borrower consent to amend the contract. In comparison, the syndicated market tends to involve larger, more sophisticated borrowers who are more engaged in LIBOR transition.

The Taskforce is concerned that the very large number of bilateral and syndicated loan contracts, the diverse nature of the borrowers, questions of cost, resource availability and other challenges to transition (e.g. creditor standstills, financial restructurings or insolvency proceedings) means that the renegotiation of all these contracts on an individual basis ahead of end 2021 creates practical difficulties for market participants.

Therefore, while the Taskforce supports fully the drive of the RFRWG for market participants to transition their legacy loan contracts proactively (and the production of materials to support this by the Cash Market Legacy Transition Task Force), the group has nevertheless concluded that there **is a case for action** to address tough legacy exposures in the loan market.

Mortgages

The tough legacy issues in the mortgage market are contained and well understood. The terms of the small number of sterling LIBOR mortgage contracts are wide ranging as there is no universally accepted standard wording used. Many contracts have weak variation clauses which do not anticipate a discontinuation of LIBOR. Some have no fallback provisions at all.

In some cases, lenders could seek variation by agreement to add necessary contractual provisions. However, the lender may not be able to gain consent from customers to vary; further, variation by agreement could result in a new mortgage contract, which not all of the relevant firms have the regulatory permissions required to enter into.

Despite the relatively small number of sterling LIBOR mortgage contracts, given the presumed difficulty of reaching agreement with all impacted mortgage customers, the nature of these customers (often individuals, who are generally not actively engaged in LIBOR transition) and the potential for harm if their mortgage contracts are not transitioned to an appropriate rate, the Taskforce considers that there **is a case for action** to address tough legacy mortgage exposures.

Common characteristics across asset classes

The Taskforce has identified certain features within an asset class that may create specific tough legacy issues, but notes that, in summary, there are common characteristics that make contracts more difficult to transition, regardless of the asset class, including:

- **Within more complex or structured transactions or arrangements**, there may be LIBOR references in one or all constituent elements (for example the underlying financial contracts or collateral, derivatives and/or the main financing itself). Therefore, they typically inherit the characteristics of the most difficult constituents. Amendments would often be needed to all elements to avoid mismatches in cashflow; for example, inter-creditor agreements would typically preclude unilateral action to adjust interest terms by a creditor or creditor group.

Reliance on fallback provisions in individual constituent elements would likely result in cash flow mismatches, potentially introducing instability into structures.

- **Where the distribution of a product is broad** e.g. syndicated loans and bonds with a wide investor base, there are additional complications with obtaining the necessary consent, as opposed to narrowly distributed products such as bilateral loans or retained securitisations.
- **The volume of outstanding contracts** creates a practical issue for transitioning contracts which may not otherwise be considered 'tough legacy'.
- **The nature of the customers** e.g. retail holders of mortgages or bonds.

Exposures to other LIBOR currency settings

As part of the RFRWG, the Taskforce has focused primarily on sterling LIBOR exposures. However, the group notes that, in general, exposures to US Dollar LIBOR exceed (in places greatly) the exposures to sterling LIBOR for UK market participants. The group also notes that English law is used extensively to govern financial contracts denominated in different LIBOR currencies, and there would be significant benefits associated with a consistent approach being applied across legacy exposures to different LIBOR currencies.

Accordingly, the Taskforce advocates that any consideration of action to address tough legacy exposures covers, or takes into account, contracts governed by English law denominated in any LIBOR currency.

Exposures within commercial contracts

The RFRWG's mandate is to catalyse a broad-based transition to using SONIA as the primary sterling interest rate benchmark in bond, loan and derivative markets. However, for completeness, the Taskforce notes there may also be instances where LIBOR is referenced within commercial contracts maturing beyond end-2021.⁴ It is difficult to determine the extent to which these other uses of LIBOR may create 'tough legacy' exposures, and in many cases firms may not have a mechanism for identifying them. Therefore, the Taskforce highlights that a way to deal with LIBOR-references in commercial contracts maturing beyond end-2021 may be helpful in situations where no fallback was envisaged in the original contract, and the parties cannot agree an appropriate alternative.

Section 2: Outcomes sought in respect of tough legacy contracts

The Taskforce recommends that to the extent official sector intervention is feasible, the following outcomes are desirable:

- The Taskforce considers that cooperation across jurisdictions is important as LIBOR is used globally. Therefore, coordination with other national working groups, and across the international official sector is required. The Taskforce notes that it would be helpful if contracts referencing US dollar LIBOR under English law could be treated in broadly the same way as legacy LIBOR contracts referencing US dollars under New York law. However local differences across products would also need to be taken into account, as necessary. For example, the ultimate fallback right now for Libor referencing loans issued under English law is typically cost of funds, whereas for loans in the US market, it is typically to the prime rate.
- The Taskforce notes therefore that there may be some potential benefits were a 'synthetic' methodology for LIBOR at source to be achievable for a wind down period beginning after the end of 2021, given the challenge of legislating in multiple jurisdictions within the time available.
- The Taskforce considers that careful thought is needed in relation to the triggers, economics and legal implications for market participants of any solution. Given that derivatives markets will move to backward looking, compounded rates, but many cash market participants may prefer contracts where the rate continues to set in advance to the extent feasible (as the current contracts do), balancing contract continuity with the desirability of easy hedging across asset classes will be critical.

⁴ For example, price escalation clauses or conditional / penalty clauses.

- This highlights the challenge the Taskforce has identified with any “one size fits all” solution – this may not be desirable, reinforcing the benefits of active transition wherever possible.
- The Taskforce believes that the tax, regulatory and accounting consequences of any solution need to be considered, to ensure they are addressed through the existing work of the official sector and relevant standard setting bodies.

Section 3: Taskforce recommendations on further areas for consideration

While not directly in scope of the Taskforce’s work, the discussions of the group have given rise to additional points that Authorities may wish to consider in the context of transition.

Firstly, it would be helpful if regulatory or legislative assistance could be provided to reduce the burden on agents or any other party contractually obliged to seek quotations under fallback language, which are highly unlikely to be given if LIBOR is discontinued. This mechanism was only intended for occasional rate unavailability and not permanent cessation. Without such assistance, discharging this obligation could cause delay, operational risk, and confusion, before an ultimate fallback is reached.

Secondly, the Taskforce again reiterates the point made by the Regulatory Dependencies Taskforce that the nomination of a replacement rate by Authorities, or by the relevant national working group, would be helpful in the operation of fallbacks which refer to such nomination, or otherwise rely on the exercise of discretion by one party.⁵

⁵ <https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/wgrfr-letter-to-financial-conduct-authority.pdf?la=en&hash=671353764364BCB708874A5728C4931AB1BEA2A1>

Section 4: Summary of Tough Legacy Taskforce analysis

	Fallback	Amendment	Linkages
Derivatives	<ul style="list-style-type: none"> Fallback to bank quotes – not a reliable medium / long term option as bank quotes are unlikely to be provided post-LIBOR cessation 	<ul style="list-style-type: none"> ISDA protocol / comparable approach by clearing houses Some counterparties may desire additional amendments to supplement the new fallbacks to be implemented via the IBOR Fallback Protocol e.g. non-linear products Otherwise parties can amend bilaterally to convert to new rates or include new fallbacks. 	<ul style="list-style-type: none"> Loans or bonds in a hedging relationship May form part of a complex structure*
Bonds	<ul style="list-style-type: none"> Pre-2017 fallback to a fixed rate Some have no fallback 	<ul style="list-style-type: none"> Some securitisations have outstanding call options, and some are retained transactions Some more recent securitisations have negative consent language, intended to make amendment easier Consent solicitation possible for some but likely not all High consent thresholds Some bonds widely held Not enough time to transition all affected bonds by consent solicitation In some cases, the sponsor for a securitisation or repackaging may no longer exist or is insolvent, meaning no decision maker or party willing to assume costs of amendment 	<ul style="list-style-type: none"> Derivatives in a hedging relationship May form part of a complex structure*
Loans – syndicated	<ul style="list-style-type: none"> Some do not have fallbacks LMA documentation contains ultimate fallback to cost of funds (but this is problematic) 	<ul style="list-style-type: none"> Unanimous consent of all parties needed to amend⁶ Practical / timing constraints 	<ul style="list-style-type: none"> Derivatives in a hedging relationship May be part of a complex structure*
Loans – bilateral	<ul style="list-style-type: none"> No standardisation of documentation Some will have no variation provisions / fallbacks Some use cost of funds 	<ul style="list-style-type: none"> Bilateral amendment by consent needed Lender may not be able to reach borrower / borrower may not agree or engage Practical / timing constraints 	<ul style="list-style-type: none"> Derivatives in a hedging relationship May be part of a complex structure*
Mortgages	<ul style="list-style-type: none"> No standardisation of contract terms Some contracts do not have fallbacks / variation terms 	<ul style="list-style-type: none"> Bilateral amendment by consent needed Lender may not be able to reach borrower / borrower may not agree or engage Lenders may not have relevant permissions if amending the contract results in entering into a new regulated mortgage 	<ul style="list-style-type: none"> May be part of a complex structure*

* Where you are dealing with a more complicated / structured arrangement, there may be embedded tough legacy derivatives or underlying financial contracts or collateral (each of which might have different fallbacks). Amendments may therefore be needed to derivative agreements, notes and/or the main financing itself, which would require consent.

⁶ Some have a majority lender