Linklaters

Mainstream debt issuance from January 2021: Themes for the year ahead
January 2021

In this edition of our annual note, we provide a high-level summary of some of the topics we expect to be on the agenda for mainstream debt issuance from January 2021.

Post-Brexit divergence

With the Brexit transition period reaching its end at the end of 2020 and the EU and UK having announced agreement on a Trade and Cooperation Agreement (the "**TCA**") (from which, as expected, financial services are largely excluded) it will be important to keep a close eye on future divergence in financial services regulation in the EU and the UK and its impact on debt capital markets.

For further information on the TCA see The future relationship between the EU and the UK: the Trade and Cooperation Agreement (30 December 2020).

The European Union (Withdrawal) Act 2018 provides for the on-shoring in the UK of the EU prospectus regime, and other regimes applicable to securities offerings (including the transparency directive, PRIIPs, MiFID product governance and MAR), with exemptions to the requirement to produce a prospectus which mirror those in the EU prospectus regime. This mechanism means that for most market participants offering wholesale debt securities, the immediate impact of the end of the Brexit transition period on transaction execution and documentation is expected to be limited.

For further information on the end of the Brexit transition period and practical implications for wholesale debt issuance see End of the Brexit transition period: considerations for mainstream DCM (December 2020).

As well as becoming familiar with the implications of the separation of the EU and UK regulatory frameworks applicable to wholesale securities offerings, market participants will need to monitor future developments at an EU and UK level to ensure that any divergence does not create additional burdens or costs in a well-functioning market.

We summarise below some areas to look out for on the EU and UK side.

What's on the horizon in the EU?

In July, the European Commission introduced a set of "quick fix" proposals to support market recovery following Covid-19. This included targeted amendments to MiFID product governance and the EU Prospectus Regulation.

With political agreement having been reached between the co-legislators in December, the MiFID quick fix proposals are expected to be adopted early in January 2021 (but not becoming applicable in the EU until early 2022). The agreed text, which was subject to much negotiation, includes a carve-out from the product governance regime for (a) bonds with no other embedded derivative than a make-whole clause and (b) financial instruments distributed to eligible counterparties.

A wider MiFID II review by the European Commission in 2021 may re-assess whether other instruments should also be excluded from scope.

At this stage, it seems likely that these targeted alleviations to MiFID product governance will have little impact on the distribution of bonds with a make-whole clause until the scope the PRIIPs Regulation is also clarified in this respect. Currently, there is no concrete proposal for an amendment to the scope of packaged products pursuant to the PRIIPs Regulation, however the Commission, in its explanatory memorandum to the quick fix proposals in July, acknowledged that to achieve the stated aim of making more plain vanilla corporate bonds available to retail investors, there would also need to be a clear rule that a make-whole clause does not of itself make a simple corporate bond a PRIIP.

The proposed changes to the Prospectus Regulation include the introduction of a new EU Recovery Prospectus which will be available for secondary issuances of shares but which will not impact the wholesale debt markets.

The timing of the application of the quick fix proposals means that neither the MiFID II product governance exemption nor the EU Recovery Prospectus will be automatically incorporated into UK domestic law.

The European Commission has also made proposals for changes to the European Benchmarks Regulation including to provide for the orderly wind-down of certain benchmarks which would include LIBOR. These changes are expected to be adopted early in 2021; thus, amending the Benchmarks Regulation as it applies in the EU only and not the UK.

In the context of mainstream debt capital markets, the main impact of the changes will be in relation to in-scope legacy LIBOR contracts once LIBOR ceases to be published or is deemed to be unrepresentative. The UK on-shored version of the Benchmarks Regulation is also expected to be amended to address LIBOR cessation but in a different manner. Consequently, this will require a careful review of the scope of each piece of legislation and its application to legacy bond transactions to identify any possible overlaps or conflicts. For more information see Interest Rate Reform.

For further detail on upcoming regulatory change affecting the financial services see our Financial Regulation Horizon Report 2021.

What can we expect in the UK?

A broad programme of work is underway to shape the future of financial services regulation in the UK following the end of the Brexit transition period. This will impact all financial entities that operate in the UK's financial system.

On day one post the Brexit transition period, the UK regimes applicable to debt capital markets mirrored their EU counterparts. However, we have already started to see indications from the UK government regarding areas where we can expect divergence, some of which will have an impact upon the debt capital markets.

The UK government launched its Future Regulatory Framework Review: Phase 2 consultation paper in October 2020 on how financial services policy and regulation are made in the UK. Read a summary of the paper on our knowledge portal.

The draft Financial Services Bill 2019 ("**FS Bill**") is the first step in shaping a regulatory framework for the UK financial services sector outside the EU, intended to maintain the competitiveness of the UK financial services sector. See The Financial Services Bill: What you need to know for more information.

Topics to look out for which are expected to have implications for the wholesale debt market include:

> **UK PRIIPS** – HMT has indicated an intention to depart from EU PRIIPs in its July 2020 policy statement, and in the draft FS Bill. The precise nature of such divergence will be determined by the FCA pursuant to powers conferred on it under the proposed FS Bill.

> **UK Benchmarks Regulation** – the FS Bill will also give the FCA a toolkit of additional powers to oversee an orderly transition away from LIBOR. For more information see Interest Rate Reform.

During 2021, we also expect the FCA to start a holistic review of the UK MiFID regime, which could have implications for bonds.

Further, a UK Listings Review: Call for Evidence was launched in November 2020 as part of a plan to strengthen the UK's position as a leading global financial centre. Whilst its focus is primarily on the UK equity market, its objective is to encourage deeper capital markets and generate momentum beyond the listings regime itself. With the deadline for responses set for early January 2021, ICMA has submitted a response focussed on the UK prospectus and related regimes as they apply to debt securities, emphasising the need to preserve the smooth functioning of the pan-European wholesale market for new bond issues and suggesting certain targeted improvements to the UK regime.

The other area of focus will be any divergence when it comes to ESG-related initiatives. There is a huge range of regulatory developments upcoming in this area on the EU side, not all of which will be automatically adopted in full in the UK. The Chancellor has outlined plans intended to position the UK at the forefront of green finance, including indications of areas where the UK government anticipates divergence from EU regulatory initiatives.

Whilst these initiatives may not directly impact participants in the debt capital markets, they present a further illustration of areas in which the market can expect divergence between the EU and UK and highlight the need for market participants to keep a careful watch on proposals at an EU and UK level going forward.

Market participants in the increasingly significant area of ESG finance will need to continue to ensure that ESG factors are addressed in prospectuses to the extent required by the Prospectus Regulation (EU or UK) – broadly, where they relate to the use of issue proceeds or have a significant effect on the financial position, or credit, of the issuer. Inclusion in a prospectus of other ESG information will not only add to cost but will often be unnecessary as it will be made by the issuer in other places, such as its annual report or website.

For more information see Green, social and sustainable finance.

Interest Rate Reform

Developments in interest rate reform have continued apace in 2020 despite the global pandemic. In 2021, we can expect a further proliferation of consultations, milestones and guidance to keep on top of. Here we break down some of the key themes relevant to debt capital market participants.

Updating MTN programmes in 2021: Where are we now with conventions for new RFR linked FRNs?

For issuers updating debt issuance programmes in early 2021, careful consideration of future issuance plans remains prudent. Whilst there still remains some divergence in the conventions being used for risk-free reference rate floating rate notes ("**FRNs**"), issuers who expect to issue floating rate products may wish to retain flexibility to select different options during the coming year.

For SONIA issuance, whilst the majority of FRNs in issue have adopted the compounded daily rate methodology with an "observation period lag" (typically five days), the publication by the Bank of England of its SONIA Compounded Index has resulted in some more recent issuance (most notably from EIB and EBRD) adopting a slightly different methodology known as the "observation period shift" to take advantage of the new index. This facilitates an easier calculation and reconciliation of the interest rate for each interest period. Issuers of SONIA FRNs may wish to retain the flexibility to issue using either of these conventions for the foreseeable future.

In the SOFR market, where divergence of conventions has been greater, potential issuers will need to keep a close eye on prevailing conventions ahead of any new issue. This may result in SOFR provisions in any debt issuance programme continuing to provide for a wide range of optionality, including a simple average, daily compounding, payment delay, a lag (also known as lookback) or an observation period shift. As with the Bank of England, the Federal Reserve Bank of New York commenced publication of SOFR Averages and Index during 2020. Sufficient momentum has not yet built up around usage of the SOFR Index to indicate that this will be the preferred mechanic for all SOFR FRN issuance going forward.

In each case, developments in other asset classes such as loans and derivatives may also have implications for the choices made by individual issuers.

With EURIBOR set to continue for the foreseeable future, the €STR FRN market remains in its nascence, however the small number of €STR FRNs in issue have followed similar conventions to those in the SONIA market.

Unfortunately for those drafting or reviewing terms and conditions for FRNs, this lack of uniformity means that, at least in the short term, programmes for issuers expecting to issue FRNs will need to continue to provide for a certain amount of optionality resulting in increased complexity.

Transition away from LIBOR: Bond consent solicitations

The fourth quarter of 2020 saw a number of UK financial institutions successfully complete consent solicitations to change the reset reference rate on existing capital securities from a LIBOR linked mid-swap rate to a SONIA linked mid-swap rate plus an adjustment spread (with an adjustment being made to reflect the economic difference between the LIBOR linked mid-swap rate and SONIA linked mid-swap rate). Most recent transactions to amend the reset reference rate for capital securities have referenced the five-year historic median approach, as adopted by ISDA in its fallback rates, for calculation of the adjustment spread. It remains to be seen whether this methodology is considered most appropriate for capital securities only, or whether the five-year historic median approach to calculation of the adjustment will now be adopted by issuers of other types of GBP LIBOR-referencing securities.

With the Working Group on Sterling Risk-Free Reference Rates encouraging issuers to accelerate reduction of GBP LIBOR-referencing contracts by end-Q1 2021 and complete active conversion where viable by end-Q2/3 2021 (Working Group latest priorities and roadmap for 2020-2021 (September 2020)) we can expect to see further consent solicitations and potentially other liability management transactions in 2021.

Tough legacy: legislative proposals

For those legacy FRNs which cannot be transitioned away from LIBOR prior to its anticipated cessation, the market continues to look to the various legislative solutions that are being proposed to facilitate the orderly wind down of this critical benchmark.

The three key proposals are for: (i) amendments to the UK on-shored version of the EU Benchmarks Regulation via the FS Bill to provide for the potential publication of certain LIBOR settings in a “synthetic” form for legacy transactions; (ii) amendments to the EU Benchmarks Regulation to provide for a contractual override in certain circumstances; and (iii) the ARRC proposal for NY state legislation in the US which would provide for a mandatory contractual override for certain NY law governed contracts referencing USD LIBOR. Each of these initiatives is at a different stage and their final scope remains subject to further development in each case. In the meantime, we expect market participants will continue to explore alternative options to reduce reliance on LIBOR where possible, in line with the recommendations from the official sector, rather than wait for legislation to deliver a solution.

Upcoming milestones: what to look out for?

January 2021 will be a busy month in interest rate reform, with key consultations from each of the FCA, ICE Benchmark Administration (“**IBA**”) and the Working group on euro risk-free rates, all drawing to a close. See the table adjacent for details of key consultations.

In addition, 25 January 2021 marks the effective date for the ISDA IBOR Fallbacks Supplement and IBOR Fallbacks Protocol.

The results of the IBA consultation and follow-up will start to provide market participants with a more complete timeline for the expected cessation of the different LIBOR settings.

The FCA consultations are the first of a number of consultations and policy statements anticipated by the FCA in advance of any exercise of its powers pursuant to the FS Bill in relation to the wind down of LIBOR. The effective date for ISDA fallbacks will mark a major milestone in the effort to transition derivatives markets from reliance on interbank offered rates.

In relation to EURIBOR, whilst it will be important for market participants to monitor the results of the consultations and ensure that contractual fallbacks to any new EURIBOR-linked products reflect the outcomes, the focus in the eurozone continues to be on robust contractual fallbacks rather than a wholesale transition away from EURIBOR.

Key consultations

FCA

Consultations in relation to the exercise by the FCA of its proposed new powers to facilitate an orderly wind-down of a critical benchmark under the UK Benchmarks Regulation (responses due 18 January 2021).

> Consultation on proposed policy with respect to the designation of benchmarks under new Article 23A and;

> Consultation on proposed policy with respect to the exercise of the FCA’s powers under new Article 23D.

ICE Benchmark Administration

Consultation on Potential Cessation (responses due 25 January 2021).

For further information see ICE Benchmark Administration to consult on its intention to cease publication of USD LIBOR: floating rate note considerations (December 2020).

Working group on euro risk-free rates

Consultations on EURIBOR fallback trigger events and €STR-based EURIBOR fallback rates (responses due 15 January 2021).

Green, social and sustainable finance

The global pandemic has accelerated the focus on green, but also increasingly, social and sustainable finance initiatives, galvanising the financial markets to act as an enabler for change. Social bond issuance raised more than US$163bn in 2020, more than 10 times the US$13bn raised in 2019. Green bonds alone raised US$210.2bn in 2020, surpassing the US$188.3bn for the whole of 2019.

The growth of social bonds precipitated by the pandemic is outpacing that of green bonds. The market response to the issue by the European Commission in October 2020 of its largest-ever social bond (on which Linklaters advised the underwriters), as part of its Covid-related financial support programme, is further proof of the growing demand from investors to align their investment strategies to a more socially-sustainable future, particularly in these extraordinary times.

Emergence of Sustainability-Linked Bonds

Linklaters has led the development on the legal side of the Sustainability-Linked Bond (“**SLB**”) market, advising on recent notable issues[1].

[1] *Linklaters recently advised on issues by LafargeHolcim (the first of its kind in the building materials industry), Schneider Electric (the first ever equity-linked SLB), Suzano (the first bond of its kind to be aligned with the ICMA’s Sustainability-Linked Bond Principles), Novartis (the first SLB to incorporate social rather than environmental targets and the first offering of SLBs in the healthcare sector) and ENEL (the first SLB in Europe).*

Unlike traditional use of proceeds green, social or sustainability bonds, in the case of a SLB, the use of proceeds is not aligned with a particular purpose, but the rate of interest payable is linked to the achievement of certain pre-defined targets, with the issuer being required to pay a coupon step-up if the relevant target is not met. See ICMA's Sustainability-Linked Bond Principles align with ENEL issuance for further information.

With the favourable announcement by the ECB that bonds with coupons linked to sustainability performance targets will become eligible central bank collateral and potentially eligible for asset purchases under the APP and PEPP (subject to compliance with programme-specific eligibility criteria) from 1 January 2021, the signs are that this product has strong growth potential for 2021.

In a further development, ICMA's Green Bond Principles launched its new Climate Transition Finance Handbook in December 2020. The objective of this initiative is to harness the capital markets to address climate change risk issues by producing clear guidance and common expectations to capital markets participants on the practices, actions and disclosures to be made available when raising funds in debt markets for climate transition-related purposes whether in the format of use of proceeds bonds or SLBs.

UK green sovereign bonds

The UK government has said it will issue its first green sovereign bond in 2021, subject to market conditions. It intends to follow up with a series of further issuances to meet growing investor demand for these instruments. These bonds will help finance projects to tackle climate change, finance infrastructure investment and create green jobs. Green gilt issuance could help to stimulate further domestic issuance of green bonds.

EU Green Bond Standard

In January 2020, the EU Commission announced that it will establish an EU Green Bond Standard with the aim of providing a uniform approach across the EU. The EU Green Bond Standard builds on the existing ICMA Green Bond principles and is a voluntary standard. It proposes that financed green investments follow the criteria set out in the EU Taxonomy Regulation, creates a requirement for issuers to publish a Green Bond Framework (currently a voluntary recommendation under the ICMA principles), sets out more stringent reporting requirements and makes external verification by ESMA accredited verifiers mandatory. The Commission held a consultation on the proposed Green Bond Standard which closed on 2 October 2020 and is currently expected to take a decision on how to take this forward in Q2 2021.

For more information on upcoming ESG developments generally, including future regulatory changes and to keep informed on the rapid pace of change in this area, email us at esg@linklaters.com to sign up for our ESG blog and ESG newsletter.

Key contacts

Jorge Alegre
Partner, Madrid
Tel: +34 91 399 6177
Mob: +34 666 430 429
jorge.alegre@linklaters.com

Veronique Delaittre
Partner, Paris
Tel: +33 1 56 43 58 85
Mob: +33 6 10 10 15 35
veronique.delaittre@linklaters.com

Ben Dulieu
Partner, London
Tel: +44 20 7456 3353
Mob: +44 7900 815 013
ben.dulieu@linklaters.com

Jasper Evans
Partner, London
Tel: +44 20 7456 4571
Mob: +44 7717 505 849
jasper.evans@linklaters.com

Pim Horsten
Partner, Amsterdam
Tel: +31 20 799 6210
Mob: +31 65 157 2707
pim.horsten@linklaters.com

Elaine Keats
Partner, London
Tel: +44 20 7456 4441
Mob: +44 7748 936 569
elaine.keats@linklaters.com

Richard Levy
Partner, London
Tel: +44 20 7456 5594
Mob: +44 7825 624 058
richard.levy@linklaters.com

Richard O'Callaghan
Partner, London
Tel: +44 20 7456 4783
Mob: +44 7766 508 097
richard.ocallaghan@linklaters.com

Neil Pallender
Partner, London
Tel: +44 20 7456 4402
Mob: +44 7920 862 428
neil.pallender@linklaters.com

Keith Thomson
Partner, London
Tel: +44 20 7456 4584
Mob: +44 7801 923 237
keith.thomson@linklaters.com

Peter Waltz
Partner, Frankfurt
Tel: +49 69 710 03 457
Mob: +49 172 653 5849
peter.waltz@linklaters.com

Carson Welsh
Partner, London
Tel: +44 20 7456 4602
Mob: +44 7703 437 237
carson.welsh@linklaters.com

Linda Taylor
Counsel, Milan
Tel: +39 02 88 393 5348
Mob: +39 347 840 0220
linda.taylor@linklaters.com

Catherine Wade
Counsel PSL, London
Tel: +44 20 7456 3593
Mob: +44 7920 565 695
catherine.wade@linklaters.com

linklaters.com

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