Edition 5: April 2020

COMMERCIAL BANKING

IBOR TRANSITION NEWSLETTER

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Welcome to our fifth Newsletter, which provides an update on the transition away from LIBOR and other Interbank Offered Rates (IBORs). With 2021 fast approaching, this Newsletter aims to raise awareness of key developments on an on-going basis. We will continue to send this newsletter to you regularly during the period of transition. We hope you will find it helpful. Please contact your Relationship Team if you have any questions or queries on the contents of this Newsletter.

What has happened recently

Preparations for IBOR transition in April continued amidst the ongoing COVID-19 pandemic as financial regulators reaffirmed the current end-of-2021 deadline, but delays to some interim targets were announced. The Financial Stability Board (FSB), the body tasked with coordinating IBOR change at the global level, stated: "the transition from LIBOR remains a priority as firms cannot rely on LIBOR being produced after end 2021". This dovetails with the message from the UK's Financial Conduct Authority (FCA) in March. That message acknowledged that certain elements of LIBOR transition were likely to be impacted by COVID-19, with the UK loan market being one particular area where "interim transition milestones are likely to be affected". Then, in late April, the Bank of England and the FCA announced the target date to stop new GBP LIBOR loans would shift from the end of Q3 2020 to the end of Q1 2021, where maturity is after 2021. They also indicated that any LIBOR loans written after the end of Q3 2020 should "include clear contractual arrangements in all new and re-financed LIBOR-referencing loan products to facilitate conversion ahead of end-2021, through pre-agreed conversion terms or an agreed process for renegotiation".

A statement reiterating the end of 2021 timeline was provided to the US dollar market where updated priorities have been published and best practices are being developed with potential impacts of COVID-19 on certain near-term steps kept in mind. Delays have also been announced in some euro related timelines.

Despite COVID-19, tangible progress towards IBOR transition was made in April. Notably, the International Swaps and Derivatives Association (ISDA) announced preliminary results of its recent consultation, reporting that a significant majority of respondents are in favour of including both pre-cessation and permanent cessation fallbacks for LIBOR in the amended 2006 ISDA definitions and also in a single protocol for updating definitions in legacy contracts. Following this Bloomberg has published a rule book that sets out the final methodologies for the IBOR fallback rate adjustments and is set to publish indicative data on a currency-by-currency basis in the coming weeks. Both the consultation feedback and the publication of the rulebook move us one step closer to the amended 2006 definitions and protocol to deal with the cessation of LIBOR, scheduled to be published by the end of Q3 2020 and effective at end of Q4 2020.

Headway has also been made with cash products. A key challenge for the transition is how to replace LIBOR, a forward-looking term rate, with SONIA, which is an overnight backward-looking risk-free rate. For a narrowly defined set of sterling products identified by the Working Group on Sterling Risk-Free Reference Rates that need term rates - the ICE Benchmark Administration, the entity responsible for compiling LIBOR, began publishing beta test SONIA term rates of 1, 3 and 6 month tenors in an early step to satisfy demand. Test rates are also due to be published by three other administrators – FTSE Russell, Refinitiv and IHS Markit. This is in line with the Bank of England roadmap published in January which targeted the availability of a term rate for limited use by the end of July this year. The sterling market timeline for term rates is ahead of the US dollar market, where term rates are

expected to be available at the end of June 2021.Still, the use of term rates in the sterling market is envisaged to be severely limited, mostly for trade related products, with overnight SONIA compounding anticipated to be the norm.

In the US, recommendations being made on US dollar cash products could portend those in other markets. The Alternative Reference Rates Committee (ARRC), the group tasked with managing IBOR transition for the US dollar market announced its recommendation to handle the gap between IBORs and risk-free rates under fallback scenarios in cash markets; this being to "adopt a spread adjustment methodology based on a historical median over a five-year look back period calculating the difference between USD LIBOR and SOFR". This approach to fallbacks is consistent with those being developed by ISDA for the derivatives markets and is supported in a new set of objectives which were published on 17th April. The harmonisation with ISDA suggests that other LIBOR currency markets will take a similar approach. In the sterling market, after publication of consultation results, a recommendation to follow a similar approach to the US dollar market is still pending.

Lastly, the International Accounting Standard Board (IASB) published its Phase 2 Exposure Draft on Interest Rate Benchmark Reform which outlines proposed amendments to IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 to cover issues that might affect financial reporting after the reform of an interest rate benchmark, including the replacement of one interest rate benchmark with another. Primarily, the focus of Phase 2 is to work out the effects of these changes on a firm’s financial statements. The draft opinion is open for comments until the 25th May 2020. Phase 1 of the project covering pre-replacement issues came into effect on 1st January 2020. These efforts follow those by other accounting standards boards to be ready for what’s required from a reporting standards perspective during and after transition.

In summary, work towards IBOR transition has continued in April across derivative and cash markets. Efforts to prepare financial reporting standards for LIBOR’s replacement also continued in earnest. Above all, regulators have reinforced the end-2021 deadline for the cessation of LIBOR despite the ongoing uncertainty from COVID-19. Still, delays to certain interim deadlines have arisen and the ongoing impact of COVID-19 is hard to predict.

A closer look

Secured Overnight Financing Rate ("SOFR")

SOFR is a secured overnight interest rate, calculated using actual transactions from the highly liquid US treasury repo market. As a risk-free rate, SOFR fits the design outlined by the ARRC of a "broad Treasuries repo refinancing rate". SOFR is administered by the Federal Reserve Bank of New York who have been publishing the rate at 8:00 a.m. US Eastern Standard Time since April 2018.

Similar to other risk-free rates such as SONIA, SOFR by the very nature of being an overnight rate is backward-looking. LIBOR, on the other hand, is forward looking over various terms (e.g. 1-month, 3-month); also LIBOR includes a measure of bank credit risk, while SOFR does not.

Since SOFR is a backward looking rate, interest payable over a period is typically calculated by compounding a series of overnight rates with interest due being calculated near the end of the relevant period. In order to make this process operationally easier, there is normally a time lag of a few days to allow the interest amount to be known before payment is due. While there has been no clear standard calculation methodology adopted for SOFR, the ARRC has expressed certain preferences.

There is also the added dimension of SOFR historically exhibiting more short-term volatility than either LIBOR or the Federal Funds Rate. The 282 basis point jump in SOFR in a single day last September is one extreme example. Some of this variability is attributed to very temporary liquidity issues in the repo market.

Since last September, the Federal Reserve, which is responsible for ensuring that short-term rates don't deviate from policy rates for too long, has undertaken direct intervention in repo markets and provided additional liquidity through purchases of US Treasury securities. Both efforts have helped to stabilise SOFR. Meanwhile, the ARRC view is that any issues related to SOFR short-term volatility are mitigated by the fact that SOFR’s use as a benchmark is primarily a compounded weighted average over time (see ARRC FAQs).

For additional information from Lloyds Banking Group on the transition from LIBOR, please see our website which includes our 'LIBOR: the countdown to 2021' paper and latest reference materials here:

Click here to visit our website >

Please let your Relationship Manager know if you have any feedback or suggestions.

Yours sincerely

Cris Kinrade
IBOR Transition Programme
Lloyds Bank Commercial Banking

Please feel free to get in touch with your relationship team to discuss any questions you may have. We would also encourage you to consult with your own advisors about these changes and any potential impacts for you.

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