Edition 6: May 2020

Welcome to our sixth 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 ongoing 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.

What has happened recently

The key message from regulators in May was that the end-of-2021 deadline for IBOR transition remains firmly in place, despite the impact of COVID-19. In the UK, regulators, through a joint forum that includes the Financial Conduct Authority (FCA) and the Bank of England (BoE), reaffirmed the deadline in a Regulatory Initiatives Grid, which summarised their key plans and impacts. Likewise, in its May Interim Financial Stability Report, the BoE reiterated the importance of “removing reliance on LIBOR by the end of 2021”, stating that financial market strain related to COVID-19 only served to highlight the “long-standing weaknesses of LIBOR benchmarks.” The Report referred to a period in March during which there were no market transactions upon which to base the data submissions for 3 month GBP LIBOR, alongside a notable divergence between it and BoE base rate. In addition, the BoE noted an even sharper divergence in 3 month USD LIBOR which rose by 50 basis points in the second half of March, at a time when the targeted Federal Funds Rate was reduced by 100 basis points. These observations of the BoE underpin the commitment made recently by regulators outside the UK to also adhere to the end-of-2021 deadline in the wake of COVID-19.

Progress towards the end-of-2021 goal continued to be made in the US dollar cash market. Last month, the Alternative Reference Rates Committee (“ARRC”), the group responsible for USD LIBOR transition, recommended adopting the ISDA approach as a way to handle the gap between IBORs and risk-free rates under fallback scenarios. This has been to “adopt a spread adjustment methodology based on a historical median over a five-year period to calculate the difference between USD LIBOR and SOFR”. During May, the ARRC published a list of the best practices that provide guidance for IBOR transition across multiple product types with a timeline of key milestones, which includes an end of June 2021 deadline to cease new USD LIBOR business loans and derivatives transactions. The ARRC also issued a supplemental consultation on technical issues related to spread adjustment methodologies, seeking to clarify how the recommended spread adjustment should be used in certain scenarios and the timing of such adjustment. This supplemental consultation closes on 28 June. As for the sterling market, after publishing results of a consultation on how to handle spread adjustment, the BoE is currently considering their next steps. UK regulators have already identified the strong consensus on how to calculate a fair credit spread as a key area to build upon despite recent interim delays.

Some of this headway toward transition, correspondingly led to additional reference materials being made available in May. The ARRC, for example, released a statement to provide market participants with information on how to reference the New York Fed's SOFR Index in floating rate notes. This included an overview of the two major compounding conventions, structuring considerations and sample term sheets. ISDA also unveiled a new IBOR reform page to its website; the new hub aims to be a one-stop shop for the information that ISDA provides on LIBOR transition and benchmark reform. There is already a wealth of material on the site ranging from a table of key target dates to supplemental research and reading materials related to transition. Finally, the Loan Markets

Association has published a summary of the loans which have been announced to the market during the past year which reference Risk Free Rates. The information is intended to support both lenders and borrowers as they consider their plans for transition. As it is based upon publicly available information, the list does not cover all market transactions; it is to be updated periodically as more information becomes available.

Looking ahead, following publication of its final report on the implementation of pre-cessation fallbacks, ISDA has confirmed that they expect to publish both amended 2006 ISDA Definitions and a single protocol for including them in legacy trades, sometime in July. Both are to come into effect before the end of the year and will be paramount in helping to facilitate transition in the derivatives market.

A closer look

COVID-19 delays – the story so far…

For sterling products, the BoE and FCA made a joint announcement in late April moving the deadline to end new issuance of LIBOR-referencing loans, where expiry is after 2021, from Q3 2020 to end of Q1 2021. A major reason cited for the change is to ensure the smooth flow of credit to the real economy. Significantly, it gives extra time for borrowers to make the operational changes that will be required to handle the different administration requirements required when using overnight rates such as SONIA.

However, the backward shift in timeline comes with an important caveat: all new and re-financed LIBOR-referencing loan products issued after Q3 2020 and expiring after the end of 2021 must include clear contractual arrangements to facilitate conversion to the non-LIBOR alternative references rates ahead of the end-2021 deadline. The intention is that these are facilitated through pre-agreed conversion terms or an agreed process for renegotiation to SONIA or other alternatives. Therefore, despite the interim delay, borrowers seeking LIBOR referencing loans expiring beyond the end of 2021 will still need to take into account the differences in mechanics of non-LIBOR linked products and any transition arrangements.

The consequences of this are that borrowers will need to thoroughly understand, among other things, the following:

1) the appropriateness of the alternative rates available e.g. whether based on the BoE base rate or SONIA

2) the triggers and timing that ultimately could lead to transition to the alternative rates

3) how compounding calculations and spread adjustments work

4) where required, hedging requirements related to future interest exposure

Alternatively, borrowers can opt for non-LIBOR linked products expiring after the end of 2021. The BoE Working Group on Risk Free Rates expects lenders to provide non-LIBOR products by the end of Q3 2020.

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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