# **LIBOR Transition** Frequently Asked Questions

**Edition 1** August 2020

We have produced these FAQs to support clients during LIBOR Transition. For further information please speak to your usual relationship contact

By the side of business



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#### Introduction

These FAQs have been prepared to support clients during LIBOR Transition. We will update this document on a regular basis as regulatory and market approaches become more established.

This document seeks to provide general guidance, but please note that the contents may not be relevant or specific to your individual circumstances. If you need more help please contact your usual relationship contact.

Lloyds Bank LIBOR Transition site contains several resources including our 'LIBOR: the countdown to 2021' and 'Our Approach to LIBOR Transition' publications.

#### 1. What is LIBOR?

The London Interbank Offered Rate (LIBOR) is an indication of the average rates at which banks could obtain wholesale, unsecured funding. It is calculated from submissions made by selected panel banks and is published in 5 currencies (British pound, Euro, US dollar, Swiss franc and Japanese yen) and it has a range of tenors (Overnight, 1 week, 1, 2, 3, 6 and 12 months). It is published each London business day and is administered by ICE Benchmark Administration.

It is a key interest rate benchmark that is currently used to set the rates for hundreds of trillions of dollars in financial products and contracts worldwide including corporate loans, derivatives, corporate bonds/FRNs, structured debt products, deposits and mortgages.

Apart from LIBOR there are a number of other Interbank Offered Rates (IBORs) such as EURIBOR (Euro Interbank Offered Rate) and EONIA (Euro Overnight Index Average).

### 2. Why is LIBOR being reformed?

The LIBOR methodology is designed to produce an average rate that is representative of the rates at which large, internationally active banks with access to the wholesale, unsecured funding market could fund themselves<sup>1</sup>. Since the financial crisis banks no longer fund themselves in this way. The decline in the underlying market means that LIBOR is now primarily sustained by the use of expert judgement. The view of global regulators is that this cannot be sustained and so 2021 is the last year the Financial Conduct Authority (FCA) will compel panel banks to carry on providing their submissions to LIBOR. As such the FCA expects that LIBOR will not continue after 2021<sup>2</sup>

# 3. What alternative reference rates have been recommended by industry bodies for each LIBOR currency?

Currency	Industry body / organisation recommending alternative rate	Alternative rate recommendation and description
British Pound		SONIA (Sterling Overnight Index Average)  Unsecured overnight rate calculated by the Bank of England from eligible transactions reported to them via their sterling money market daily data collection process. Reformed SONIA has been published since April 2018.
Euro	Working Group on Risk-free Rates for the Euro Area,	<b>€STR</b> (Euro Short Term Rate)

<sup>&</sup>lt;sup>1</sup> ICE website – methodology paper

 $<sup>^2</sup>$  Examples include Andrew Bailey, then FCA CEO, July 2017, July 2018 and July 2019 speeches on the future of LIBOR

	formed by FSMA, ESMA, ECB and European Commission	€STR reflects wholesale Euro unsecured overnight borrowing costs of Euro area banks and has been published since 2nd October 2019.
US Dollar	Alternative Reference Rates Committee, convened by the Federal Reserve Board	SOFR (Secured Overnight Financing Rate)  A new, broad-based secured US Treasuries repo financing rate. It has been published since April 2018.
Swiss Franc	The National Working Group on CHF Reference Rates set up by the Swiss National Bank	SARON (Swiss Average Rate Overnight) SARON references actual market transactions in the Swiss franc interbank repo market (i.e. secured). It has been published since August 2009.
Japanese Yen	Study Group on RFR convened by the Bank of Japan	TONAR (Tokyo Overnight Average Rate)  An uncollateralised overnight call rate. It has been published since 2016.

These alternative rates are near risk-free rates, known as Risk-Free Rates (RFRs).

Other options for alternative rates may include, in the UK, the Bank of England Bank Rate (commonly known as Base Rate) for Sterling products, or a fixed rate.

Alternative benchmark rates are materially different from LIBOR and are calculated using different methodologies. As such they are not direct replacements for LIBOR.

Further information from industry bodies and organisations referenced in question 6 below.

# 4. Apart from LIBOR, what other IBORs are affected?

There are a number of other inter-bank offered rates (IBORs) which are being reformed or phased out. These include:

**EURIBOR** (Euro Interbank Offered Rate) has been reformed to comply with the EU Benchmark Regulation and there are no current plans to discontinue it.

**EONIA** (Euro Overnight Index Average) has been reformed and since 2nd October 2019 has been quoted as Euro Short Term Rate (€STR) plus a fixed spread of 0.085%. It is scheduled to be discontinued from 3rd January 2022.

**TIBOR** (Tokyo Interbank Offered Rate) has been reformed and will continue to exist alongside TONAR.

# 5. What are the main differences between LIBOR and Near Risk-Free Rates (RFRs)?

- LIBOR prices in term risk and bank credit risk whereas the RFRs do not
- LIBOR rates are forward-looking for certain identified terms (1 month, 3 month etc.), RFRs are point in time overnight rates
- This means that RFR interest payable over a period is typically calculated by daily compounding a series of overnight rates with the interest due being calculated near the end of the relevant period for which interest is to be changed, rather than at the beginning. This change may have an impact on systems, operations and payments.

# 6. How do I keep up to date with the latest developments on LIBOR transition?

Please visit to our Lloyds Bank LIBOR Transition site. It contains several resources including our 'LIBOR: the countdown to 2021' and 'Our Approach to LIBOR Transition' publications. If you don't already receive our monthly newsletter please speak to your relationship manager to be added to the mailing list.

If you are looking for more detailed information the following links from industry bodies and organisations may be useful:

**UK (British Pound)**: the Sterling Working Group publishes educational resources and general updates on transition on the Bank of England website at

https://www.bankofengland.co.uk/markets/transition-tosterling-risk-free-rates-from-libor;

**USA (US Dollar)**: the Federal Reserve Board and the Federal Reserve Bank of New York (New York Fed) convened a group of market participants to form the Alternative Reference Rates Committee (ARRC), which publishes updates on transition on the New York Fed website at <a href="https://www.newyorkfed.org/arrc/">https://www.newyorkfed.org/arrc/</a>;

**Europe (Euro)**: the Working group on euro risk-free rates focuses on the Euro rates EONIA and EURIBOR. Further information can be found at

https://www.ecb.europa.eu/paym/initiatives/interest\_rate\_ben chmarks/WG\_euro\_risk-free\_rates/html/index.en.html;

**Switzerland (Swiss Franc)**: the National Working Group on Swiss Franc Reference Rates (NWG) is the key forum for considering proposals to reform reference interest rates in Switzerland. Further information can be found at

# https://www.snb.ch/en/ifor/finmkt/fnmkt\_benchm/id/finmkt\_reformrates;

Japan (Japanese Yen): the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks established to facilitate the selection and use of JPY interest rate benchmarks publishes updates at

https://www.boj.or.jp/en/paym/market/jpy\_cmte/index.htm/;

**ISDA**: The International Swaps and Derivatives Association publishes information on benchmark reform of derivative markets at: https://www.isda.org/2020/05/11/benchmark-reform-and-transition-from-libor/.

# 7. When will we hear more about your plans to amend existing LIBOR agreements?

If you have a LIBOR agreement that matures after 2021, we expect to start speaking with you later in 2020 about changing it to an alternative rate. However, should you want to discuss any additional amendments, please speak with your relationship manager as usual.

Existing LIBOR agreements that are due to mature before the end of 2021 will run to maturity using LIBOR, unless they are refinanced. Similarly, existing LIBOR agreements that mature in 2022 but have a final LIBOR fixing scheduled to take place in 2021 can also run to maturity, unless they are refinanced.

# 8. How will compounding in arrears methodology be used to calculate the interest on my lending?

RFRs (near risk-free rates) are point in time overnight rates, unlike LIBOR which is a forward-looking term rate, and so RFR interest payable over a period is typically calculated by compounding a series of daily overnight rates. In order that the interest payment is known a few days before it is due, a time lag of a few days may be used. For example, with a 5-day time lag the compounding calculation begins with the rate published 5 business days before the start of the lending interest period and finishes 5 business days before the end of the lending interest period. This is known as the observation period. An interest payment notification is then issued once the compounding calculation has been performed. This is then likely to be notified to clients 3 or 4 days before the interest payment falls due.

There are different approaches to how the day weightings of each overnight rate are handled, day weightings are the number of overnights each daily rate applies for (i.e. 1 for a normal weekday, 3 for a Friday, where Saturday and Sunday are also counted). Where we use the day weighting from the interest period this is called the "Observational Lag" method, and where we use the weighting from the observation period this is called the "Observational Shift" method. The loan agreement will specify the method used. A recent paper from the Sterling Working Group recommended the 'use of a Five Business Days Lookback without Observation Shift as the standard approach" this is also known as the Observational Lag method.

The Sterling Working Group statement on **Recommendations for SONIA Loan Market Conventions** contains additional information.

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<sup>&</sup>lt;sup>3</sup> Sterling Risk-Free Rate Working Group Publication

In the US the expectation is for the same methodology to be used for SOFR, although simple averaging may be used for smaller borrowers.

The Bank of England has published a compounded SONIA index since August 2020. A SOFR Index has been published since March 2020 by the Federal Reserve Bank of New York.

### 9. What is a credit adjustment spread (CAS)?

RFRs (near risk-free rates) are economically different to LIBOR. LIBOR includes a measure of term risk and bank credit risk, whereas RFRs do not. Consequently, RFRs are typically lower than LIBOR. To account for this economic difference, an additional rate may be applied to an RFR, called the credit adjustment spread (CAS). The CAS can also be applied to rates that are calculated using RFRs, such as the compounded overnight rates commonly used in RFR loan agreements.

There are a number of situations in which a CAS would be used, for example: where transition occurs due to a fallback being triggered (such as at LIBOR cessation or it being declared non-representative); during an earlier proactive transition of an agreement; or when a new RFR agreement is taken out, such as a loan or Revolving Credit Facility.

# 10. Will CAS methodologies and timelines be the same across different products, such as lending and derivatives?

Whilst there is the potential for challenges around coordinating transition timelines and methodologies across products, currencies and jurisdictions, the latest evidence points towards working groups and regulators co-ordinating effort and timelines. As such we anticipate that a degree of consistency may emerge in conventions, and across different jurisdictions. However, clients should be aware of the potential for mismatches between linked products and risks should be managed accordingly.

The derivative and cash markets are moving towards consensus on adopting the historical 5 year median methodology for credit adjustment spreads (CAS) for fallbacks.

In the derivative markets ISDA published their **final parameters** for fallback spread adjustments in November 2019 and Bloomberg are now **publishing** these rates.

In the cash markets, the Sterling Working Group published a **summary of responses** to their consultation on CAS methodologies for fallbacks in March 2020. The results of the consultation will be used by the Sterling Working Group to consider how they can help catalyse further transition in sterling cash markets and they are expected to publish their recommendations before the end of September.

Currently there is no standard market convention for calculating CAS for facilities transitioning prior to cessation so we cannot confirm our approach to the spread adjustment at this time.

# 11. Can I take out a new LIBOR product that matures after 2021?

Our preference now is to use an RFR (near risk-free rate) product where possible. The Financial Conduct Authority and Bank of England have both emphasised their expectation that LIBOR will cease after the end of 2021. For lending products, the Sterling Working Group have set the following targets:

- April 2021 cease issuance of GBP LIBOR-referencing loans, where expiry is after 2021
- October 2020 new and re-financed GBP LIBORreferencing loan products must include clear contractual arrangements to facilitate conversion to the non-LIBOR alternative reference rates ahead of the end-of-2021 deadline, where expiry is after 2021

In the US, the ARRC have set similar deadlines, being:

- June 2021 cease issuance of USD LIBOR Loans
- September 2020 for USD LIBOR Syndicated business loans to incorporate hardwired fallback language
- October 2020 for USD LIBOR bilateral business loans to include hardwired fallback language

Whilst LIBOR products may continue to be available until cessation, in line with the Sterling Working Group's recommendation, we will discuss transition to alternative reference rate products or products which include an automatic switch mechanism to an alternative reference rate to prevent the need for conversion at a later date.

### 12. Can I take out a product based on Term SONIA?

We do not currently plan to offer lending products using Term SONIA. Some trade products, such as supply chain finance, receivables purchase and discounted letters of credit, work by discounting future cashflows and we are developing Term SONIA trade products for the expected full launch of Term SONIA in early 2021.

This follows the publication of the **Term Rate Use Case Report** by the Sterling Working Group in January 2020. The report emphasises their expectation that SONIA compounded in arrears 'will and should become the norm in most derivatives, bonds, and bilateral and syndicated loan markets' and the report addresses the limited instances where Term SONIA might be relevant, most notably to working capital products (where a discount rate is required) and lower value loans to smaller borrowers.

The Financial Stability Board (FSB) has said that the transition of most derivatives to overnight, rather than term, rates is important to ensuring financial stability. The FCA has advised on numerous occasions that market participants should not delay transition until term rates arrive, an example being this **speech** in July 2019 from Andrew Bailey, then CEO of the FCA.

There are potentially 4 different Term SONIA providers, with differences in methodology. Currently final test versions of SONIA term rates are being published by ICE Benchmark Administration (IBA), FTSE Russell and Refintiv, and full launches are expected at the end of 2020 after the current testing period. IHS Markit has also confirmed they are working to develop a term SONIA rate. The sterling market timeline for term rates is ahead of the US dollar market, where term rates are expected to be available by the end of June 2021.

# 13. Is the US working to the same timetable as the UK?

The end of 2021 timeline applies to all LIBOR currencies, including USD. Transition in the US is being facilitated by the Alternative Reference Rates Committee (ARRC), a group of private-market participants convened by the Federal Reserve Board and the Federal Reserve Bank of New York. For the latest information visit the **ARRC website**.

# 14. What is happening to EURIBOR (Euro Interbank Offered Rate)?

EURIBOR has been reformed to comply with the EU Benchmark Regulation and there are currently no plans to discontinue it. We have no plans to make changes to any references to EURIBOR in our products, including in multicurrency facilities where benchmarks in other currencies are transitioning to alternative reference rates, although we will look to follow the ECB guidance in relation to fallbacks.

### 15. What can clients do to make sure they are ready?

## **☑** Keep up to date:

- Understand the latest transition developments for each of the currencies you deal with
  - How do the new rates differ from LIBOR? How does the market function for the new rates?
  - What are the main hurdles on the path to transition? What is the timeline to resolve them?
- Speak to banking partners and legal and financial advisors to understand how the market is developing by product and currency
- Get involved through industry bodies (e.g. ACT, LMA) and participate in working groups if you can

### **Identify LIBOR exposures:**

- Develop an inventory of all transactions affected by LIBOR along with their maturities
- Some exposures may be obvious such as floating rate loans, interest rate swaps; some less so such as intragroup agreements, working capital arrangements, etc.
- Identify which counterparties are involved banks, investors, commercial counterparties, group entities

## ☑ Assess potential impact of transition:

- Review existing documentation to understand what fallback terms are included
- Determine the expected outcomes of LIBOR transition for each group of transactions

- Consider early termination settlement/break costs if earlier refinancing or termination occurs
- Understand the impacts on systems, processes, operations, valuations, tax, accounting, etc.

## Develop a transition plan:

- Legacy contracts: consider whether to amend fallback terms and how can this be achieved; engage with counterparties;
  - Can existing agreements be restructured to remove LIBOR linkage, e.g. to replace with SONIA or other rates
- New transactions: can you use an alternative reference rate from the start? Or embed a more certain transition into the agreement? Stay up-to-date with the LIBOR lending target dates from the Sterling Working Group and the ARRC in the US
- Develop a detailed project plan, determine resource requirements & constraints, mobilise a project team

### 16. Glossary

ACT	Association of Corporate Treasurers	
ARRC	Alternative Reference Rates Committee	
BoE	Bank of England	
EONIA	Euro Overnight Index Average	
€STR	Euro Short Term Rate	
EURIBOR	Euro Interbank Offered Rate	
FCA	Financial Conduct Authority	
FSB	Financial Stability Board	
ISDA	International Swaps and Derivatives Association	
LIBOR	London Interbank Offered Rate	
LMA	Loan Market Association	
New York Fed	Federal Reserve Bank of New York	
PRA	Prudential Regulation Authority	
RFR	Near risk-free rate	
SARON	Swiss Average Rate Overnight	
SOFR	Secured Overnight Financing Rate	
SONIA	Sterling Overnight Index Average	
Sterling Working Group	Bank of England Initiated Sterling Risk-Free Reference Rate Working Group	
TONAR	Tokyo Overnight Average Rate	

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