COMMERCIAL BANKING

LIBOR Transition Frequently Asked Questions

Edition 2
December 2020

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

By the side of business

LLOYDS BANK

Contents

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 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 talk to your usual relationship contact.

The **Lloyds Bank LIBOR Transition website** contains a number of resources which may assist you, including the '**Our Approach to LIBOR Transition'** presentation.

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/floating rate notes, 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 TIBOR (Tokyo Interbank Offered Rate).

2. Why is LIBOR being phased out?

The LIBOR methodology is designed to produce an average rate that is representative of the rates at which large, leading internationally active banks with access to the wholesale, unsecured funding market could fund themselves[1]. 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; global regulators view this as unsustainable. Therefore, 2021 is the last year the Financial Conduct Authority (FCA) will compel panel banks to carry on providing these submissions to LIBOR. As a result, the FCA expects that **LIBOR will not continue after 2021.**[2]

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	Working Group on Sterling Risk-Free Reference Rates, set up by the Bank of England	**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	**€STR** (Euro Short Term Rate)

[1] **ICE website – methodology paper**

[2] Examples include Andrew Bailey, then FCA CEO, July 2017, July 2018 and July 2019 speeches on the future of LIBOR

	the Euro Area, 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 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 Risk-Free Reference Rates 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 reference rates are materially different from LIBOR and are calculated using different methodologies. As such they are not direct replacements for LIBOR.

We list sources of further information from industry bodies and organisations in question 6 below.

4. Are other reference rates affected by these changes?

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. However, you should be aware that cash fallbacks might need to be strengthened in light of regulatory guidance and some products may transfer to other Euro rates.

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 rates are forward-looking for certain identified terms (1 month, 3 month etc.) RFRs are point in time overnight rates
- LIBOR prices in term risk and bank credit risk whereas the RFRs do not
- RFR interest payable over a period is typically calculated by daily compounding a series of overnight rates with the interest due being calculated at the end of the relevant interest period, rather than at the beginning. As term risk and bank credit risk are not included in RFRs, an adjustment spread may be added to the compounded RFR. This is known as a Credit Adjustment Spread (CAS). See question 9 for more information on CAS.

- These changes 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 the **Lloyds Bank LIBOR Transition website** which includes our latest '**Our Approach to LIBOR Transition**' presentation and other useful resources. If you don't already receive our monthly newsletter please talk to your usual relationship contact 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 Bank of England-initiated Working Group on Sterling Risk-Free Reference Rates (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-to-sterling-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 **https://www.newyorkfed.org/arrc/**;

Eurozone (Euro): the Working Group on euro risk-free rates publishes information and updates on the ECB website: **https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/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 or early 2021 about changing it to an alternative rate. However, should you wish 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. Existing LIBOR agreements that mature in 2022 but have a final LIBOR fixing scheduled to take place in 2021 may also run to maturity.

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 (or lookback) the compounding calculation begins with the rate published 5 business days before the start of the **interest period** and finishes 5 business days before the payment is due. This is known as the **observation period**.

Interest is compounded on banking days only. For each calendar day which is a weekend or bank holiday, the immediate preceding banking day's rate is applied, weighted by the number of calendar days until the next banking day. A weighting of 1 would be applied for Monday to Thursday (assuming no bank holidays) and a weighting of 3 for Friday to account for Saturday and Sunday (assuming no bank holidays).

Where we use the day weighting from the **interest period** this is called the **"Observation Lag" method**, and where we use the weighting from the **observation period** this is called the **"Observation 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*'[3]. An interest payment notification is issued once the compounding calculation has been performed and before the interest payment is due.

[3] **Sterling Risk-Free Rate Working Group Publication (Sept 2020)**

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

The expectation is for the same methodology to be used for other RFRs, although simple averaging may be used in the US for smaller borrowers using SOFR.

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, RFR rates are typically lower than LIBOR. To account for this economic difference, an adjustment spread may be applied to the compounded RFR, called the credit adjustment spread (CAS).

There are a number of situations in which a CAS may be applied, for example: in fallbacks in cash products and the ISDA fallbacks for derivatives; in proactive transition from LIBOR to RFRs; or when a new RFR agreement is taken out, such as a term loan or revolving credit facility. The timing of the calculation for determining the CAS may vary according to whether it is incorporated in a fallback, agreed as part of a proactive transition or contained in a new RFR agreement.

A CAS is calculated for each currency and tenor.

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.

The derivative and cash markets have moved towards consensus on adopting the historical 5 year median methodology for credit adjustment spreads (CAS) for fallbacks. In the derivative markets ISDA has published an IBOR Fallbacks Protocol (Protocol) and a Supplement to the 2006 ISDA Definitions. The Protocol allows market participants to incorporate the revised fallbacks into their legacy non-cleared derivatives trades with other counterparties that also choose to adhere to the Protocol. 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.

Currently there is no standard market convention for calculating the CAS for facilities actively transitioning prior to cessation. There are two main approaches; the historical 5 year median approach and the forward approach based on the forward-looking basis swap market. It is important to consider which approach to use when transitioning existing loans where there is hedging in place. Clients should be aware of the potential for mismatches between linked products and risks should be managed accordingly.

The Sterling Working Group has been clear that market participants should not wait for further market-wide discussions before taking steps to transition.

11. What are the interim targets for reducing reliance on LIBOR?

The Financial Conduct Authority and Bank of England have both emphasised their expectation that LIBOR will cease by the end of 2021. The Sterling Working Group has set the following interim targets:

- **October 2020** - new and re-financed GBP LIBOR-referencing 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 maturity is after 2021
- **April 2021 – firms to cease issuance of GBP LIBOR-referencing loans**, where maturity is after 2021

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

- **September 2020** – for USD LIBOR **syndicated business loans** to incorporate recommended hardwired fallback language where maturity is after 2021
- **October 2020** – for USD LIBOR **bilateral business loans** to include recommended hardwired fallback language where maturity is after 2021
- **June 2021** – cease issuance of USD LIBOR loans where maturity is after 2021

Whilst some LIBOR products may continue to be available until cessation, in line with the Sterling Working Group's recommendation, we will discuss transition options to alternative reference rate products or products which include an automatic switch mechanism which mean there is no need for conversion at a later date.

12. Why is the launch of the new ISDA IBOR Fallbacks important for derivative contracts?

On 23 October 2020 the International Swaps and Derivatives Association (ISDA) launched the IBOR **Fallbacks Supplement** and **Fallbacks Protocol**. This initiative provides a critical safety net for those market participants that still have exposure to IBORs in the event of cessation. ISDA has prepared this **short video** to explain what fallbacks are and how they operate.

The **Fallbacks Supplement** (Supplement) amends ISDA's standard definitions to incorporate robust fallbacks for interest rate derivatives linked to certain IBORs and comes into effect on 25 January 2021. From this date all **new derivatives** that reference the ISDA definitions will automatically include these new fallbacks, irrespective of whether parties adhered to the Fallbacks Protocol.

A **Fallbacks Protocol** (Protocol) allows the Supplement to be applied to **existing derivatives** providing that both parties to a trade have signed up to it**.**

ISDA has invited all market participants to adhere to the Protocol. At its launch the Protocol had 257 adherents and this number continues to grow. The initiative has received widespread support from regulators globally, including the **Bank of England** who confirmed its own adherence on 23 October 2020.

Market participants can sign up to the Protocol via the **ISDA website**. For non-ISDA members the adherence fee of US$500 is waived until 25 January 2021. It will be possible to sign up after that date on payment of the fee.

Lloyds Bank plc, Bank of Scotland plc and Lloyds Bank Corporate Markets plc have adhered to the Protocol.

Alternatively, the fallback terms can be incorporated into existing derivatives contracts by means of a bi-lateral agreement.

It should be noted that active transition to an alternative reference rate before LIBOR cessation is preferred by both regulators and industry. Andrew Bailey, Governor of the Bank of England has **said** that whilst signing-up to the Protocol is encouraged, it is 'not a substitute for continuing to move business onto near risk-free rates'. We consider that adhering to the Protocol will be useful, particularly if active transition proves impossible for any reason.

13. 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, as set out in this **speech** by Andrew Bailey, then CEO of the FCA in July 2019.

There are currently 3 different Term SONIA providers, each with different methodologies. ICE Benchmark Administration (IBA), FTSE Russell and Refintiv are publishing beta test SONIA term rates. Full launch of usable term SONIA rates is expected at the end of 2020 or start of 2021 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.

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

EURIBOR has been reformed to comply with the EU Benchmark Regulation and there are no current plans to discontinue it. However, you should be aware that cash fallbacks might need to be strengthened in light of regulatory guidance and some products may transfer to other Euro rates.

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

☑ Keep up to date:

- Understand the latest transition developments. The websites of the Bank of England-initiated **Working Group on Sterling Risk-Free Reference Rates**, the **FCA, the US Alternative Reference Rates Committee** and **ISDA** are good sources of information
- A summary of the interim dates is set out in the **September** issue of our IBOR Transition Newsletter
- Talk to your bankers and legal and financial advisors
- Familiarise yourself with SONIA, SOFR and any other rates relevant to you, and how interest is calculated
- 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. Some exposures may be obvious such as floating

rate loans, interest rate swaps; some less so such as intra-group agreements, working capital arrangements, etc.
- Identify which counterparties are involved – banks, investors, commercial counterparties, group entities

☑ Understand how transition could affect your products:

- Review your existing contracts to understand where LIBOR is referenced and whether there are fallback provisions in place setting out what will happen if LIBOR is no longer available
- Consider whether fallbacks across linked products are consistent where they are intended to match, and whether other provisions may be affected by transition away from LIBOR
- For derivative products, consider whether signing the ISDA Fallbacks Protocol would be appropriate for you. Various Lloyds Banking Group entities have signed the Protocol and a current list of adherents can be found **here**. Non-ISDA members are able to sign for free until 25th January 2021
- Determine the expected outcomes of LIBOR transition for each group of transactions and consider the risks and impacts of not taking action
- Understand how your systems, processes, operations, valuations, tax, accounting may be affected

☑ Develop a transition plan:

- Consider which contracts might need to be amended either to replace LIBOR or to confirm the steps to be taken if LIBOR is no longer available
- New transactions: can you use an alternative reference rate from the start, or include a conversion mechanism?
- Develop a project plan, determine resource requirements

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	Working Group on Sterling Risk-Free Reference Rates
TONAR	Tokyo Overnight Average Rate

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Please contact us if you would like this information in an alternative format such as Braille, large print or audio.

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