COMMERCIAL BANKING

LIBOR Transition Frequently Asked Questions

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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

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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 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'** report.

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 global 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 and in March 2021 the Financial Conduct Authority (FCA) announced the dates that panel bank submissions for all LIBOR settings will cease, after which representative LIBOR rates will no longer be available.

3. When will LIBOR end?

On 5 March 2021 the FCA **announced** that all LIBOR settings will either cease to be provided by any administrator or no longer be representative:

- immediately after **31 December 2021**, in the case of all sterling, euro, Swiss franc and Japanese yen settings, and the 1-week and 2-month US dollar settings; and
- immediately after **30 June 2023**, in the case of the remaining US dollar settings

Spread Adjustments

The International Swaps and Derivatives Association (ISDA) has **confirmed** that the FCA's announcement constituted an index cessation event for all LIBOR settings. As a result the credit adjustment spreads to be used in its IBOR fallbacks, which are calculated using the 5-Year Historic Median (5YHM), are now fixed for all sterling, euro, Swiss franc, US dollar and Japanese yen LIBOR settings. ISDA has selected Bloomberg to publish these spread adjustments and the full list is available **here**.

Synthetic LIBOR and Tough Legacy

The FCA will consult on requiring the continued publication of a small number of LIBOR settings, including 1, 3 and 6-month sterling LIBOR, on a non-representative, 'synthetic' basis. This is being done because authorities recognise that there are some existing LIBOR contracts which are particularly difficult to amend, often known as 'tough legacy'.

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

The FCA has emphasised that any synthetic LIBOR setting will not be representative and is not to be used in new contracts. It is intended for use in tough legacy contracts only. A further FCA consultation will take place in Q2 2021 to determine which legacy contracts will be permitted to use synthetic LIBOR.

The FCA has also **published** a statement of policy in regards to the proposed new powers to be granted by the UK Government which will be needed to effect these changes.

What does this mean?

The announcements provide greater certainty on the cessation of LIBOR and reinforce the need to finalise planning as soon as practicable. Please be aware that cessation may trigger fallbacks in LIBOR contracts. All clients should ensure they understand the fallback terms in their current contracts.

As a reminder, there are some important official sector **interim milestones** approaching. One example is the end-Q1 2021 cessation of new sterling LIBOR-linked lending products and linear derivatives (e.g. swaps) that mature after the end of 2021.

We will continue to work with our affected clients on options for transition. If you have any questions please get in touch with your usual contact.

4. 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 (BoE)	**SONIA** (Sterling Overnight Index Average) Unsecured overnight rate calculated by the BoE from reported eligible transactions. Reformed SONIA has been published since April 2018.

Currency	Industry body / organisation recommending alternative rate	Alternative rate recommendation and description
Euro	Working Group on Risk-Free Rates for the Euro Area, formed by FSMA, ESMA, ECB and European Commission	**€STR** (Euro Short Term Rate) Reflects wholesale euro unsecured overnight borrowing costs of euro area banks. Published since 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) References the Swiss franc 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) A measure of the cost of borrowing in the Japanese yen unsecured overnight money market. 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. Bank Rate is an example of a central bank rate.

In the context of LIBOR cessation, RFRs and relevant central bank rates are collectively called Alternative Reference Rates (ARRs).

ARRs 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 7 below.

5. Are other reference rates affected by these changes?

There are a number of other inter-bank offered rates (IBORs) affected. 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.

6. 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 10 for more information on CAS.
- These changes may have an impact on systems, operations and payments

7. 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**' report 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/**.

8. When will we hear more about options for existing LIBOR agreements?

If you have a LIBOR agreement that matures after cessation, and we have not contacted you already, we will contact you shortly to discuss options for your affected LIBOR agreements. However, if you wish to discuss a refinance or restructure of an existing LIBOR agreement, please speak with your relationship manager or usual sales contact. You should note that this option is likely to incur additional costs for you.

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

9. 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 for RFR products 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. The period over which the rate is derived is known as the **Observation Period**. An interest payment

notification is issued once the compounding calculation has been performed and before the interest payment is due.

Interest is compounded on banking days only. For each calendar day which is a weekend or bank holiday, the immediately 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 rates from the Observation Period but weighted according to the days in the **interest period** this is called the **"Observation Lag" method**, and where we use the weightings from the **Observation Period** this is called the **"Observation Shift" method**.

The loan agreement will specify the method used. A September 2020 **paper** from the Sterling Working Group recommended the "*use of a Five Business Days Lookback without Observation Shift as the standard approach"*[2] for GBP borrowing.

The expectation is for similar methodologies to be used across other RFRs, although daily simple interest may be used in the US for some borrowers using SOFR.

The Bank of England publishes a compounded **SONIA index**. In the US **SOFR indices and periodic averages** are published by the Federal Reserve Bank of New York.

10. 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 adjustment spread is usually applied to the compounded RFR, called the credit adjustment spread (CAS).

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

There are a number of situations in which a CAS may be applied, for example: fallbacks in cash products and the ISDA fallbacks in derivatives; proactive transition from LIBOR to RFRs; or when a new RFR agreement is taken out, such as a term loan or revolving credit facility.

Similarly, central bank rates such as Bank of England Bank Rate usually have a CAS applied to account for the economic difference with LIBOR.

A CAS is calculated for each currency and tenor.

11. 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 working to co-ordinate effort and timelines.

The derivative and cash markets have moved towards consensus on adopting the 5-year historic median (5YHM) 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.

Following the FCA announcement on 5 March 2021, the International Swaps and Derivatives Association (ISDA) **confirmed** an index cessation event for all LIBOR settings. As a result the credit adjustment spreads to be used in its IBOR fallbacks, which are calculated using the 5-Year Historic Median (5YHM), are now fixed for all sterling, euro, Swiss franc, US dollar and Japanese yen LIBOR settings. ISDA has selected Bloomberg to publish these spread adjustments and the full list is available **here**.

In the **cash** markets the Sterling Working Group published a **statement** in September 2020 recommending the use of the 5YHM methodology for fallbacks in GBP LIBOR cash products.

There is no standard market convention for calculating the CAS for facilities actively transitioning prior to cessation. There are two main approaches; the 5YHM 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.

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

The Sterling Working Group has set a series of interim targets, including:

- **End-Q1 2021** - Banks to stop selling GBP LIBOR-linked loans, bonds, securitisations and linear derivatives (swaps) where expiry is after end-2021, except for the risk management of existing positions.
- **End-Q2 2021** – Banks to stop entering into GBP LIBOR-linked non-linear derivatives (options) that expire after the end of 2021, except for the risk management of existing positions.
- **End-Q3 2021** - Conversion of legacy **GBP LIBOR** contracts expiring after end-2021 to be completed (where active conversion is viable). Note that “conversion” means making changes to the contract. The switch to the new rate may take place later, for example on or after 1 January 2022.

In the US, the Federal Reserve, with other bodies, has confirmed the following interim target date:

- **End-Q4 2021 at latest** - No new **USD LIBOR** contracts to be issued.

13. 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 came into effect on 25 January 2021. From this date all **new derivatives** that reference the ISDA definitions 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** as at this date providing that both parties to a trade have signed up to it**.**

ISDA has invited all market participants to adhere to the Protocol, and as at March 2021 there were more than 13,000 adherents. 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**. There is an adherence fee of US$500.

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

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

On 5 March 2021 the FCA announced made an announcement on the end of LIBOR. Following that announcement, the International Swaps and Derivatives Association (ISDA) **confirmed** that the FCA's

announcement constituted an index cessation event for all LIBOR settings. As a result the credit adjustment spreads to be used in its IBOR fallbacks, which are calculated using the 5-Year Historic Median (5YHM), are now fixed for all sterling, euro, Swiss franc, US dollar and Japanese yen LIBOR settings. ISDA has selected Bloomberg to publish these spread adjustments and the full list is available **here**.

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.

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

In January 2020 the Sterling Working Group published the **Term Rate Use Case Report**. The report emphasised the expectation that SONIA compounded in arrears "will and should become the norm in most derivatives, bonds, and bilateral and syndicated loan markets". The report addressed the limited instances where a forward-looking term rate might be relevant, most notably for working capital products (where a discount rate is required) and lower value loans to smaller borrowers.

ICE Benchmark Administration (IBA), FTSE Russell and Refintiv began publishing beta test SONIA term rates in mid-2020. IBA and Refinitiv are now publishing usable term SONIA rates. FTSE Russell will withdraw their indicative TSRRs from 4 June 2021.

We do not currently plan to offer lending products using Term SONIA reference rates (TSRRs). Some trade products, such as supply chain finance, receivables purchase and discounted letters of credit, work by discounting future cashflows. We are developing new trade products using TSRRs and we anticipate that these will be launched during Q2.

The sterling market timeline for term rates is ahead of the US dollar market, where term rates are unlikely to be available during 2021.

15. 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.

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

☑ **Keep up to date:**

- Understand the latest transition developments. The websites of the **Sterling Working Group**, 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 advisers
- 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, LSTA) and participate in working groups where possible

☑ **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 when 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 IBOR Fallbacks Protocol, or entering into a similar bilateral agreement, would be appropriate for you
- 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 need to be amended either to replace LIBOR or to confirm the steps to be taken when LIBOR is no longer available
- New transactions: can you use an alternative reference rate from the start, or if not can you include a conversion mechanism where this is still permitted?
- Review your plans: finalise actions, determine resource requirements, engage external advisers/ vendors if needed

17. 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
LSTA	Loan Syndications and Trading 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 seek independent financial and legal advice if you have any questions about any of the issues raised in this communication

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

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