LIBOR Transition

In our previous FAQs we have advised on the global shift on LIBOR reliance, where firms (and their customers) will need to identify alternative rates for transition.

The replacement rates for LIBOR are near risk-free rates and are known as Risk-Free Rates "RFRs". The Sterling Overnight Index Average "SONIA" is an example of an RFR. While, SONIA, compounded in arrears, was envisaged as the main alternative reference rate to replace LIBOR for new products and the amendment of existing GBP LIBOR contracts by the UK Working Group on Sterling Risk-Free Reference Rates "RFRWG", it is not the only option available for bank facilities. Other alternative rates ,such as The Bank of England rate (known as the "Bank of England base rate" or "Base Rate"), are considered to be more appropriate by many financial institutions for certain market and product segments. Forward-looking term SONIA Reference Rates "TSRRs" are currently under development and, along with fixed rates, could also be considered as an option, where appropriate.

What does the LIBOR transition mean in practice?

As mandated by regulation, any of our clients who are currently paying interest linked in any way to LIBOR will need to have their facility agreements amended and, in due course, be transitioned to an alternative rate (e.g. The Bank of England base rate) before the end of 2021.

How can LIBOR transition be achieved?

Transition from LIBOR can be achieved through referencing an RFR (e.g., SONIA) or an alternative rate (e.g., Base Rate) directly in new or refinanced loans. For existing facilities, this can be achieved through either pre-agreed conversion terms (taking effect at a pre-agreed switch date) or an agreed process for renegotiation of those agreements (re-papering of existing contracts).

The alternative RFRs are considerably different from LIBOR however and, as such, are calculated using different methodologies - they are not direct replacements for LIBOR.

What are the key differences between LIBOR and RFRs?

- LIBOR is a forward-looking term rate whereas RFRs are overnight rates without a term structure.
- LIBOR is based on quotes provided by panel banks' submissions that are meant to be estimates of where th could borrow funds whereas RFRs are calculated on a range of actual eligible transactions reported to an administrator; the Bank of England serves as the administrator of SONIA and calculates/publishes the RFR on a daily basis.
- LIBOR is an unsecured borrowing rate and includes the implied credit risk of the panel banks and a liquidity premium related to the length of the interest period. As overnight rates, RFRs include neither the panel bank credit risk element nor a liquidity premium related to the length of the interest period. Some RFRs are unsecured and others are secured.

Going Forward

The RFRWG has published a roadmap for 2021, listing its top-level priorities and urging active conversion of legacy contracts.

Some of the milestones include (for full list please see the **RFRWG 2021 Roadmap**):

- **End Q1 2021 Targets:**

  Cease new issuance of GBP LIBOR-referencing products maturing after 2021

  Complete identification of all legacy LIBOR contracts expiring after end 2021 that can be actively converted

  Accelerate active conversion [of LIBOR linked contracts] where viable (e.g. at renewal, proactive negotiation, or using preagreed terms) to reduce legacy volumes.

- **End Q2 2021 Targets:**

  Progress active conversion of all legacy GBP LIBOR contracts expiring after end 2021 where viable and, if not viable, ensure robust fallbacks are adopted where possible.

- **End Q3 2021 Targets:**

  Complete active conversion of all legacy GBP LIBOR contracts expiring after end 2021 where viable and, if not viable, ensure robust fallbacks are adopted where possible.

- **End Q4 2021 Targets:**

  Be fully prepared for the end of GBP LIBOR

Active transition has been further supported in the September 2020 RFRWG publication, "**Active transition of GBP LIBOR referencing loans**", which covers the amending of GBP LIBOR referencing loans to reference SONIA, or another appropriate alternative rate (e.g. Base Rate), and proposes that "Market participants should be looking to amend their legacy GBP LIBOR referencing loans now where feasible".

When will NBKI contact me regarding my existing LIBOR linked facility with the Bank?

If you have a residential mortgage with NBKI which references LIBOR and matures after 2021, we expect to start speaking with you in Q1 2021 about amending it to transition to Base Rate before the end of 2021. Should you wish to discuss any additional amendments, please do not hesitate to speak with your relationship manager in London as usual.

Existing LIBOR agreements that are due to mature before the end of 2021 will run to maturity using LIBOR where feasible, unless they are refinanced.

NBKI has adhered to ISDA's IBOR Fallbacks Protocol. What does this mean?

On 23 October 2020 ISDA launched the IBOR Fallbacks Supplement and Fallbacks Protocol. ISDA has invited all market participants to adhere to the Protocol.

Where both bilateral parties in over-the-counter (OTC) derivatives adhere to the ISDA IBOR Fallbacks Protocol, relevant trades will have certainty of replacement rates at fallback.

Fallback within the protocol is triggered once LIBOR is deemed to be non-representative or ceases to be published. Relevant trades are those traded before 25 January 2021 and are included in the list of documentation types within the ISDA IBOR Fallbacks Protocol.

<u>Key Terms We Will Be Using in Our Direct Communication With Our Clients</u>

What is compounding in arrears methodology and how will it be used to calculate the interest on a SONIA linked facility?

This is a method of compounding the daily overnight RFR to produce a rate, for a period, by applying the RFR compounding formula to the RFR only and applying the compounded rate to the principal to calculate the interest due.

The compounded / averaged in arrear method of calculating an interest rate involves compounding / averaging an RFR over an interest period (or an observation period) to produce a backward-looking rate. To determine an interest payment obligation of say 3 months, the RFR compounded during the 3-month interest period (or observation period) would be used. The interest payment is therefore only known when it becomes due, or a few days prior to it becoming due if a Lookback is used.

What is "fallback language"?

Fallback language sets out the alternative rates (usually in the form of a waterfall of priority) which may become the benchmark rate where the originally referenced benchmark rate is no longer to be used. Fallback language in documentation is contingent on a trigger (i.e. an event that initiates that switch from one interest rate to another). There are three different fallback triggers discussed and adopted by market participants:

- "cessation fallback triggers": cessation of a rate (e.g. the potential cessation of LIBOR at the end of 2021 when the FCA will no longer compel panel banks to submit to LIBOR and as a consequence LIBOR ceases to be published);
- "pre-cessation fallback triggers": which operate before the cessation of LIBOR and trigger as a consequence of a regulatory announcement of non-representativeness; and
- "early opt-in fallback triggers": which operate before any such regulatory announcement of non-representativeness and allow parties to move to an alternative rate if certain conditions are met.

What does "switch" mean?

Similarly, a "switch" or "switch mechanism" refers to clear contractual arrangements which are incorporated in LIBOR referencing products to actively facilitate conversion away from LIBOR by a fixed date ahead of end-2021, which would fall into the category of "pre-agreed conversion terms" - as recommended by **the UK Working Group on RFR**.

What is a credit adjustment spread ("CAS")?

A credit adjustment spread is designed to minimise the economic impact of moving from LIBOR to RFRs. Historically, RFRs have been lower than LIBOR; this is because LIBOR includes a bank credit risk component and reflects a variety of other factors (e.g. liquidity, fluctuations in supply and demand) which are not reflected in the RFRs. To minimise any value transfer and accommodate those differences to the extent possible, industry working groups have recommend the usage of a credit spread adjustment.

Therefore, if parties wish to avoid value transfer, a credit adjustment spread will be needed when transitioning to RFRs or Bank of England's base rate from LIBOR (through either a Fallback mechanism or an Amendment to facilitate transition).

For further details on the global approach to CAS you can refer to the outlined principles of credit spread adjustments in consultations issued by **Bank of England**; International Swaps and Derivatives Association "ISDA") and the **Alternative Reference Rates Committee "ARRC**".

For more information on the progress of global transition away from LIBOR, please visit:

- **Financial Conduct Authority**
- **Bank of England**
- **International Swaps and Derivatives Association, Inc.**
- **Loan Market Association**
- **Financial Stability Board**
- **Federal Reserve – Alternative Reference Rate Committee**
- **European Central Bank**