

Active transition of GBP LIBOR referencing loans

The Working Group on Sterling Risk-Free Reference Rates

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Foreword

The overall objective of the Working Group on Sterling Risk-Free Reference Rates (the "Working Group") is to enable a broad-based transition to SONIA (Sterling Overnight Index Average) by the end of 2021 across the sterling bond, loan and derivative markets.¹ This will reduce the financial stability risks arising from widespread reliance on GBP LIBOR, which in the years since the financial crisis has been based on relatively few underlying transactions.²

This paper is addressed to lenders, borrowers and investors in the GBP LIBOR referencing loan market. The Working Group recognises that the loan market involves a wide range of lenders and borrowers, from the most complex global banking groups and largest multinational corporates, to the smallest local lenders and businesses.

This paper can be used by all wholesale loan market participants to initiate discussions about actively amending GBP LIBOR referencing loans to reference SONIA or another appropriate alternative reference rate. This process is preferable to relying on "fallback" provisions triggered by either: (i) the cessation of the publication of GBP LIBOR; or (ii) the Financial Conduct Authority (the "FCA") accelerating the timetable ahead of the intended cessation at the end of December 2021 by declaring any rate settings to no longer be representative of the underlying market.

Market participants should be looking to amend their legacy GBP LIBOR referencing loans now where feasible. Taking an active approach to transition enables lenders and borrowers to take some control over the impact of the inevitable transition on such loans. Whilst the Working Group recognises that the development of standardised conventions and updated infrastructure from loan and treasury system providers will drive wider transition in the loan market, market participants can start to take steps now to transition to alternative reference rates.

To assist with the transition across the wider loan market, the Working Group also encourages lenders and borrowers transitioning to SONIA or other appropriate alternative reference rates to consider disclosing, where possible, the fact that they have executed transactions referencing alternative reference rates (together with any discloseable information around the transition mechanisms) in order to help drive momentum, transparency and the development of conventions in the loan market.

The Working Group is particularly grateful to the Cash Market Legacy Transition Task Force for having developed this paper.

The Bank of England and FCA are each ex-officio members of the Working Group. The views and outputs set out in this paper do not constitute guidance or legal advice from the Bank of England (including the Prudential Regulation Authority (the "PRA")) or the FCA or the Working Group and are not necessarily endorsed by the Bank of England (including the PRA) or the FCA. In addition, this paper is not intended to impose any legal or regulatory obligations on market participants. This paper has been prepared for the purpose of highlighting to market participants some of the potential considerations. It does not constitute a comprehensive outline of all relevant considerations. Market participants should seek their own advice in relation to their legal, regulatory, tax and other obligations and as to any other considerations or risks that may arise or be relevant.

¹ <https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr-terms-of-reference.pdf>

² This was particularly evident during the period of disruption brought on by COVID-19 in March 2020 where the limited market transactions underpinning GBP LIBOR benchmarks fell away leaving them almost entirely reliant on expert judgment. Additionally, during this period, LIBOR rates – and hence costs for borrowers – rose as central bank policy rates fell and underlying market activity was low. This has reinforced the importance of completing the transition to alternative rates by end-2021. For more on this please refer to the Bank of England's May 2020 Financial Stability Report: <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2020/may-2020.pdf>

Executive summary

1. The Working Group has set a series of target milestones for active conversion of stock of GBP LIBOR referencing contracts ahead of the expected cessation of publication of GBP LIBOR after the end of 2021.³
2. Market participants are encouraged to take steps to ensure they are prepared for the end of GBP LIBOR. Alternative and robust reference rates for the loan market, such as SONIA, Bank of England's Bank Rate ("Bank Rate") and fixed rates, are available now, with other alternatives being developed.
3. As part of the transition process, it is expected market participants will need to undertake a number of practical steps. As a summary, these could include:
 - Step 1: Reviewing outstanding GBP LIBOR referencing loans (including multi-currency loans containing a GBP LIBOR option);
 - Step 2: Identifying the alternative reference rate to be used for each loan;
 - Step 3: Familiarising yourself with how the alternative reference rate will be calculated, and how to calculate any economic difference between GBP LIBOR and the selected alternative reference rate;
 - Step 4: Considering whether systems and operations are ready to accommodate alternative reference rates;
 - Step 5: Documenting the transition of the loans. All parties should also undertake appropriate due diligence on any changes that are proposed – ask your bank what preparations they are making and what that means for you/your business.
4. It is important to be aware that these alternative rates are not a like-for-like replacement for GBP LIBOR⁴. An overarching concern from the point of view of treating customers fairly when replacing LIBOR is that the transition to alternative reference rates should, as far as possible, be one which mitigates any transfer of value between the parties.⁵ As such, GBP LIBOR discontinuation should not be used to move borrowers with continuing contracts to replacement reference rates that are expected to be higher than what GBP LIBOR would have been or otherwise introduce inferior terms. Conversely, when transitioning existing contracts, firms receiving GBP LIBOR-linked interest are not expected to give up the difference between this and SONIA (which results from the term credit risk premium that is built into the LIBOR rate, but not into SONIA) or other alternative rates.
5. The time required for, and considerations around, amending existing GBP LIBOR referencing loans should not be underestimated. Early action should therefore be taken to transition now.

³ <https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfr-working-group-roadmap.pdf>

⁴ GBP LIBOR contains elements to compensate lenders for term bank credit risk and liquidity premium, which alternative reference rates might not include. GBP LIBOR is therefore economically different to alternative reference rates such as SONIA compounded in arrears, TSRRs and Bank Rate. Given this difference, a credit adjustment spread may be required when transitioning a GBP LIBOR referencing loan to an alternative reference rate such as SONIA compounded in arrears, Bank Rate and fixed rate or TSRR in order to eliminate or minimise any transfer of value.

⁵ Please refer to the FCA website for more on this: <https://www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition>

6. A glossary is available at Appendix 1 to assist readers with terms used in this paper.

Purpose and scope of the paper

7. This paper is intended to assist all wholesale loan market participants but it is expected to be particularly helpful to borrowers in initiating discussions on amendments by outlining practical steps that they can take to transition their GBP LIBOR referencing loans to alternative reference rates. It also sets out some of the benefits of replacing GBP LIBOR with an alternative reference rate and of an early transition rather than waiting for the discontinuation of GBP LIBOR. Borrowers can use this paper to approach their lenders and advisers to discuss amendments.
8. It is also expected that lenders will use this paper to approach borrowers to initiate discussions on amendments.
9. This paper covers:
 - i) GBP LIBOR only and the alternatives to GBP LIBOR;
 - ii) Corporate borrowers of syndicated, club or bilateral loans (e.g. revolving credit facilities, term loans, drawn and committed undrawn facilities);
 - iii) The amendment of GBP LIBOR referencing loans to reference an alternative rate prior to the cessation of GBP LIBOR.

This paper does **not** cover:

- i) 'Tough legacy' loans (being a narrow pool of contracts that genuinely have no or inappropriate alternatives and no realistic ability to be renegotiated or amended);
- ii) Retail loans (e.g. personal loans, credit cards and mortgages);
- iii) The impact of the transition from GBP LIBOR on areas such as tax, accounting and pensions. The impact on these areas will, however, need to be considered by lenders, borrowers, investors and their advisers;
- iv) Any considerations which may apply under laws other than English law.

Section 1: Background and reasons to transition from GBP LIBOR in loan markets

Background

10. Regulatory reform in relation to LIBOR has been ongoing for many years. Following a July 2017 speech⁶ by Andrew Bailey, then Chief Executive of the FCA and now Governor of the Bank of England, about the uncertain future of LIBOR, there has been a focus on the need to transition. LIBOR is based on banks' submissions of their interbank borrowing rates, but banks no longer fund themselves in this way. The absence of an active underlying market means LIBOR is increasingly based on the use of 'expert judgment', which is unsustainable. The FCA has obtained agreement from panel banks to remain on the LIBOR panels until the end of 2021 to enable an

⁶ In this speech, Andrew Bailey said "one of the aims of such reform, as set out in the Financial Stability Board's July 2014 report on Reforming Major Interest Rate Benchmarks, has been to try to anchor LIBOR submissions and rates to the greatest extent possible to actual transactions. This is to ensure the rate is genuinely representative of market conditions". Andrew Bailey also said "the underlying market that LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – is no longer sufficiently active". Full speech can be accessed here: <https://www.fca.org.uk/news/speeches/the-future-of-libor>

orderly transition to alternative reference rates. The FCA has also stated that LIBOR cessation may be preceded by a period in which it is still published but the FCA finds that any LIBOR settings are no longer going to be representative of the underlying market the rates seek to measure.

11. Market participants are therefore urged to consider the ramifications of using a rate which its regulator may find to be non-representative of the underlying market. LIBOR is expected to cease by the end of 2021 at the latest and this should not be considered a remote possibility. All users of GBP LIBOR must therefore act now.

Reasons for early transition away from GBP LIBOR

12. There are other advantages to transition away from GBP LIBOR before its expected cessation:

- a. There are alternatives that are more robust and stable. Unlike GBP LIBOR, SONIA, which is administered by the Bank of England, is robust as it is anchored in an active and liquid underlying market. It reflects the average of the interest rates that banks pay to borrow sterling overnight from other institutions. SONIA also tracks the Bank Rate very closely (see figure 1) and the compounded rate is comparatively stable and predictable (see figure 2).

Figure 1: SONIA and Bank Rate

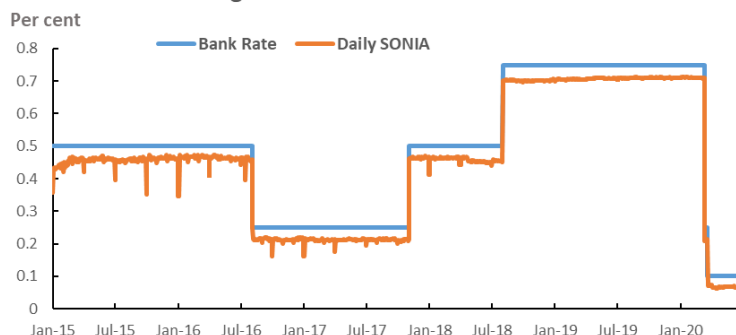
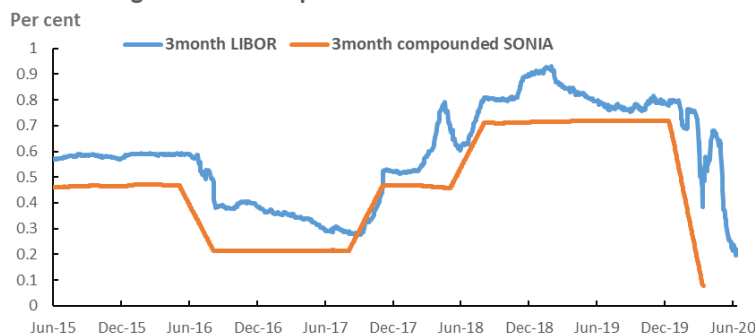


Figure 2: 3m compounded SONIA and 3m £ LIBOR



Source: Bank of England website, Bank of England calculations, and Bloomberg data.

- b. Risks / costs of relying on a non-representative rate. As the end of 2021 draws closer, the risks associated with continuing to rely on agreements that reference GBP LIBOR beyond that point are increasing. This is because LIBOR is expected to cease after end-2021 and there is uncertainty over how the volatility of GBP LIBOR and depth of liquidity in GBP LIBOR instruments may change as the end of 2021 approaches. At that stage LIBOR is likely to be based on even fewer transactions and the lack of depth to the market may increase the likelihood of more volatile results of calculations of the benchmark.
- c. Limited availability of time and resources. The transition is one that will require significant time and resources, for example, engaging legal expertise, engaging with lenders and discussion with systems providers. Given the number of GBP LIBOR referencing loans to be transitioned across the market, resources to provide legal, lending and systems expertise may become more limited the closer we get to the end of 2021. Early transition may therefore help enable the change to be managed more efficiently and effectively.

Box 1: Examples of transition in the loan market

Transition to alternative reference rates is already underway in the GBP LIBOR referencing loan market.⁷ There have been borrowers entering into bilateral SONIA referencing loans (e.g. National Express, Associated British Ports ("ABP"), SSE and Coastline Housing) and amending their GBP LIBOR referencing loans to SONIA (e.g. South West Water and Riverside). There has also been activity in the syndicated loan market with British American Tobacco's ("BAT") multicurrency facility agreement providing for an in-built switch from GBP LIBOR and USD LIBOR to SONIA and SOFR (the selected near risk-free rate for USD) and ABP's sterling facility agreement providing for an in-built switch from GBP LIBOR to SONIA. These transactions show appetite to start transitioning away from GBP LIBOR now and are a helpful path for borrowers and lenders to consider in their plans.

Section 2: Practical steps that lenders and borrowers can take now to amend their existing GBP LIBOR referencing loans

Step 1: Reviewing outstanding GBP LIBOR referencing loans

13. One of the first practical steps to take is to identify your outstanding GBP LIBOR referencing loans that mature after the end of 2021. You may want to consider the following:
- a. Bilateral or syndicated. If the loans are syndicated, identify the size and composition of the syndicate. A larger syndicate and one with non-relationship lenders is likely to require more time to transition.
 - b. Fallback provisions. Check whether there are fallback provisions contained within the loan agreement and their robustness. Whilst existing loan agreements may include fallback provisions setting out what will happen if GBP LIBOR is not available, these provisions do not generally envisage the permanent cessation of GBP LIBOR. If agreements are not amended this may lead to the current fallbacks being relied on and such fallbacks may only work in the short term, if at all, and not be robust. Reliance on existing fallbacks, unless they are robust and specifically cover the envisaged end of LIBOR, should not be used as a primary method of transition to an alternative reference rate.
 - c. Amendment provisions. The terms of the amendment provisions and (in a syndicated loan) the level of consent required (which will depend on the terms of the loan) should be checked. Consider whether there are other third parties or sub-participants that need to consent to the amendment (e.g. guarantors, secured parties, regulatory or public authorities).
 - d. Sterling only or multicurrency. Additional considerations apply to multicurrency loans. Working groups across the five LIBOR jurisdictions have selected overnight near risk-free rates as alternatives to LIBOR,⁸ however, the selected rates are not consistent across jurisdictions. Therefore, if the loan is multicurrency, multiple alternative reference rates will

⁷ The following website includes a list of RFR referencing bilateral/syndicated loans executed and publicly disclosed to date: <https://www.lma.eu.com/libor>. The current list (as at the date of this paper) can be found here: https://www.lma.eu.com/application/files/6915/9532/9886/List_of_RFR_referencing_bilateral_and_syndicated_loans_July_2020.pdf

⁸ For example, the Alternative Reference Rates Committee in the US has selected the Secured Overnight Financing Rate (SOFR) as its recommended alternative to USD LIBOR

need to be considered so that the loan agreement only needs to be amended once. In cases where the market conventions for alternative reference rates in a relevant currency are yet to be settled, parties should also assess whether successive amendments will be required and any alternatives that may be available.

- e. Hedging considerations. There may be hedging associated with the loan (e.g. interest rate swaps, cross-currency swaps or other hedging arrangements). If so, consideration needs to be given to the fallbacks contained in the hedging arrangements as these fallbacks may operate differently to those in the loan agreement. Consideration should be given to assessing the benefit of transitioning the related hedging at the same time to minimise additional, unintended risks and to manage the entire economic impact.
- f. Amendment process and costs. In terms of the process for amendment, consider who will take the lead on the amendment process, the relevance of any applicable provisions on consents⁹ and agree if any costs need to be allocated.
- g. Accounting considerations. The International Accounting Standards Board (“IASB”) has considered the potential effects of the transition on financial reporting under IFRS. Their Phase 2 amendments make allowance for narrowly specified financial instrument modifications directly required by benchmark reform. These amendments were issued in August 2020.¹⁰ Their use in the EU and UK requires them to be endorsed.

Step 2: Identifying the alternative reference rate to be used

- 14. This will depend on a number of factors, such as whether the alternative reference rate provides enough notice of payment and operational feasibility. In addition, it is important to ensure you understand the mechanics of the rate, and associated hedging options.
- 15. In January 2020, the Working Group published a paper on "*Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives*" (the “Alternative Rates Paper”).¹¹ The Alternative Rates Paper notes that **SONIA compounded in arrears is an appropriate alternative reference rate for a large volume (by value) of the GBP LIBOR referencing loan market and that SONIA should become the norm in most derivatives, bonds, and bilateral and syndicated loan markets** given the benefits of the consistent use of benchmarks across markets and the robust nature of overnight SONIA. However, it was also noted that some parts of the loan market may require alternative rates (e.g. forward-looking term rates, Bank Rate or fixed rates).
 - a. SONIA compounded in arrears. In contrast to GBP LIBOR which is fixed in advance for a set period (e.g. 3 months), compounding in arrears involves aggregating the overnight SONIA rates over a period to derive term interest payable (i.e. longer than overnight). As compounding in arrears does not give parties visibility of the rate until the end of the period,

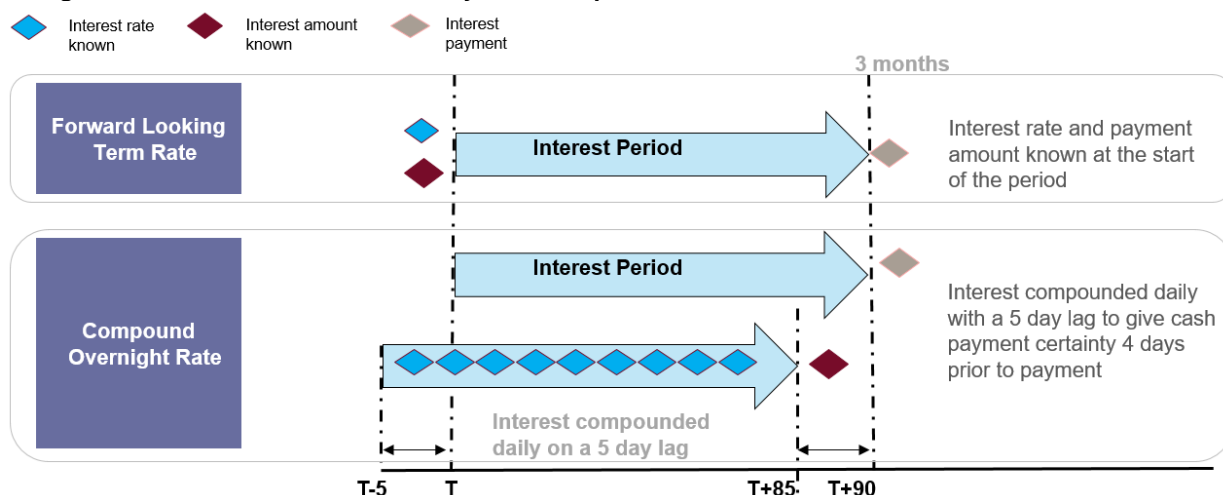
⁹ For example, "snooze/lose" provisions which are clauses in documentation which disenfranchise any lender that fails to respond within a specified time-frame to a request to an amendment relating to LIBOR transition. The LMA Replacement of Screen Rate language includes an optional clause with this wording. Lenders need to be aware of such clauses to ensure they respond promptly to any requests for consent to LIBOR transition-related amendments.

¹⁰ <https://cdn.ifrs.org/-/media/project/ibor-phase-2/project-summary-iborphase2-aug2020.pdf?la=en>

¹¹ <https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/use-cases-of-benchmark-rates-compounded-in-arrears-term-rate-and-further-alternatives.pdf>

the cash market has developed the concept of a lookback (or lag) period when referencing the SONIA rate; this means the final interest payment is known a few days before it is due to be paid at the end of the interest period. See figure 3 for an illustration of this approach (using a 5 business day lookback period).

Figure 3: Illustration of 5 business day lookback period



This approach is different to having a forward-looking term rate, so practical issues with forecasting and planning need to be considered, especially when thinking about the appropriate length of the lookback period. However, there have been loans to date referencing SONIA compounded in arrears demonstrating the feasibility of this approach (see the examples of transition in the loan market noted in Box 1 in this paper). SONIA compounded in arrears is also consistent with fallbacks being developed for ISDA documentation for derivatives. See further *Step 3: Familiarising yourself with how your replacement reference rate will be calculated* below in relation to conventions relating to the calculation of SONIA compounded in arrears.

b. Alternatives to SONIA compounded in arrears. The alternatives to SONIA compounded in arrears include: (i) Bank Rate; (ii) fixed rate; and (iii) a forward-looking Term SONIA Reference Rate ("TSRR"). **It should be noted that the Working Group considers that the use of TSRRs should be limited as indicated in the Alternative Rates Paper.**

16. The above alternatives to SONIA compounded in arrears will be particularly relevant to:
 - i) smaller borrowers for whom simplicity and/or payment certainty is a key factor;
 - ii) those who need longer to be able to adapt to the technology or process changes needed for SONIA compounded in arrears;
 - iii) specific products where the use of SONIA compounded in arrears may create operational difficulty regardless of the sophistication of the borrower (e.g. trade and working capital, export finance, emerging markets and Islamic finance).
17. Bank Rate and fixed rates may be available to transition to. TSRRs are not yet available for use but are being developed with a view to being made available for use later in 2020. If using Bank Rate, fixed rates or a TSRR, consideration will need to be given as to whether suitable hedges are available.

Step 3: Familiarising yourself with how your replacement reference rate will be calculated

18. The interest rate on a transitioned loan should be calculated as the sum of: (i) the alternative reference rate; and (ii) a credit adjustment spread to account for differences between the alternative reference rates (such as SONIA compounded in arrears, Bank Rate, fixed rate and TSRR) and GBP LIBOR, with the margin added to this sum. Appendix 2 (*Worked example of the mechanics of active transition from GBP LIBOR to SONIA compounded in arrears*) sets out a worked example of the mechanics for calculating the interest rate in a transition scenario.
19. It is important that borrowers discuss and agree with their lenders how the calculation of SONIA compounded in arrears works and the conventions around it, together with the practicalities of counterparties being able to inform borrowers of interest amounts due and how borrowers can meet settlement timelines. In particular, consideration should be given to the points below.
 - a. Use of the SONIA Compounded Index. Unlike Bank Rate, fixed rate and TSRRs, the calculation of SONIA compounded in arrears requires a number of data points (i.e. a SONIA rate for each day in the reference period). The Bank of England publishes a daily SONIA Compounded Index¹² which may help simplify the calculation of SONIA compounded in arrears as the change in this Index between any two dates could be used to calculate the interest rate payable over that period. Use of daily floors may affect usage of the SONIA Compounded Index for loans. Daily zero floors are likely to be required by certain investors and also for the purposes of loan trading.
 - b. Length of the lookback period. Consideration should be given to the appropriate length of the lookback period and to what is required by the borrower.¹³ A 5 business day lookback period has been used in SONIA referencing loans to date (which follows the SONIA referencing floating rate note market). Please note that in September 2020 the Working Group published a statement¹⁴ that use of a **Five Banking Days** Lookback without Observation Shift is recommended as the standard approach for sterling loan markets.
 - c. Use of lookback without observation shift (i.e. lag) or with observation shift. Lookback can be used with or without an observation shift. Please note that in September 2020 the Working Group published a statement¹⁵ that use of a Five Banking Days Lookback **without Observation Shift** is recommended as the standard approach for sterling loan markets. Lookback without observation shift (i.e. lag) is where each SONIA rate would be weighted according to the number of days that apply in the actual *interest period*. There have been a number of SONIA referencing loans using the lookback without observation shift. This is different to the use of the observation shift which weights each SONIA rate according to the

¹²

<https://www.bankofengland.co.uk/boeapps/database/fromshowcolumns.asp?Travel=NlxSUx&FromSeries=1&ToSeries=50&DAT=RNG&FD=1&FM=Jan&FY=2010&TD=3&TM=Aug&TY=2020&FNY=&CSVF=TT&html.x=108&html.y=20&C=UMQ&Filter=N>

¹³ For more information on advantages and disadvantages to having a longer or shorter period for the lookback mechanism please refer to paragraph 25 of this paper which sets out the considerations:

<https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/discussion-paper-conventions-for-referencing-sonia-in-new-contracts.pdf>

¹⁴ <https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/statement-on-behalf-of-rfrwg-recommendations-for-sonia-loan-market-conventions.pdf>

¹⁵ <https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/statement-on-behalf-of-rfrwg-recommendations-for-sonia-loan-market-conventions.pdf>

number of days that apply in the earlier *observation period*. The concept of an observation shift is used in the SONIA Compounded Index and is also compatible with the derivatives market. It has also been used by Shell, ABP and BAT in their syndicated loan transactions.

20. As noted earlier in the paper, GBP LIBOR contains elements to compensate lenders for term bank credit risk and liquidity premium, which alternative reference rates might not include. GBP LIBOR is therefore economically different to alternative reference rates such as SONIA compounded in arrears, TSRRs and Bank Rate. Given this difference, a credit adjustment spread may be required when transitioning a GBP LIBOR referencing loan to an alternative reference rate such as SONIA compounded in arrears, Bank Rate and fixed rate or TSRR in order to eliminate or minimise any transfer of value.
21. The Working Group previously consulted¹⁶ on credit adjustment spread methodologies for cash products in respect of fallbacks applying on cessation or a non-representativeness trigger and ISDA had previously consulted on this issue for derivatives. These consultations selected a historical median over a five year lookback period as the recommended methodology. However, these consultations did not cover active transition (i.e. transition made ahead of LIBOR cessation) nor transition to a non-SONIA based rate.
22. When looking to transition GBP LIBOR referencing loan products, it may be useful to consider the approaches taken in the SONIA-referencing floating rate note market where numerous transitioning amendments by way of consent solicitations have been concluded, using an approach based on the forward-looking swap market to calculate the credit adjustment spread. This approach has also been seen in the loan market (e.g. South West Water's amendment). The ISDA historical median approach has also been used in the loan market (e.g. in the BAT and the Associated British Ports transactions). These approaches are described below:
 - a. Forward approach. This approach involves calculating the credit adjustment spread based on the forward-looking basis swap market. It is calculated as the linear interpolation between differing tenors of GBP LIBOR vs SONIA swaps, which is then added to the original margin.¹⁷
 - b. ISDA historical median approach. Under this approach, the credit adjustment spread is based on the difference between GBP LIBOR and SONIA compounded in arrears calculated over a five-year lookback period. The credit adjustment spread calculated using this methodology for different tenors of GBP LIBOR is currently being calculated and published by Bloomberg Index Services Limited.¹⁸
 - c. Other approaches. Market participants could use a credit adjustment spread methodology developed on an individual basis. Borrowers and lenders should also carefully consider any bespoke arrangement and conduct their own due diligence to ensure that it is appropriate.

¹⁶ <https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/consultation-on-credit-adjustment-spread-methodologies-for-fallbacks-in-cash-products-referencing-gb.pdf>

¹⁷ For example, the ABP consent solicitation in May 2019 involved notes which had between 3 and 4 years to run. The credit adjustment spread was the interpolation between the 3 year and 4 year 3m GBP LIBOR vs SONIA basis for sterling basis swap transactions. The South West Water loan amendment used the linear interpolation to the final maturity date of the 3m GBP LIBOR vs SONIA basis.

¹⁸ For more information please refer to this Fact Sheet: <https://data.bloomberglp.com/professional/sites/10/IBOR-Fallbacks-Fact-Sheet.pdf>

23. Given the complexities, the proposed methodologies for calculating a spread adjustment may be subject to further market-wide discussion but this may not determine a single specific solution. As the appropriate credit adjustment spread will always be subject to bilateral agreement, market participants are encouraged not to wait for the outcome of further market-wide discussions before taking steps to transition.
24. When transitioning existing loans and considering which approach to use, consistency with the derivatives market for hedging purposes needs to be considered, if hedging is a relevant consideration. The parties will also need to decide the date on which the credit adjustment spread is to be determined. As market prices may move, it is particularly important to be clear on the timing of the calculation, as well as the potential consequences of any mismatches which may threaten hedge accounting treatment, where relevant.

Step 4: Considering whether / when systems and operations are ready

25. Given the differences between GBP LIBOR and alternative reference rates, changes may need to be made to existing treasury management and loan systems in order to use alternative reference rates. For example, among other things, the use of SONIA compounded in arrears on any scale will require updates to both treasury management systems and loan systems to be in place. The relevant system providers will need to develop the necessary systems and borrowers and lenders should engage with their system providers on this. Such systems will need to be implemented and tested and may require users to be on the latest version of the system. The time and costs of such systems upgrades and implementation will need to be considered.
26. If you are not operationally ready for transition now, you may want to consider the use of switch mechanisms to transition (see *Box 2 below*).

Step 5: Documenting the transition of the loans

27. An amendment agreement is likely to be required in order to transition a loan from GBP LIBOR to an alternative reference rate. The loan market does not have a protocol system for amendments (such as that used in the derivatives market) in order to amend multiple agreements,¹⁹ so each individual loan agreement referencing GBP LIBOR would need to be amended to refer to an alternative reference rate.
28. The method of amendment may depend on the type of deal. For example, a single amendment agreement detailing all the amendments needed to the relevant loan agreement may lend itself more to bilateral loans and club deals. With syndicated loans, borrowers should consider the amendment process with their syndicate to assess the feasibility of all requisite parties approving all of the changes to the facility agreement. Where this would be difficult to achieve (for example, given the size of the syndicate), a two stage process, whereby all requisite parties agree the key commercial terms but then delegate authority to the facility agent and obligors to determine and make the necessary changes to the facility agreement, could be used.²⁰ The Loan Market

¹⁹ This is due to the less standardised nature of loans and also the multilateral nature of syndicated loans.

²⁰ The use of a two stage process should be carefully considered. Whilst in some cases it may help to make the process of agreement to amendments easier to manage for the agent and the lenders (who would not need to approve all of the changes to the relevant facility agreement), it may be more time consuming and costly than a "one step" amendment process.

Association ("LMA") has published an exposure draft²¹ "reference rate selection agreement" for use when transitioning syndicated loans based on this process (and which works alongside an exposure draft²² of compounded risk-free rate facility agreement for sterling).

29. The use of an alternative reference rate requires the consideration of a number of points which will need to be reflected in the documentation. Some of these have already been discussed in this paper (e.g. the appropriate replacement rate and the credit adjustment spread). Parties will also need to consider other terms of the loan agreement, including among other things: (i) the interest periods which can be selected; (ii) fallback provisions to the replacement reference rate; (iii) the application or not of break costs; (iv) aligning the notice period for prepayments with the lookback period to address mismatch risks; and; (v) market disruption provisions. If there are forward looking debt service or interest cover projections, these will need to be considered and economic assumptions in financial models around interest rates may need to be updated.
30. In addition to the amendment agreement, there may be other elements to consider as part of the documentation process. For example, requirements to obtain legal opinions, hold board meetings for approval of documentation, satisfy conditions precedent, along with the impact on security documentation, guarantees, related hedging and any other documentation related to the loan which also references GBP LIBOR. As noted earlier in the paper, transition away from GBP LIBOR should not be taken as an opportunity to renegotiate the loan agreement generally and any amendment should be limited to those clauses directly impacted by transition.
31. Market participants should seek their own legal advice on the documentation of the transition.

Box 2: Switch mechanisms

Parties who wish to actively transition their loans now but are not yet operationally ready for SONIA compounded in arrears may wish to consider the use of switch mechanisms to transition away from GBP LIBOR.

Switch mechanisms provide for an in-built switch from GBP LIBOR to SONIA compounded in arrears (or another alternative reference rate) upon a specified trigger, with the documentation setting out the mechanics and provisions for the use of that rate. It provides a phased approach to transition whereby GBP LIBOR is used until a point in time after which there will be a switch to the alternative reference rate. A benefit of this approach is that it requires a consideration of the same calculation, convention and documentation issues as a new loan directly referencing SONIA compounded in arrears (or other alternative reference rate). It also mitigates against the need for a further amendment process. There are various different methods by which a switch can be documented and this requires careful consideration.

The Working Group understands that this is being considered by a Loan Market Association working party (consisting of representatives from a wide range of market participants and advisers including corporate borrowers and the Association of Corporate Treasurers) in respect of syndicated loans.

²¹

https://www.lma.eu.com/application/files/8415/7925/5873/Exposure_draft_of_reference_rate_selection_agreement_for_transition_of_legacy_transactions_to_risk-free_rates.docx

²²

https://www.lma.eu.com/application/files/6615/8289/7161/Exposure_draft_of_a_compounded_SONIA_based_sterling_term_and_revolving_facilities_agreement.docx

Section 3: Further information

32. Appendix 3 sets out links to further information on some of the topics covered within this paper.
33. Appendix 4 contains a summary sheet of the practical steps that can be taken now to amend existing GBP LIBOR referencing loans.
34. It is recommended that borrowers contact their adviser or relationship manager at their lender(s) for further information on the transition.

Appendix 1: Glossary

Bank Rate	The main policy rate of the Bank of England. Also known as 'Base Rate'.
Credit adjustment spread	A credit adjustment spread is designed to minimise the economic impact of moving from LIBOR to RFRs: historically RFRs have been lower rates 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. Therefore, if parties wish to avoid value transfer, a credit adjustment spread will be required when transitioning to RFRs from LIBOR (either through a fallback mechanism or an amendment to facilitate transition).
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).
Lag	See definition of Lookback without observation shift.
Lookback	<p>Under a lookback mechanism the Observation period for the interest rate calculation starts and ends a certain number of days prior to the interest period. As a result, the interest payment can be calculated prior to the end of the interest period. The rate is calculated over the interest period itself – but for each day in that period the rate used is that from the relevant number of days before.</p> <p>For example, for a one month interest period of 1 March to 1 April with a 5 London business day lookback, the rate for 1 March would be taken from 22 February (the day falling 5 London business days' prior) and so on. On 25 March, the agent would know the full month's interest amount and would be able to invoice the borrower for payment at the end of the interest period. The borrower would then have approximately five days' notice of the interest payment due on the last day of the period (depending on what time the compounded RFR is ascertainable).The method is intended to help to alleviate some of the operational challenges associated with calculating interest using the SONIA compounded in arrears method.</p>
Lookback without observation shift	Lookback without observation shift (also known as "lag") provides for each SONIA rate to be weighted according to the number of days that apply in the actual interest period. This is in contrast to the Observation shift mechanism which weights the rate according to the number of days that apply in the Observation period.
Non-representativeness trigger	The invocation of a contractual trigger event if the FCA finds that any LIBOR settings are no longer going to be representative of the underlying market the rates seek to measure earlier than the current expected cessation after December 2021.
Observation period	This is a period over which SONIA compounded in arrears applicable to any loan is calculated. It operates by reference to a specified Lookback which determines both the first day of the observation period and the last day of the observation period.
Observation shift	<p>The observation shift mechanism provides for the rate to be calculated and weighted by reference to the Observation Period rather than the relevant interest period.</p> <p>The observation shift weights the rate according to the number of days that apply in the observation period; this is in contrast to the Lookback without</p>

observation shift which weights the rate according to the number of days that apply in the interest period. Using the example of a 2-business day lookback period, the lookback uses the rate from 2 days ago to calculate today's interest owed. So if today were Friday, one would use Wednesday's rate in calculating today's interest:

- The Lookback without observation shift would imply that you should apply Friday's weighting (i.e. of 3, since Friday covers three calendar days until payment is due) to Wednesday's rate.
- The observation shift in contrast would apply Wednesday's weighting to Wednesday's rate (i.e. of 1).

Note that with a 5-business day lookback, the differences in weighting solely occur with bank holidays.

SOFR	Secured Overnight Financing Rate. The chosen risk-free rate for US dollar markets which is administered by the Federal Reserve Bank of New York.
SONIA	The Sterling Overnight Index Average. The chosen risk-free rate for sterling markets which is administered by the Bank of England.
SONIA Compounded Index	The name of the index that is published daily by the Bank of England. It consists of a series of daily data that represent the returns from a rolling unit of investment earning compound interest at the SONIA rate each day.
SONIA compounded in arrears	This is a method of calculating an interest rate by compounding SONIA over an interest period (or an observation period) to produce a backward-looking rate. To determine an interest payment obligation of say 3 months, SONIA 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.
Switch mechanisms	Switch mechanisms in loan documentation provide for an in-built switch from LIBOR to RFRs upon a specified trigger and the loan documentation includes the mechanics and provisions for the use of that rate. A benefit of this approach is that it requires a consideration of the same calculation, convention and documentation issues as a new loan directly referencing RFRs. It also eliminates the need for a further amendment process.
TSRR	Term SONIA Reference Rate. A measure of the market's forward expectation of the average SONIA rate over a designated term. This is currently in development.
Working Group	The Working Group on Sterling Risk-Free Reference Rates, initiated by the Bank of England whose mandate is to catalyse a broad-based transition to using SONIA – the market's preferred risk-free rate – as the primary sterling interest rate benchmark in bond, loan and derivatives markets.

Appendix 2: Worked example of the mechanics of active transition from GBP LIBOR to SONIA compounded in arrears

For simplicity in this example:

- (i) The transition of the loan will take place on an interest payment date (most active transitions of bonds through consent solicitations have used this approach).
- (ii) Example numbers are used for illustrative purposes only.
- (iii) The computation of SONIA compounded in arrears is not covered.

It is assumed that the current loan facility has the following characteristics:

- 5-year bilateral GBP loan of £500m
- A rate of 3-month GBP LIBOR + 200 bps
- Quarterly interest payments
- Maturity date of 31/12/2024
- Next interest payment date is 30/09/2020
- Remaining life of the loan is 4.25 years

The loan will be actively transitioned with an effective date of 30/09/2020. Outlined below are the mechanics for determining the interest payable following transition:

1. The interest rate for the current interest period was fixed using the 3 month GBP LIBOR rate of 90bps on 30/06/2020.
2. The rate for the current interest period is 290bps (90bps GBP LIBOR +200bps spread over LIBOR).
3. On 30/09/2020 the LIBOR-OIS forward basis curve is observed.
4. The loan has a remaining maturity of 4.25 years and we will interpolate between the 4y and 5y point of the basis curve. 4y basis is 10bps and 5y basis is 14bps.
5. The credit adjustment spread based on the interpolated forward LIBOR-OIS is 11bps.²³
6. The interest rate on the loan for the next period will be SONIA (compounded in arrears over the 3 months) + 211bps (200bps spread over LIBOR + 11bps of the OIS/LIBOR basis).
7. The calculation of SONIA compounded in arrears is not covered specifically here but by example we could use a 5-day observation shift as described in Section 2 above.
8. The next interest payment will settle on the next quarterly date of 31/12/2020.
9. On 31/12/2020 the SONIA compounded in arrears 3-month rate is calculated to be 6 bps. The interest rate on the loan for that period is 217 bps (211bps + 6bps) or 2.17%.

²³ The use of the forward approach is assumed for illustration purposes only. Please refer to paragraphs 22 to 24 for further discussion of methodologies for the credit adjustment spread.

Appendix 3: Useful resources

Background

- **Factsheet on Calling time on LIBOR: Why you need to act now**, ACT, CBI, Bank of England and FCA, January 2020:
<https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/factsheet-calling-time-on-libor-why-you-need-to-act-now.pdf>
- **New and legacy loan transactions referencing Sterling LIBOR**, Working Group, December 2018:
<https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/new-and-legacy-loan-transactions-referencing-sterling-libor.pdf>

Conventions and indices

- **Statement on behalf of the Working Group: Recommendations for SONIA Loan Market Conventions**, Working Group, September 2020:
<https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/statement-on-behalf-of-rfrwg-recommendations-for-sonia-loan-market-conventions.pdf>
- **Discussion Paper: Conventions for referencing SONIA in new contracts**, Working Group, March 2019:
<https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/discussion-paper-conventions-for-referencing-sonia-in-new-contracts.pdf>
- **Statement from the Working Group and Summary of Responses to Discussion Paper on Conventions for referencing SONIA in new contracts**, Working Group, August 2019:
<https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/statement-and-summary-of-responses-to-sonia-conventions-discussion-paper.pdf>
- **Discussion Paper: Supporting Risk-Free Rate transition through the provision of compounded SONIA**, Bank of England, February 2020:
<https://www.bankofengland.co.uk/-/media/boe/files/paper/2020/supporting-rfr-transition-by-providing-compounded-sonia.pdf>

Credit adjustment spread

Consultation on credit adjustment spread methodologies for fallbacks in cash products referencing GBP LIBOR, Working Group, December 2019:

<https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/consultation-on-credit-adjustment-spread-methodologies-for-fallbacks-in-cash-products-referencing-gb.pdf>

Use cases of alternative reference rates

- **Use Cases of Benchmark Rates: Compounded in Arrears, Term Rate and Further Alternatives**, Working Group, January 2020:
<https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/use-cases-of-benchmark-rates-compounded-in-arrears-term-rate-and-further-alternatives.pdf>

Path to discontinuation of new GBP LIBOR lending

- **Further statement from the RFRWG on the impact of Coronavirus on the timeline for firms' LIBOR transition plans**, Working Group, April 2020
<https://www.fca.org.uk/news/statements/impact-coronavirus-firms-libor-transition-plans>

Tough Legacy contracts

- **Paper on the identification of Tough Legacy issues**, Working Group, May 2020
<https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/paper-on-the-identification-of-tough-legacy-issues.pdf>

Appendix 4: Summary of practical steps that can be taken now to amend existing GBP LIBOR referencing loans



BANK OF ENGLAND



The Working Group on Sterling Risk-Free Reference Rates Summary of practical steps that can be taken now to amend GBP LIBOR referencing loans

Calling time on LIBOR: Why you need to act now

- 1** Interest rate benchmarks, such as LIBOR, are used to calculate the interest rate in financial products. These rates are written into loans, bonds and mortgages, and many other contracts.
- 2** LIBOR is the most common interest rate benchmark in the UK. LIBOR is expected to cease after end-2021. In particular, LIBOR-linked loans may not be offered after Q1 2021. This will impact the variable rate in LIBOR-linked financial products.
- 3** All financial products will need to remove dependence on LIBOR by end-2021. All users of LIBOR must act now.

What's happening?

LIBOR is being phased out

Since the 1980s LIBOR has been used widely as an interest rate benchmark for many products. LIBOR is based on banks' submissions of their interbank borrowing rates. However, since the financial crisis, banks no longer fund themselves in this way. The absence of an underlying active market means LIBOR is sustained by the use of "expert judgement". This cannot continue indefinitely, and [2021 is the last year panel banks](#) have agreed to participate in providing their submissions to LIBOR.

LIBOR is expected to cease after end-2021

Public authorities, in the UK and internationally, have been clear that LIBOR is expected to cease to exist after 2021. For loans, LIBOR products may not be offered beyond Q3 2020. All counterparties to a financial product or contract that references LIBOR will need to take action to remove any dependence on LIBOR that remains after 2021.

Robust alternative benchmark rates have been established, this includes SONIA* for sterling loans

LIBOR is available in five currencies. Each relevant jurisdiction has established an alternative to LIBOR. This includes SONIA in the UK. Unlike LIBOR which is fixed in advance for a set period (e.g. 3 months), SONIA is an overnight rate, measured on each day over the interest period to produce a final interest rate at the end. It is a (nearly) risk-free rate as it does not include any term bank credit risk or liquidity premium. These differences between SONIA and LIBOR will impact how interest is calculated.

Transition from LIBOR is underway, but all users must take further action

You will need to discuss with your bank or provider how you will switch your contract away from LIBOR. It is important that all users of LIBOR understand how the new rates differ from LIBOR, so they are prepared when providers get in touch about transition and the actions needed.

Where can I find more information?

Please refer to the Sterling Risk Free Reference Rate Working Group website:
<https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor>

This document is not intended to serve as legal advice, or as a substitute for firms' conduct obligations when offering products linked to LIBOR or alternative rates. There are risks to the valuation, pricing or cost of your LIBOR product in the event the rate is no longer published or based on reduced submissions. Replacing the rate may raise tax, accounting and/or legal risks. You should consider with your legal advisors whether there may be risks of contractual frustration if your products continue to reference LIBOR beyond 2021.

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What do I need to do?

Borrowers can take practical steps now to transition.

Ask your bank what preparations they are making and what that means for you/your business. You can seek further advice from financial service professionals as you consider how to prepare for transition.

As a summary, key steps to be discussed with your lender(s) and advisers are likely to include the following.

1. Reviewing your LIBOR referencing loans

It is important to identify your LIBOR referencing loans and understand the provisions so that you know what will happen to these when LIBOR is no longer available.

2. Identifying alternative reference rate to be used

The Working Group considers that SONIA compounded in arrears is an appropriate alternative reference rate for a large volume of the GBP LIBOR referencing loan market. Some parts of the loan market may require alternative rates (e.g. forward looking term rates, Bank Rate or fixed rates).

3. Familiarising yourself with how your replacement reference rate will be calculated

Discuss and agree with your lender(s) how the calculation of your selected alternative reference rate works and the conventions around calculation.

4. Considering whether systems and operations are ready

Given the differences between the two rates, you or your business may need to make changes to systems in order to use SONIA or other alternative reference rates.

5. Documenting the transition of your loans

Contractual amendment will be required to transition each individual loan from GBP LIBOR to an alternative reference rate.