Think Ahead ACCA

Technical factsheet:
LIBOR transition – SME frequently asked questions

In 2017, public authorities globally announced that LIBOR (London Interbank Offered Rate), the most common benchmark that lenders use to calculate the interest rate for financial products in the UK, was no longer sustainable and the market should move to robust alternative rates by **31 December 2021**.

This will affect a significant number of businesses.

The following questions and answers will cover all the main information needed to prepare for the transition and provide links to the documents and websites that offer more detail. This factsheet is featured on the new UK Finance SME LIBOR transition resource, which also has a resource link list, a glossary and a Who's Who.

Banks and lenders are increasing conversations with customers, looking to transition as many contracts as possible before the end of September to ensure a smooth transition in line with expectations from the UK's national working group and regulators. **If you have any questions, speak to your bank, lender or financial adviser.**

With the deadline getting closer, for any business with products linked to LIBOR, the time to act is now.

The Working Group for Sterling Risk-Free Reference Rates

Throughout this factsheet, you will see reference to the Risk-Free Reference Rates Working Group (RFR WG). This is a group of lenders, corporates, professional services firms and business groups, as well as the Bank of England and the Financial Conduct Authority (FCA), which has been working to deliver a smooth transition in the sterling market for businesses. The RFR WG has set the pace for transition, establishing a series of milestones for the industry to meet in order to transition away from LIBOR by the end of 2021. For details on this timeline, see the RFR WG's roadmap.

WHAT DOES THE LIBOR TRANSITION MEAN FOR MY BUSINESS?

Does this affect me?

LIBOR can be found mainly in commercial loans, but also in leasing and servicing contracts, commercial contracts, discount rates used in valuations and company pension schemes.

Is your loan…	
A fixed-rate loan (one exception – see below)	**NO IMPACT**
A variable loan tracking the base rate	
A variable loan or other product based on LIBOR ending before 31 December 2021	
A fixed-rate loan which does or could revert to a variable rate based on LIBOR that ends after 31 December 2021	**THIS WILL IMPACT YOU**
A variable loan or other product on LIBOR that ends after 31 December 2021	

What does it mean for future borrowing or existing contracts?

The LIBOR transition means two key changes:

- There will be no more new loans based on LIBOR.
- Existing business contracts based on LIBOR will need to be moved to more robust alternative rates.

In sterling, the first has been delivered. Since April 2021, banks and lenders have no longer been able to issue loans based on LIBOR, so any new loans will reference a 'risk-free rate' or alternative non-LIBOR rate.

The second change is happening now. Any existing contracts based on LIBOR that mature after December 2021 should be switched to an alternative reference rate when and where possible, and banks and lenders have already started to contact clients and propose changes. Though it is worth checking your financial facilities first, **LIBOR may also be present in other less obvious areas** such as intra-group accounts and commercial contracts, eg in late-payment clauses. These might not be things your bank or lender can identify for you.

LIBOR is also used (and is transitioning) in **other currencies** and you could have borrowing linked to another currency – through a multi-currency facility, for example. Each of the five LIBOR jurisdictions (sterling, US dollar, euro, Japanese yen and Swiss franc) has their own working group which has been charged with selecting a new rate, supporting on issues and setting the pace for transition. While sterling is leading the charge in most areas of transition, if you have multicurrency facilities, or exposure outside of sterling, consideration needs to be given to the expectations for progress and diverging timelines internationally, to ensure you are prepared for how these could impact you.

Could a contract rate change impact my wider business?

The change is significant for all involved, including for banks. For businesses, a change in interest rate can change how much is paid, when it is paid and the systems required to pay it. It is important to look at **the bigger picture** of all borrowing, timings and requirements, and understand if and how this affects you. It could have implications ranging from the way your business is financed, to when and how you pay your tax.

LIBOR is not only in financial products or contracts, but can be found in other parts of your business, so we would advise you to also review the following, as plans will need to be put in place to repaper these agreements or amend contracts:

- director and stakeholder agreements (in reference to capital)
- partnership agreements
- intra-group accounts (including transfer pricing agreements)
- internal financial analysis
- pension schemes
- commercial contracts

What if I have hedging products?

Particularly for mid-size to larger businesses, you should be mindful to not only identify exposures but also consider how these are interconnected or have an impact on accounting. For example, where you may be hedging a loan through an associated derivative, you should assess the extent to which consistency is needed for both the rate selected and the timing of transition for both products. In all instances, both the cash product and the derivative hedging should be considered in order to assess the potential difference between the results that the transition of each may cause, and the potential for any increase in basis risk exposure.

This video from the RFR working group will help you review if/how this could impact you and the work done to help minimise the impact.

What if I have several accounts with different banks?

If you have several accounts with different banks, you should assess each product held individually and engage with each lender. Though the industry shares an overall timeline for transitioning away from LIBOR and a number of recommended approaches, how and when each contract will move away is a matter for lenders and borrowers to determine together. Therefore, it is possible that the timing, method and replacement rate used to transition your impacted products may vary across the banks you have relationships with. To be sure that you have a comprehensive picture of how all your exposures to LIBOR will be affected, make sure you engage with each individual lender you hold LIBOR-linked contracts with.

WHAT DO I NEED TO DO?

1. **Review** if you have any loans or products that are based on the LIBOR rate. Also identify where else in your organisation references LIBOR (eg accounting systems or late-payment clauses).
2. **Assess** the alternative rates being offered and consider what impact a rate change might have on your business as a whole – **look at the bigger picture**.
3. **Plan** how you will transition away from LIBOR by the end of the year – your advisers can help you.
4. **Speak** to your bank, lender or financial adviser if you are unsure of your exposure or have any questions.

Key resources for next steps:

- The RFR WG has created a key factsheet with recommended actions.
- For more detail, there is also a series of videos from a number of speakers to help prepare borrowers for LIBOR transition. For example, see the RFR WG's videos on what it means for your lending agreement and recommended next steps for transition.
- The CBI has created a very useful guide highlighting key questions for businesses to ask and what to do.
- UK Finance and the CBI have partnered on a more in-depth guide to the discontinuation of LIBOR for business customers.

Make a plan and if you have any questions speak to your lender or financial adviser.

The time to act is now.

WHAT ARE THE ALTERNATIVE RATES?

In the UK, there are a number of robust alternative rates that could be used in new lending or to replace LIBOR in an existing contract. These include:

- SONIA (Sterling Overnight Index Average)
- A term SONIA reference rate
- Bank of England bank rate (often referred to as 'base rate')
- Other alternatives such as a fixed rate

These each have different features and ways of being calculated.

It is worth familiarising yourself with the replacement rate your contract moves to, to see how this may impact how you pay interest, and what may affect the rate and the subsequent amount of interest you pay.

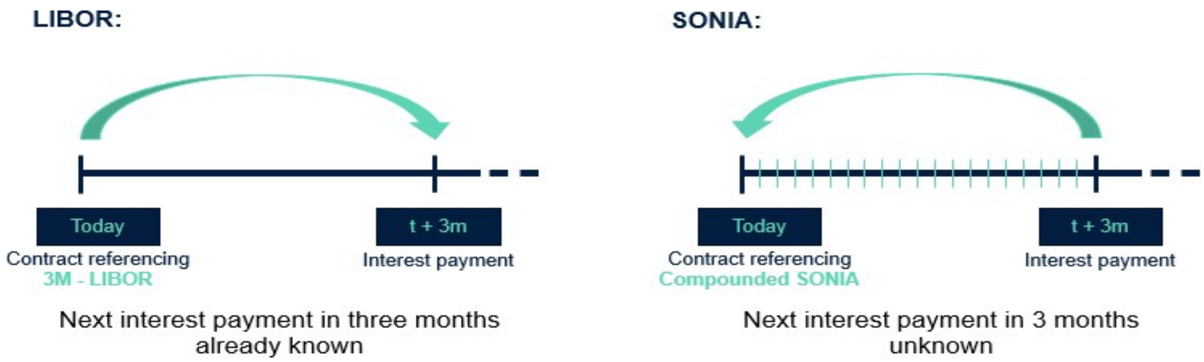
SONIA (Sterling Overnight Index Average)

SONIA is published every London business day by the Bank of England. SONIA is an overnight rate, measured each day over the interest period to produce a final interest rate at the end. This is a near ‘risk-free rate’ as it does not include any term bank credit risk or liquidity premium. SONIA is fully based on actual transactions and more in line with the economic reality of inter-bank lending.

You can find both the current, and historic, position of SONIA on the Bank of England website, along with more information on how SONIA is run and governed.
The RFR WG has also created *What is SONIA?*, a video and supporting slides.

SONIA compounded in arrears

For most markets – for example, for larger corporate lending – the primary recommended way to use SONIA is to calculate interest in contracts called ‘compounded in arrears’. This involves taking the SONIA rate for each business day over the interest period to calculate the applicable rate:

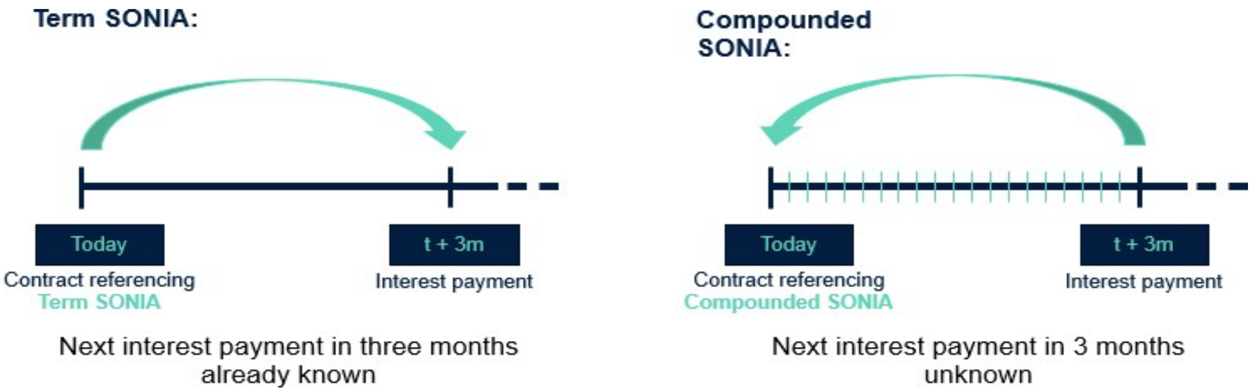


Source: UK Finance

Using compounded daily rate fixings will smooth day-to-day fluctuations that can arise over the period the interest is being calculated. Therefore, it is expected that any volatility will be reduced in compounded SONIA relative to LIBOR over an equivalent term.

Term SONIA reference rate

A term SONIA reference rate reflects the expected average SONIA rate over a given period. Unlike SONIA, it is not necessarily based on actual transactions. Term SONIA operates similarly to a term LIBOR in its features, including being forward-looking, ie set and known at the beginning of the term. Unlike LIBOR, a term SONIA rate would not reflect term bank credit risk:



Source: UK Finance

Set-use cases have been identified by the RFR WG for where a term SONIA could be appropriate to use. These include smaller corporate lending and for retail customers.
For more information on the two rates, see the RFR WG video *What is SONIA Compounded in Arrears and term SONIA?* and supporting slides.

Other alternative replacement rates

Other alternative rates will also be available, including fixed rates and the Bank of England policy rate, known as the bank rate or base rate. Base rate is used to determine the interest rate charged to banks who hold money with the Bank of England. It is already a widely used tool in the interest rates banks and lenders charge their borrowers.

What are the differences between the rates?

LIBOR	SONIA (compounded in arrears)	Term SONIA reference rate	Bank of England bank (base) rate
• Forward-looking rate (the rate is fixed at the outset of the given interest period). • Widely acknowledged not to be sufficiently robust or sustainable. • Relies on submissions from banks of their borrowing costs. However, lack of activity in the underlying market on which these submissions are based has meant the number of actual transactions underpinning them has declined; instead, the submissions are largely determined by the ‘expert judgment’ of the submitting banks. • Includes bank risk premiums – a term premium to reflect the risk of providing funding on unsecured terms beyond overnight, as well as a premium to reflect bank credit risk.	• Backward-looking (the rate is not known until the end of the interest period). • Extremely robust – takes the SONIA rate on every business day and aggregates it over a period, meaning it is underpinned by a large volume of transactions. • Works in a significantly different way to LIBOR and requires fairly complex calculation – may require technical system changes before borrowers can take on products linked to this rate. • Does not include the bank risk premiums included in LIBOR.	• Forward-looking rate (the rate is fixed at the outset of the given interest period). • A term SONIA rate is based off of overnight SONIA markets. Unlike SONIA, it is not necessarily based on actual transactions. • Works in a more similar way to LIBOR. Term SONIA provides payment certainty at the start of the interest period and works in a way borrowers are more used to. • Does not include the bank credit risk premium included in LIBOR.	• Determined differently to other rates, in that it is set by the Bank of England’s Monetary Policy Committee who meet (roughly) every six weeks. • Borrowers are more likely to be already familiar with the rate and may even already have some interest payments for other forms of finance linked to this. • Does not include the bank risk premiums included in LIBOR.

WHICH RATE WILL I BE OFFERED AND WHICH ONE IS RIGHT FOR ME?

Which rate will I be offered?

Your lender will be in touch to discuss which rate will be appropriate for your existing loan. The way lenders will approach moving a contract away from LIBOR will vary depending on borrower type and the contract in question, and will involve private discussions between lender and client.
The RFR WG has encouraged, through a statement published in April 2021, that in all scenarios borrowers should engage with their financial providers, who will let them know when the change will occur and how their existing facility will be moved, or discuss the options open to them.

Which rate would be right for me?

The exact rate your contract will move to is something to discuss with your lender, and some lenders may make the decision about which rate is best rather than offering a choice. Industry precedents have been set by the RFR WG as to which replacement rate may be suitable for which type of borrower/product.

Much of new and existing business previously using LIBOR will be able to use SONIA compounded in arrears in contracts, for example, for larger corporates and specialist lending sectors (eg project finance and real estate).

However, for smaller corporate and retail lending (eg mortgages), it has been identified that other rates – and not SONIA compounded in arrears – may be preferable. This is because alternatives offer both greater payment certainty and simplicity for borrowers. Therefore, for these segments of the market it is more likely that either Bank of England base rate, term SONIA, or a fixed rate could be an appropriate option.

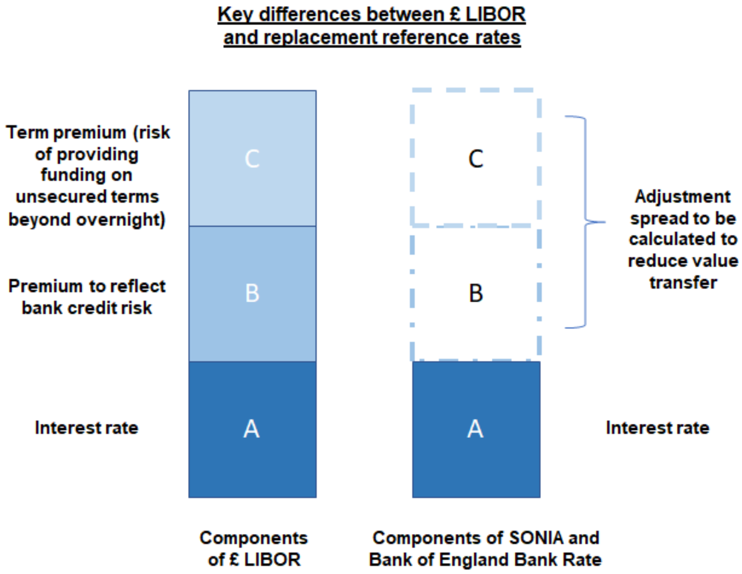
To review the RFR WG's recommendations for rates across product segments and borrower types, see the *Use Cases for Benchmark Rates* paper.
Engage with your lender on the replacement rate, and make sure you understand the characteristics of the rates and the impact on your business.

The time to act is now.

HOW WILL THE NEW RATES BE CALCULATED AND WILL IT BE FAIR?

The credit adjustment spread
As the simple illustration below shows, the main difference between LIBOR and the replacement rates is that LIBOR has more elements, including a bank credit risk premium. Replacement rates will not have this, which is one of the key benefits of LIBOR's end. The 'risk-free' replacement rates (SONIA as well as Bank of England base rate) are different in nature.

When transitioning contracts from LIBOR, a 'credit adjustment spread' has internationally been seen as an appropriate way to resolve the differences in rates and ensure **a fair conversion of existing contracts.** This reduces a difference which would constitute value transfer for contracts transitioning from LIBOR. The application of the credit adjustment spread should be consistent with regulatory and national working group guidance.



Source: UK Finance

Further information can be found in a video and slide deck from the Financial Conduct Authority (FCA).

Note that this adjustment only applies to existing LIBOR contracts. Pricing of new lending on SONIA or other alternative rates is a matter for individual firms and their customers.

For borrowers who would like detailed explanations on how SONIA compounded in arrears is generally calculated in loans, see the RFR WG documents below:

- Best practice guide for GBP loans
- Recommendations for SONIA loan market conventions
- Detailed loan conventions – supporting slides
- Detailed RFR compounding conventions for the sterling loan market – worked examples

How will it be calculated?

If a credit adjustment spread is applied to a lending contract, the calculation of this may vary depending on a) when the contract moves to a replacement rate and b) what this replacement rate is.

- If a contract moves to SONIA at certain triggers, the RFR WG has recommended the historical five-year median spread adjustment methodology. This essentially takes the median difference between LIBOR and SONIA calculated over the previous five-year period. These credit adjustment spreads have now been fixed and are published by Bloomberg, along with more information on fallbacks, on Bloomberg's website.
- If the contract moves to SONIA before the end of LIBOR, there is no single recommended methodology, but the RFR WG has set out some appropriate options that firms could consider.
- If the contract moves to a replacement rate that is not SONIA, eg Bank of England base rate, the FCA has set out considerations as to how firms can fairly apply a credit adjustment spread to these contracts, noting the close correlation of SONIA and Bank of England base rate, in its conduct risk Q&A.

Where possible, banks and lenders will be seeking to apply a consistent methodology to align with supervisory expectations. Lenders will be able to explain their approach to customers for any impacted lending contracts.

How is fairness ensured?

The FCA has made it clear that LIBOR transition should not be used to move customers with LIBOR-linked loans to replacement rates that are expected to be higher than LIBOR would have been, or to otherwise introduce inferior terms.

At the same time, the FCA also does not expect lenders to be worse off as a result of the transition away from LIBOR. So, because the way each reference rate (such as SONIA or Bank of England base rate) is calculated, the replacement rate loans will transition to may include a credit adjustment spread to ensure a fair conversion of existing contracts.

Please see details from the FCA's conduct risk Q&A.

WHY DO I NEED TO ENGAGE AND WHAT IF I DO NOTHING?

Why now?

Acting now will move you onto a more robust rate, reduce vulnerability to a potentially increasingly volatile market and give you time if needed to change accounting and other systems.

Communications from banks and lenders are increasing and many will be looking to switch client contracts ahead of the deadline. It is best to be prepared for the conversations, particularly if you might want to engage external advisers, and have any questions ready.

Do I need to give consent?

Whether or not you need to give consent before your contract is amended or moved away from LIBOR will depend on the wording included in your contract. It may be that your lender cannot move your contract to a new rate without your consent, or alternatively your lender might just need to let you know how they intend to move your contract and to what replacement rate. There is also a chance that your contract may already have provisions in place that automatically switch it to a new rate when LIBOR becomes unavailable, and therefore neither you nor your lender will have to make any more decisions. This is particularly common in more recent contracts in anticipation of LIBOR's cessation.

The best way to know what you will need to do to help your contract transition smoothly at the end of the year is to speak to your lender. If you want more information regarding what your contractual terms mean for how you will be moved to a new rate, speak to a legal adviser.

Can't I rely on the fallback in my contract?

Fallbacks are a contractual language which answers the question 'If LIBOR ceases or is unusable, to what rate would my product fall back?'. Robust fallbacks allow firms to guarantee they have a rate to rely on when LIBOR ceases.

Fallback language has two key parts. The first is the trigger event that initiates a transition from LIBOR to a replacement rate. The second component is the benchmark replacement rate, or the new rate that replaces LIBOR.

In many cases, robust fallbacks can be an effective route to transition by smoothly switching a contract to a new rate at a suitable point. However, not all contracts have these fallbacks, and even where they do, not all fallbacks are robust or specify for the long-term unavailability of LIBOR. The RFR WG has published a statement on active transition, stating that existing fallback provisions, unless they are contractually robust and specifically anticipate the permanent end of GBP LIBOR, should not be relied upon as a primary method of transition. If your contract does contain a fallback provision, you and your lender should be carefully assessing this to determine its effectiveness and suitability before relying on it to transition your contract.

What is a 'tough legacy' contract and what will happen to them after LIBOR discontinues?

You may hear mentions of 'tough legacy' LIBOR contracts. These are existing LIBOR-linked contracts which genuinely have no realistic ability to be amended to reference an alternative replacement rate before the discontinuation of LIBOR at the end of this year.

To ensure that these contracts still remain valid once LIBOR ceases in May 2021, legislation (the Financial Services Act) was passed. This includes articles that provide the FCA with powers to make the administrator of LIBOR continue to publish the rate on a different methodology beyond the end of this year (this is commonly referred to as 'synthetic LIBOR'). Though the FCA has now been granted these powers, it is currently consulting the industry on how they should be exercised. This includes questions such as which contracts will be allowed to use the synthetic LIBOR rate after the end of 2021.

We do know that the use of synthetic LIBOR rate will be strictly limited. It will not be able to be used in any new contracts, and it will only be permitted for use in the small minority of existing contracts where it is absolutely necessary. However, further detail will not be known until more information is provided by the FCA.

More information on the solution for 'tough legacy' contracts can be found through the HM Treasury and FCA resources below:

- Treasury statement announcing tough legacy legislation
- Financial Services Act 2021
- FCA Q&A on proposed amendments to the Benchmarks Regulation
- Financial Services Bill explanatory notes (p10-15)

Issued July 2021

This factsheet is adapted from UK Finance guidance.