ISDA MARKS A NEW STAGE IN TRANSITION

Welcome to our Newsletter. This is our eleventh edition, and it provides an update on the transition away from the London Interbank Offered Rate (LIBOR) and other Interbank Offered Rates (IBORs). With the end of 2021 fast approaching, these newsletters aim to raise awareness of key developments on an ongoing basis. The key topics for this month are:

- **ISDA FALLBACKS SUPPLEMENT & PROTOCOL**
- **GBP SONIA LIQUIDITY IN FOCUS**
- **TRANSITION MOMENTUM BUILDS**
- **A CLOSER LOOK: NEW FLOORING**

Please contact your Relationship Team if you have any questions or queries on the contents.

ISDA FALLBACKS SUPPLEMENT & PROTOCOL

On 9th October the Board of Directors of the International Swaps and Derivatives Association (ISDA) gave notice of the publication of the IBOR Fallbacks Supplement to the 2006 ISDA Definitions (the Suppletment) and the 2020 IBOR Fallback Protocol (the protocol). This was a watershed event for LIBOR transition, reflecting years of consultation between industry and regulators. The Supplement documents the fallback provisions that will apply upon the permanent discontinuation of certain key IBORs and on a 'non-representative' determination for LIBOR, whichever occurs first. The Supplement will come into effect for all new deals on 25th January whilst the Protocol, which comes into effect on the same date, allows counterparties to apply the provisions to all legacy trades. Lloyds Banking Group's (LBG) legal entities are adhering to the protocol and regulators globally are encouraging financial and non-financial firms to do the same. The inclusion and introduction of robust fallbacks within financial instruments is now a regulatory requirement in both the UK and Europe. The fallbacks provided for derivatives by the ISDA documentation are what has been described as a 'safety belt' in the event of cessation or non-representativeness regulators are nevertheless urging firms to pursue a policy of active transition ahead of cessation.We would recommend you readi the Closer Look Section from our August newsletter titled *How will LIBOR end?*, where we outline the kind of events that could trigger fallbacks and their consequences.

GBP SONIA LIQUIDITY IN FOCUS

There have been further steps made to increase liquidity in SONIA swap markets with the Bank of England (BoE) and the UK Financial Conduct Authority (FCA) releasing a statement encouraging liquidity providers to adopt new quoting conventions for inter-dealer trading that are based on SONIA rather than LIBOR from 27th October this year. A shift in liquidity towards SONIA is intended to support a BoE Working Group on Sterling Risk Free Rates (BoE WG) milestone to cease initiation of new GBP LIBOR linked linear derivatives expiring after 2021 by end-Q1 2021. The FCA/BoE proposal has been endorsed by the BoE WG and included as an update to its roadmap. Another milestone event has been ICE Benchmark Administration (IBA) commencing publication of indicative GBP SONIA ICE SWAP Rate 'Beta' settings. This follows positive feedback on the consultation published in January 2020.

Recent efforts to promote SONIA derivative liquidy seem to be working. The September ISDA-Clarus Adoption Indicator, which tracks activity in cleared over-the-counter (OTC) and exchange-traded interest rate derivatives (IRD) referencing risk-free-rates, showed a 39.2% rise in GBP activity - the largest amongst the currencies tracked.

MOMENTUM BEHIND TRANSITION BUILDS

Meanwhile, efforts to promote transition in Sterling markets have continued apace. In a key note speech to a BoE Webinar on 18th September, Andrew Hauser, Executive Director of Markets at the BoE outlined three key messages for market participants: that LIBOR transition affects every company that borrows in sterling; that there is time to transition if you start now; and for those needing to transition, there is help, and lots of it. In October, the BoE WG published a summary of the key messages and practical next steps checklists for each of the panel discussions. The document also includes a helpful resources section providing easy access to the material mentioned by the panellists. The full recording of the Webinar has been made available on YouTube.

Lloyds Banking Group (LBG) is also making groundbreaking strides in transition, announcing a consent solicitation at the end of September seeking bondholder's approval to change the terms of two of its Addiitonal Tier 1 (AT1) instruments to reference SONIA from LIBOR previously. Issuers, LBG included, have already competed similar exercises for secured transations, though this latest one is understood to be the first in the AT1 market. If approved the change will take effect on 21st October 2020.

This activity follows on from Lloyds Bank Corproate Markets' (LBCM) participation in the London Clearing House (LCH) first SONIA/SOFR cross currency swap in September. The GBP/USD basis swap was executed between LCH SwapAgent members Bank of America and LBCM.

A CLOSER LOOK: NEW FLOORING

Due to a sustained period of low, and for certain currencies negative, interest rates the incorporation and operation of "interest rate floors" have become common place in loan agreements. Their prevalence has also made them a key area of focus in terms of LIBOR transition. Granted, the subject can be complex and certain elements related to the topic are still under development, but there are some common aspects most clients will likely need to understand in terms of LIBOR transition.

An interest rate floor is what it suggests - a level below which a referenced interest rate cannot fall, with the intention of providing clarity on the minimum rate in the event that interest rates go below the floor. This is already in place for many LIBOR referencing loans where the historic approach had been to commonly have them at 0%. A similar approach has largely applied to the treatment of newer facilities originated with SONIA or other alternative reference rates.

The challenge is that when transitioning existing loan contracts referencing LIBOR to a risk-free rate such as SONIA, the formula for using an interest rate floor within the interest calculation requires adjustment. This is because, unlike LIBOR, the calculation of interest payable using SONIA requires a compounded calculation as it is an overnight rate. Therefore, the floor within a product that is transitioning needs to consider the added dimension of compounding effects as well as the credit adjustment spread (CAS) required when aiming to preserve economic equivalence. Market participants therefore need to be aware of these changes not only from the commercial but also from an operational perspective.

For GBP-LIBOR facilities transitioning to SONIA, the BoE WG has recommended an approach which outlines that where daily SONIA + a Credit Spread Adjsutment (CAS) is less than the floor value, CAS will remain unchanged and the SONIA rate which is being compounded to reflect the term will be adjusted to ensure SONIA + CAS is equal to the floor. The BoE WG believes that the benefits of this approach, over and above its simplicity are that loan system vendors are expected to be able to deliver the required computational capability quickly. Nevertheless the approach is not without its challenges not least the requirement to calculate and/or to reconcile the compounded SONIA component using variable floors for each day in the interest period.

For USD-LIBOR to Secured Overnight Financing Rate (SOFR) transitions, the Alternative Reference Rates Committee (ARRC) has made a similar recommendation. If there are interest rate floors in an existing USD-LIBOR credit agreement that converts to SOFR, the ARRC Guiding Principle should be interpreted as applying that floor to SOFR plus the associated CAS recommended by the ARRC. For legacy loans fallbacks the floor would be applied to the daily SOFR rates, and would be the difference between the LIBOR floor and the SOFR CAS. The SOFR component of the floored rate would be compounded, while the spread adjustment component would not be compounded.

Clearly, how transition affects LIBOR interest rate floors is not without complexity. Likewise, different types of LIBOR floors will require different approaches. Still, it is important that clients begin to understand the kinds of changes that transition will inevitably bring to this aspect of their loan agreement. The similar approaches recommended by the BoE WG and ARRC provide a good learning base.

In addition in the months ahead, we will provide individual illustrations of how transition will impact existing interest rate floors for affected borrowers.

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