TRANSITION AWAY FROM LIBOR

EXTENDED SET OF FAQ

Mauritius Bankers Association Limited ©

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INTRODUCTION

On 5 March 2021, the Financial Conduct Authority (UK) confirmed that all London Inter Bank Offered Rate (LIBOR) settings would either, cease to be provided by any administrator, or no longer be representative immediately after 31 December 2021 (in the case of all sterling, euro, Swiss franc and Japanese yen settings, and the 1-week and 2-month US dollar settings) and immediately after 30 June 2023 (for US dollar: Overnight, 1-month, 3-month, 6-month and 12-month settings).

Interest-Rates contracts denominated in these currencies would need to be amended and expressed in a new rate, particularly those that mature after the LIBOR cessation dates. While there may be temporary differences between credit sensitive LIBOR and the new risk-free rates, the latter will prevail after the end dates.

These alternate rates to the LIBOR have been set internationally by regulators and are being adopted globally by banks and other market participants. Consistent with the international best practice, Mauritian banks are adhering to these new benchmark rates, as well as to the deadlines set for ending LIBOR denominated contracts.

There may be variations between how different banks apply the new benchmark risk-free rates as each bank will have its own adjustment methodology in addition to ISDA fallback rates. These Frequently Asked Questions (FAQ) have been elaborated to explain the new terms used in LIBOR transition and are for customers' information. For any discussion on the impact of these changes, customers are encouraged to contact their banks directly or seek independent, professional advice, where applicable.

SECTION 1 - LIBOR

1. What is IBOR?

IBOR stands for Inter Bank Offered Rate. It is the interest rate at which banks lend to, and borrow from one another in the interbank market, which is a global market for the trade of currencies, loans, and other financial instruments. Examples include LIBOR (the London Interbank Offered Rate), EURIBOR (Euro Interbank Offered Rate) and JIBAR (Johannesburg Interbank Average Rate).

2. What is LIBOR?

The London Interbank Offered Rate (LIBOR) is the benchmark interest rate at which major global banks lend to one another. LIBOR is one of a number of IBORs, that is widely used in the financial markets.

3. How is LIBOR calculated?

LIBOR is administered by the Intercontinental Exchange Benchmark Administrator (ICE BA).

LIBOR is based on submissions from a group of large banks, known as ''panel banks'', using available "market and transaction data-based expert judgment''.

LIBOR is currently produced for five currencies (U.S. dollar, the euro, the British pound, the Japanese yen, and the Swiss franc) and seven tenors or time periods (Overnight/Spot Next, 1 Week, 1 Month, 2 Months, 3 Months, 6 Months, and 12 Months).

4. How is LIBOR currently used?

LIBOR is used worldwide in a wide variety of financial products. LIBOR is often referenced in consumer loan-related products, derivatives, bonds, securitisations, and deposits, to calculate interest payments under those products.

LIBOR should provide an indication of the average rate at which each LIBOR contributor can borrow unsecured funds in the London interbank market for a given period, in a given currency. This average is published and used by the financial markets for the purposes of the above-mentioned products.

5. Why is LIBOR being discontinued?

The two main reasons are:

(a) the underlying market that LIBOR has historically sought to measure – the market for unsecured wholesale term lending to banks – has not been an active market since the financial crisis; and

(b) the financial markets' over-reliance on LIBOR creates systemic risk.

In response, the Financial Conduct Authority (FCA), which regulates LIBOR, announced in 2017 that it would no longer compel "panel banks" to continue submitting quotes for LIBOR after December 2021.

6. When will LIBOR be phased out?

In its latest news release published on 5 March 2021, the FCA clarified and confirmed that all LIBOR settings would either cease to be provided by any administrator or no longer be representative as follows:

(i) immediately after 31 December 2021, in the case of all sterling, euro, Swiss franc and Japanese yen settings, and the 1-week and 2-month US dollar settings; and

(ii) immediately after 30 June 2023, in the case of the remaining US dollar settings. The sole purpose of this extension is to deal with trickier historical transactions in US LIBOR settings.

7. Will EURIBOR be phased out as well?

EURIBOR underwent a methodological reform in 2019 and has been authorised by the competent authority, meaning that the benchmark can continue to be used for new and legacy contracts after 3 January 2022.

A report dated 23 July 2020 from the European Central Bank on preparations for benchmark rate reforms however stresses that it is important for banks to be prepared for all scenarios, including the disappearance of this benchmark.

8. What is a Risk-Free-Rate (RFR)?

RFRs are overnight interest rate benchmarks, which are perceived by the FCA and other regulators to be more representative and reliable than LIBOR. This is because these benchmarks are intended to be based on liquid markets, and so they can be calculated by reference to actual transactions.

9. Can a borrower move to a Risk-Free Rate (RFR) before LIBOR ceases?

This will depend on the operational readiness of the lender and banks will be reaching out to borrowers in due course. Borrowers are encouraged to seek independent advice to understand what rates are appropriate for its specific circumstances.

SECTION 2 - LIBOR V/S RISK-FREE RATES

10. Which rates are likely to replace LIBOR?

In preparation for the transition away from LIBOR, relevant authorities have released a series of alternative Risk-Free Rates (RFRs).

Regulators for the 5 LIBOR currency jurisdictions have published their preferred alternative reference rates as shown in the table below:

Jurisdiction	Current LIBOR-IBOR	Administrator	New Risk-Free Rate	Secured/Unsecured
Euro Area	EONIA EURIBOR EUR LIBOR	European Central Bank (ECB)	€STR (Euro Short-Term Rate)	Unsecured
UK	GBP LIBOR	Bank of England (BoE)	SONIA (Sterling Overnight Index Rate)	Unsecured
USA	USD LIBOR	Federal Reserve Bank of New York (Fed)	SOFR (Secured Overnight Financing Rate)	Secured
Switzerland	CHF LIBOR	SIX Swiss Exchange	SARON (Swiss Average Rate Overnight)	Secured
Japan	JPY LIBOR	Bank of Japan (BoJ)	TONAR (Tokyo Overnight Average Rate)	Unsecured

11. How are Risk-Free Rates (RFRs) different from LIBOR?

While RFRs and LIBOR are both benchmarks, there are distinct differences between them which are as follows:

(i) Methodology: LIBOR is derived from quotes provided by panel banks' submissions that are meant to be estimates of where they could borrow funds, whereas RFRs are benchmarks generally based upon a broader range of actual transactions (please see table above).

(ii) Reference Period: LIBOR is a forward-looking term rate, whereas RFRs are backward-looking overnight rates (i.e., published after the period to which they relate).

(iii) Credit Risk: 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, whereas RFRs do not include the panel bank credit risk element, nor a liquidity premium related to the length of the interest period, as they are overnight rates. Some RFRs are unsecured, and others are secured.

Given the separate methodologies being used in the calculation of LIBOR and RFRs, a credit adjustment spread is applied by banks to mitigate the risk of value transfer when transitioning to RFRs, as well as to cater for credit risk and lending over a term period.

SECTION 3 - LEGACY LOANS

12. How are banks preparing for the transition away from LIBOR?

Banks are working closely with the Central Bank and participating in industry working groups on this subject matter. Banks are assessing how and where LIBOR is used in their products and as a result, considering the enhancement of their systems, documentation, project management, risk identification, assessment & mitigation, and training of their staffs, in anticipation of this transition out of LIBOR.

Banks will engage with their customers, more specifically with those clients in relation to affected products, to raise awareness on the consequences of a potential discontinuation of LIBOR.

13.What is ''fallback language''?

Fallback language refers to document terms, that are intended to provide for a smooth transition to an alternative reference rate in the event LIBOR ceases to exist.

14. What are the existing fallbacks that may be present in the loan documentation for existing LIBOR-based loans with a term beyond 2021 and/or being repaid after 30 June 2023 (legacy LIBOR loans)?

Lenders will need to assess each loan agreement to assess whether there are existing fallbacks when LIBOR will no longer be available for the relevant setting. The most common one is the lender's cost of funds (in lieu of LIBOR) but this is unlikely to be a viable long-term solution and is a precursor to negotiations between the borrower and the lender to transition to an RFR.

15. What should a lender do in the absence of fallback language in the loan documentation for a legacy loan?

Banks are required to amend the loan terms to adopt one of the following approaches:

(i)Outright switch to RFR: Amend the existing loan agreement so that interest is calculated by reference to an RFR. This approach however implies that the lender is ready from a systems perspective to accommodate the new basis of calculation.

(ii)Hard-Wired Switch: Amend the existing loan agreement to switch from LIBOR to an economically equivalent RFR-based rate at a specified future date.

(iii)Hard-Wired Fall: Amend the existing loan agreement to switch from LIBOR to an economically equivalent RFR-based rate if an event occurs connected to the discontinuation or other unavailability of LIBOR. This is similar to a Hard-Wired Switch, but without an automatic move away from LIBOR on a specified date.

(iv)Screen Rate replacement approach: Amend the existing loan agreement to reflect this approach: The LMA's replacement of screen rate clause provides a mechanism for the parties to a syndicated facility agreement to agree a replacement benchmark rate using a lower consent threshold than would otherwise have been the case (a majority of, rather than all, lenders). This can be adapted for bilateral financings.

16. Will any other terms in the loan document change as a result of LIBOR transition?

Other than fallback provisions, loan documents may also contain other operational, technical, or administrative provisions that may be impacted by the transition from LIBOR to an alternative RFR.

17.What about new offerings after the transition to RFRs?
Banks must be ready to provide loans fully linked to a RFR on day one from a systems and documentation perspective after the discontinuation of LIBOR.

18.What is the relevance of LIBOR transition to derivatives?

ISDA has developed fallbacks based on RFRs to include in legacy IBOR-based derivatives contracts with a view to ensuring contractual continuity.

On 9 October 2020, ISDA published its IBOR Fallbacks Supplement. This amends the definitions of IBORs in the 2006 ISDA Definitions by adding a Hard-Wired Fallback to:

(i)a compounded RFR; plus
(ii)a credit adjustment spread based on the historical difference between the relevant IBOR and that compounded RFR, with the switch to that fallback occurring automatically on an "Index Cessation Effective Date".

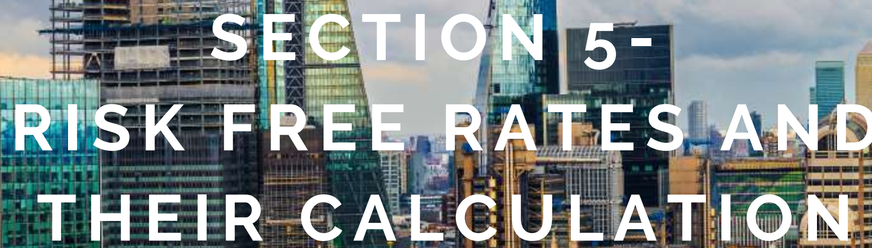
For LIBOR, this means either the date on which it ceases to be published, or any earlier date of a non-representativeness statement. These amendments apply automatically to trades dated on or after 25 January 2021 that incorporate the 2006 ISDA Definitions.
At the same time, ISDA published a Protocol to enable parties to incorporate this mechanism into legacy trades. The Protocol also formally launched on 25 January 2021.

19.What is the relevance of ISDAs to the loan markets?

The loan markets are, to an extent, adopting some of the methodologies ISDA has developed, such as those relating to credit adjustment spreads. The spread adjustment calculation as recommended by ISDA, the UK Working Group on Sterling Risk-Free Reference Rates for cash products and the Alternative Reference Rates Committee (ARRC) for cash products is based on a historical median with 5-year lookback approach and was calculated from 5 March 2021, which is the date the FCA formally announced the cessation of certain LIBOR settings.

20. Are any protocols available or anticipated to streamline the process of amending legacy loans?

It is not anticipated that an ISDA style protocol will be developed for amending legacy LIBOR loans.



SECTION 5- RISK FREE RATES AND THEIR CALCULATION

21.How can RFRs be used to calculate interest on loan transactions?

There is no single, settled methodology for using RFRs on loan transactions – there are a number of possible variables within this basic approach. For instance, the following variants are possible with respect to SOFR:

(i)Daily SOFR;
(ii)Term SOFR – not currently in existence. A forward-looking term RFR could be developed based on sufficient activity in the relevant markets.
(iii)Compounded SOFR in advance;
(iv)Compounded SOFR in arrears;
(v)Simple SOFR in arrears.

It is anticipated lenders will use compounded in arrear RFRs (compounded RFRs) with a "look-back" period of five business days for loan products that have historically used LIBOR. As for GBP, SONIA, compounded in arrears, is expected to become the industry standard in most parts of the bilateral and syndicated loan markets.

22. What is the significance of the "look-back" when using a compounded RFR?

LIBOR for an interest period is fixed at the beginning of that interest period: all the parties know then how much interest the borrower will have to pay at the end of the interest period.

By contrast, the total interest accruing over a period based on a compounded RFR cannot be determined until the end of that period. A "look-back" mechanism provides that the interest payable over an interest period is not determined by the RFR over the interest period itself, but over an "observation period".

The observation period is the same number of business days as the interest period but starts and ends a specified number of business days before the relevant interest period. This ensures the parties know the interest that will be payable at the end of that interest period a few days in advance of the payment date.

23. What does the "compounding" of an RFR involve?

Broadly, this means that the RFR itself is compounded on each business day over the relevant observation period, using the daily published rates during that period. It does not involve any "capitalisation" or compounding of accrued interest. Consequently, the principal amount of the loan does not increase as interest accrues during the interest period.

24. Is it anticipated that all types of loan products that have used LIBOR to date will use compounded RFRs instead?

Certain products have been identified as problematic because it is particularly important for parties to these products to be able to ascertain the amount of interest (or equivalent) that will accrue during an interest period at the outset of that interest period, or significantly in advance of the interest becoming payable.

For example, payments under trade finance loans are often funded by, or otherwise linked to, an underlying transaction such as sales and purchases of commodities, hedging transactions or the issue of letters of credit. Using a forward-looking rate makes it easier for parties to ensure that payments will match and to plan cash flows. The desirability of using forward-looking RFRs for trade finance transactions has been recognised by industry bodies and currency working groups.

However, the ARRC announced on 29 July 2021 that it is formally recommending the use of CME Group's forward-looking Secured Overnight Financing Rate (SOFR) term rates (SOFR Term Rates), following the completion of a key change in interdealer trading conventions on July 26, 2021 under the SOFR First initiative.

25.What is the relevance of credit adjustment spreads to the transition to RFRs?

LIBOR and RFRs are calculated using separate methodologies and therefore there may be differences between the published rates of the two benchmarks. In order to accommodate the differences observed and minimize value transfer to the extent possible, industry working groups recommend the usage of a credit adjustment spread.

SECTION 6- GENERAL

26.If I have any further questions relating to the discontinuation of LIBOR, who can I contact?

For any queries relating to the discontinuation of LIBOR, please contact your specific bank and /or your Relationship Manager.

Disclaimer:

The purpose of this document is to provide information to the customers/public, regarding the likely discontinuation of LIBOR and to outline key aspects of this forthcoming change. The above information is provided for information only and it is not complete or exhaustive nor does it constitute legal or regulatory advice. The author of this note makes no representation as to any matter referred to therein and the reader is advised and remains responsible for taking independent advice, where applicable.

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