EuropeArabBank
PART OF THE ARAB BANK GROUP

Sterling LIBOR Transition

We would like to help you to understand certain important changes which are about to take place in the banking market, so that you are able to make informed decisions in relation to existing and future business.

Sterling LIBOR is being phased out and will no longer be published in its current form after 31 December 2021.

What is LIBOR and how is it used by EAB?

The London Interbank Offered Rate (**LIBOR**) is a function of what it costs a bank to lend money. It is a major interest rate benchmark underpinning around $300tn of financial contracts across the globe, including loans, derivatives and bonds. It is published in five major currencies and a range of tenors up to 12 months. Many of EAB's financial products, including variable rate mortgages and loan agreements, currently use LIBOR in their interest rate calculations.

What is happening to LIBOR?

One of the UK's financial services regulators, the Financial Conduct Authority (**FCA**), has recently confirmed that Sterling LIBOR will no longer be published beyond 31 December 2021 in its current form. The FCA has stated that all UK lenders, including EAB, may not offer new Sterling LIBOR based cash products (including mortgages and other loans) from 31 March 2021. Moreover, existing Sterling LIBOR based products maturing after 31 December 2021 will need to be transitioned to a replacement rate before that date.

LIBOR is also published for currencies other than Sterling. The LIBOR rate for most other currencies, including the euro, will also stop being published after 31 December 2021 and UK lenders are expected to move to an alternative rate.

In relation to US Dollar LIBOR, the most common LIBOR tenors (the time period for which LIBOR is quoted) will continue to be published until 30 June 2023; only the 1 week and 2 month US Dollar LIBOR rates will cease to be published after 31 December 2021. However, for all US Dollar products entered into before 31 December 2021 using tenors that will continue to be published, lenders should seek to either use an alternative risk free rate (**RFR**) or to specifically incorporate a transition to the appropriate RFR (being SOFR in the case of US Dollars) when US Dollar LIBOR stops being published.

What will replace LIBOR?

The Bank of England and FCA are strongly promoting the use of RFRs as an alternative to LIBOR. RFRs are overnight rates calculated on the basis of a theoretical return on an investment with zero risk. This is slightly different to the way in which LIBOR is calculated, as LIBOR takes into account term risk and bank credit risk over a range of tenors. Because LIBOR and RFRs are calculated using different methodologies, there will naturally be a level of divergence between them. The key differences between LIBOR and RFRs are:

1. **Currency specific.**
   RFRs are currency specific, as opposed to LIBOR which was published in several currencies. This means that a loan facility made available in several currencies may need to incorporate several RFRs. The US Dollar RFR replacement is called the secured overnight financing rate (**SOFR**), with the replacement RFR for Sterling being the new Sterling overnight index average (**SONIA**). The Bank of England's official bank rate (**Base Rate**), which is a rate set periodically by the Bank of England's Monetary Policy Committee, is an alternative interest rate that is already used extensively amongst UK lenders for certain types of banking relationships.

2. **Backwards looking.**
   Whereas LIBOR is a forward-looking rate, determined on the basis of "*what would it cost to lend in X currency for Y amount of time*", RFRs are not. An RFR on a given date is only known after that date, which means that (unlike LIBOR) the amount of interest due in an interest period will only be known at the end of that interest period. Most RFRs will have interest calculated through being "compounded". This means that the interest rate will be calculated by taking the daily rate applicable to each day during that interest period and aggregating these daily rates to calculate a rate applicable to the interest period. For instance, an interest period of 3 months will essentially be made up of 3 months' worth of daily interest rates. Because the daily rates are only known after that day, some lenders use a set "lag" or "lookback" period to allow interest to be calculated slightly in advance of the end of the interest period. This means that the daily rates used would be those appearing a set number of days prior. For instance, the rate applicable on the first day of an interest period would be the one applicable a certain number of days before that day, and so on.

3. **Credit adjustment spread (existing transactions).**
   As mentioned above, RFRs are calculated on the basis of a risk free transaction and hence do not take account of any term or bank credit risks. This means that there will always be a difference between LIBOR and SONIA (or SOFR, or Base Rate) at any given point in time. As such, when replacing LIBOR with an alternative rate in an existing transaction, to create an economically equivalent rate lenders will need to add a "*credit adjustment spread*" into the calculation.

What does this mean for our clients?

Scenarios depending on our existing relationship and requirements:

1. Products maturing 1 January 2022 onwards

Where clients have an existing Sterling LIBOR product, which is due to mature after 1 January 2022, this would need to be updated to incorporate a new reference rate. The client's "*margin*" will remain the same, but we will need to add a credit adjustment spread with the aim of maintaining economic equivalence as far as possible.

There will also be some other technical changes to any loan agreement to reflect differences in the way the new reference rate is calculated. However, the key aim in this process will be to ensure that our clients understand the changes resulting from the Sterling LIBOR transition and that the changes are not intended to increase the level of interest that they would ordinarily have paid over the term of the product.

EAB has contacted affected customers about the changes described above. In the coming weeks and months we will be sending affected customers the legal paperwork needed to make the necessary changes to their existing legal agreements with EAB ahead of the Sterling LIBOR "cessation date" of 31 December 2021.

2. New variable rate products

In line with FCA guidance, as from 31 March 2021 EAB no longer offers Sterling LIBOR based cash products (e.g. mortgages, other loans and fixed rate deposits) and has developed a range of alternative floating rate products, which incorporate Base Rate or SONIA/SOFR. Clients who are considering applying to extend or renew an existing Sterling LIBOR based product will need to move to one of our new products.

Recommended next steps for all our clients

It is important to understand these changes and the implications for any existing agreements with EAB. If you have any immediate questions, please do not hesitate to contact your Relationship Manager.