Ulster Bank
Help for what matters

Alternatives to LIBOR – your options explained

As part of our preparation for the expected cessation of the London Interbank Offered Rate (LIBOR) at the end of 2021, Ulster Bank is launching loan products that reference replacement rates, called Risk-Free Reference Rates (RFRs), alongside existing alternatives to LIBOR-linked loan products.

This brochure summarises why LIBOR is changing, what the timelines are, and what the options are for your business – whether you are considering new loan products or are ready to start moving your existing facilities from LIBOR onto a new RFR.

Contents

What is LIBOR and why is it changing?

LIBOR is one of a number of Interbank Offered Rates that are used in global financial markets. It's used as a key interest rate benchmark across a number of products such as bonds and loans, as well as for banks and other financial institutions own funding and capital needs.

Financial regulatory authorities have expressed their concern that the interbank lending market, which LIBOR is intended to reflect, is no longer sufficiently active or liquid. The Financial Stability Board has advised that near RFRs, which are based on more active and liquid overnight lending markets, are used instead of LIBOR.

In April 2020, the Bank of England's (BoE) Working Group on Sterling Risk-Free Rates (the RFR Working Group) issued revised interim milestones to facilitate the transition away from LIBOR. The end of Q1 2021 milestone is now the remaining action for Sterling LIBOR.

By the end of Q3 2020

Lenders should be in a position to offer non-LIBOR linked products to their customers.

End of Q3 2020

Lenders, working with their borrowers, should include clear contractual arrangements in all new, amended and re-financed LIBOR-referencing loan products to facilitate conversion ahead of end-2021, through pre-agreed conversion terms or an agreed process for renegotiation, to SONIA or other alternatives.

Our response:
New product options available for new lending and transition of existing facilities including SONIA, switch and Base Rate.

End of Q1 2021

All new issuance of sterling LIBOR-referencing loan products that expire after the end of 2021 should cease.

Our response:
We expect to withdraw our sterling LIBOR-referencing loan products from this date .

NatWest Group is committed to assisting the transition away from LIBOR and has been leading the market in development of RFR based products.

What are RFRs?

RFRs have been chosen by various regulators to replace LIBOR for Sterling, US Dollars, euro, Swiss Francs and Japanese Yen, all referenced in the table below.

RFRs are overnight rates, based on actual lending transactions with high volumes, so are highly representative of the actual market. This is a significant improvement on LIBOR which has become based on 'expert judgement' due to the lack of underlying term lending transactions.

What are the benefits of RFRs?

RFRs lack any term premium or interbank credit premium meaning that they are less susceptible to the volatility that we have seen in LIBORs on multiple occasions historically. Interest volatility is further mitigated by the daily RFRs being compounded over time to calculate the final interest rate and payment. This provides borrowers with more certainty in relation to the rate's performance.

SONIA explained

Sterling Overnight Index Average (SONIA) is the RFR for Sterling LIBOR selected by the RFR Working Group and the BoE. It is calculated based on an average rate on Sterling unsecured overnight lending. It has been very stable and historically has tracked the BoE Base Rate very closely.

SONIA offers a robust alternative to Sterling LIBOR. The rate is based on overnight interest rates in wholesale markets, so is close to a risk-free measure of borrowing costs. The rate is anchored to an active and liquid underlying market. It is compounded over a lending period to produce a backward-looking term interest rate.

Summary of the five LIBOR replacement rates

Currency	Alternative rate	Working Group	Nature
GBP	SONIA	Working Group on Sterling Risk-Free Rates	Overnight, Unsecured
USD	SOFR[1]	Alternative Reference Rates Committee (ARRC)	Overnight, Secured
EUR	€STR[2]	Working Group on Euro Risk-Free Rates	Overnight, Unsecured
CHF	SARON[3]	National Working Group on Swiss Franc Reference Rates	Overnight, Secured
JPY	TONAR[4]	Study Group on Risk-Free Reference Rates	Overnight, Unsecured

1. Secured Overnight Financing Rate.
2. €STR is the new wholesale unsecured overnight bank borrowing rate (replacing EONIA and euro LIBOR), which the ECB began publishing in 2019.
3. Swiss Average Rate Overnight.
4. Tokyo Overnight Average Rate.

Notes:

- The EURIBOR benchmark will continue, meaning any euro borrowing will remain on this benchmark. Euro LIBOR is being replaced, although this benchmark is little used due to the existence of EURIBOR. The euro Short Term Rate (€STR) will replace euro LIBOR as well as the current Euro Overnight Interest Average rate (EONIA).
- Following announcements made by UK and US authorities in December 2020, USD LIBOR will now continue to be published until June 2023 for use on existing contracts. Guidance is to cease issuance of new USD LIBOR business as soon as possible but no later than 31 December 2021

How does LIBOR compare with RFRs?

LIBOR
Forward looking 'term rates'

Includes an element of credit spread reflecting the borrowing risk in the interbank market.

Provides a known interest rate and amount of interest due at the end of the borrowing term, something that some customers may find helpful for cash flow forecasting.

RFRs
Overnight rates

Based on actual transactions and reset daily in arrears, removes any expectation of future events inherent in a term rate.

Is likely to be a less volatile rate known only at the end of the borrowing term. Customers may favour this rather than a more volatile term rate known at the start of the borrowing term.

What are the alternatives to LIBOR?

For new borrowing or transitioning existing facilities, the following pages show three options which could be suitable for your business.

Options 1 and 2 may be appropriate for existing LIBOR transactions that will need to switch from LIBOR before the end of 2021. **Option 3 is only available until the end of Q1 2021.**

We encourage you to start reviewing your existing LIBOR exposures and consider which option best suits your requirements.

1. An RFR-linked loan from the outset

An RFR loan may be suitable for you if you are comfortable with a market facing interest rate. It may also be important for you to match the reference rate basis with other financial products you have, for example multi-currency loans, capital markets instruments or interest rate hedging derivatives. RFRs are expected to be the benchmark rate used in the syndicated loans market where your borrowing is provided by a group of lenders under the same loan contract.

An RFR is based on actual transactions from the previous business day. Consequently, it is a backward looking overnight only rate with no forward, or term, component. It also lacks any interbank credit premium and as a result is far more stable than LIBOR, historically tracking very close to Central Bank Base Rates.

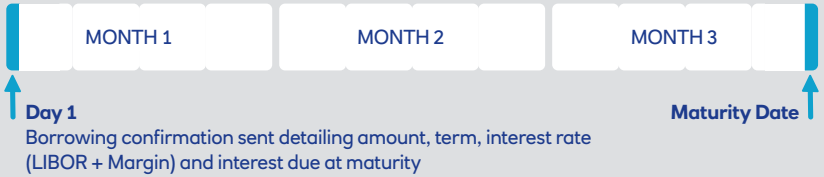
As a backward looking, overnight rate, it's not possible to confirm the rate or interest amount due until the end of a particular borrowing fixture. Plus, the rate resets daily, but as there is no mechanism to settle interest daily the RFR component is compounded on a daily basis.

To allow some notice ahead of interest settlement, a five-day rate set lookback period has been developed meaning we are able to calculate and send you the interest due amount five days prior to settlement.

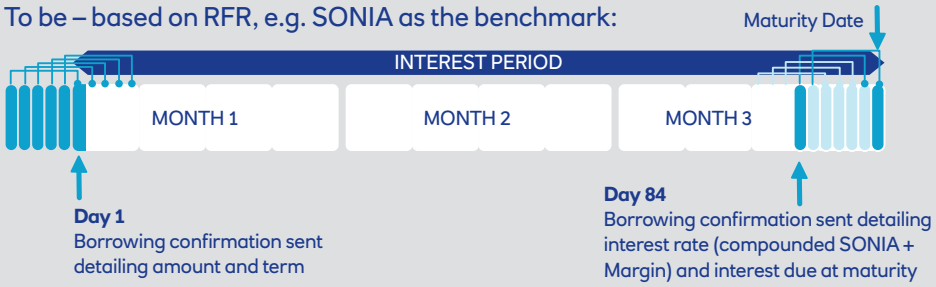
How the lookback is applied compared to LIBOR:

Example using a typical 3m interest fixture

As is – based on LIBOR as the benchmark:



To be – based on RFR, e.g. SONIA as the benchmark:



The daily SONIA rate is set using a 5 day lag. This means the rate applied to day 1 is the SONIA rate from 5 business days prior. Day 2 will use the rate 5 business days prior to day 2, etc throughout the fixture. The SONIA interest element only (not the margin) is compounded daily throughout the fixture.

The 5 day lag allows the determination of interest 5 days prior to maturity. The rate applicable to day 90 is the rate from day 84, day 89 is the rate from day 83 etc. So, on day 85, we know the interest rates for the next 5 days allowing us to calculate the interest due.

In order to better illustrate the calculation, the following table shows a simple example tracking a £150M loan for a week with a SONIA RFR using the 5-day lookback. For clarity the margin component has been excluded from the table however this would continue to be calculated on a simple interest basis and not part of the compounding.

Start date	End date	Day count	Principal	RFR Rate	RFR rate accrual	Balance to compound	Compound accrual
10/07/2019	10/07/2019	1	£150M	0.7089%	£2,913.29	£0.00	£0.00
11/07/2019	11/07/2019	1	£150M	0.7093%	£2,914.93	£2,913.29	£0.06
12/07/2019	14/07/2019	3	£150M	0.7077%	£8,725.07	£5,828.28	£0.34
15/07/2019	15/07/2019	1	£150M	0.7088%	£2,912.88	£14,553.68	£0.28
16/07/2019	16/07/2019	1	£150M	0.7089%	£2,913.29	£17,466.84	£0.34
		7			**£20,379.45**		**£1.02**

* This illustration uses a compounded balance method. The market has decided to use compounded rate which, whilst similar, results in a slightly different set of numbers due to rounding approaches.

2. Base Rate

A Base Rate referenced loan may be appropriate if the approach required for RFR-linked loans is too complex.

Base Rate referenced loans will operate in the same way as existing LIBOR loans for their remaining term and a Credit Adjustment Spread will be added, as for transitions to SONIA. Any renewal of the loan at the end of the term would require re-documentation.

Options 1 & 2 could be suitable for your existing LIBOR transactions that will need to switch before the end of 2021. We will contact you to agree how best to work with you to achieve this transition.

3. LIBOR with a switch mechanism

You can continue to enter into a new LIBOR-linked loan, but the contract will set out a detailed mechanism to switch the loan from LIBOR to the appropriate RFR(s) at a future point, with specific language setting out the trigger event for the switch.

The switch will occur from the first interest settlement date following the cessation of LIBOR, or earlier if you elect to do so. Once the trigger event occurs, a revised rate selection is applied to select the replacement of LIBOR to either:

1. Ulster Bank calculated daily compounded RFR + margin + an adjustment spread; or, if not available,
2. Relevant Central Bank Base Rate + an adjustment spread.

The adjustment spread is required to neutralise the economic impact/value transfer of moving from a LIBOR to RFR basis. It will be calculated and fixed at the point of conversion for the remaining duration of the loan contract. It will result in the same all-in rate payable as would be the case for a LIBOR loan.

By taking a switch approach, your business will have time available to establish operational and financial system requirements ahead of conversion. Plus, a switch contract will not require further amendment to switch to an RFR.

This form of contract will only be available until the end of March 2021.

Borrowing costs after LIBOR

The transition away from LIBOR is not an opportunity to increase costs to borrowers. Regulators have been clear that there must be no "winners or losers" as a result of transition.

The various ways in which banks fund themselves require changes to the way in which we price our lending. The adjustment spread is an example of this as it is required to ensure our funding costs are covered.

The examples below illustrate how pricing will change. The important thing to note is that whilst margins will increase or adjustment spreads will be added, the RFR benchmarks are lower than comparable LIBOR and the all-in rate paid will be the same.

Example of Day 1 RFR Deal

	LIBOR	SONIA
Facility amount	£50,000,000	£50,000,000
Term	5 years	5 years
Ref Rate	3M LIBOR	SONIA
LIBOR	0.15%	N/A
SONIA	N/A	0.06%
Margin	0.50%	0.59%
Adjustment Spread	N/A	N/A
All-in Rate	0.65%	0.65%

Example of adjustment spread application

	LIBOR	SONIA
Facility amount	£50,000,000	£50,000,000
Term	5 years	5 years
Ref Rate	3M LIBOR	SONIA
LIBOR	0.15%	N/A
SONIA	N/A	0.06%
Margin	0.50%	0.50%
Adjustment Spread	N/A	0.09%
All-in Rate	0.65%	0.65%

Term RFR

Various regulators have acknowledged that, in certain circumstances, forward-looking, or Term RFRs may be required. Following a consultation, the RFR Working Group set out its recommended criteria for use of a Term SONIA Reference Rate (TSRR).

In adherence to regulators' requirement that Term RFRs have very limited application in the market, NatWest Group will not be offering a TSRR in respect of our lending products, i.e. loans and revolving credit facilities.

It should be noted that the administration of a TSRR is not yet finalised and there remains some uncertainty on precisely how it will be published. Additionally, there is currently no certainty on when there will be a Term RFR for Secured Overnight Financing Rate (SOFR).

What about your other lending products?

NatWest Group provides a number of other non-lending products to customers requiring Asset Finance (typically through our Lombard business) or Trade and Working Capital financing.

Our Asset Finance products are being developed to reference Base Rate and we will communicate with you again once this work has completed and the products are available.

For our Trade and Working Capital products, many of these , e.g. overdrafts, already reference Base Rate. Other products, such as Supply Chain Finance and Bills Discounting are expected to use a TSRR. We will let you have more information once this work has concluded.

RFRs and LIBOR Transition – what else should you be aware of?

Rate Risk

The adoption of RFRs as replacements for LIBOR addresses the increasing risks associated with this benchmark – particularly that LIBOR is seldom set by reference to actual market transactions and relies on prescribed calculation methods and expert judgement instead.

As LIBOR includes an interbank credit measurement it is subject to volatility as can be seen historically e.g. at the Brexit vote and the early period of the coronavirus pandemic.

Although borrowing may be fixed to LIBOR for a specific interest period, there is no certainty on what the rate will be for the following periods leaving borrowers exposed to this volatility.

Lifecycle Risk

You will need to adapt to an interest approach where the RFR and therefore interest due is not known at the point of borrowing.

This may require enhancements to operational and financial processes that have thus far been based on a known interest rate.

Finance and accounting platform providers may not yet be ready to provide solutions meaning there may be a need for manual processes to be adopted in the interim.

Contract Risk

Your own commercial contracts may reference LIBOR and therefore require amendment to RFRs or alternatives. Without amendment, these contracts may become invalid.

Contracts from your lenders will look different and you may require assistance from your advisors (e.g. lawyers or accountants) to understand these.

The market has been actively developing RFR solutions, however, there remain aspects where consensus has yet to be reached. Consequently, the contracts you enter into may require further amendment to align to final market standards and practices. Our contracts will include provisions to ensure that borrowers are not disadvantaged in the event of more favourable market standards emerging.

To find out more

Further information, including the latest LIBOR transition news is available on our website:
digital.ulsterbank.co.uk/business/support/libor-transition.html

What do you need to do next?

- There is no immediate action for you to take and we'll continue to provide timely updates to support you through this transition.
- However, we do encourage you to start reviewing your existing LIBOR exposures and consider which option best suits your requirements.
- At this time, you may wish to engage with your independent professional advisors, such as accountants or lawyers, to help you assess what these changes may mean for you.

To find out more

If you would like more information, or want to discuss any of the options shown in this brochure, please contact your Relationship Manager, or usual contact within Ulster Bank.

For further information and the latest LIBOR news please visit **digital.ulsterbank.co.uk/business/support/libor-transition.html**

LIBOR029/UBOptionsFebruary2021