Content

Contract Remediation................................................................................................................3
Glossary..................................................................................................................................5
Disclaimer.................................................................................................................................6
Contract Remediation

1. I have USD LIBOR contracts maturing beyond 30 June 2023, when should I commence remediation activities?

Overnight, 1-month, 3-month, 6-month and 12-month settings of USD LIBOR will continue to be published until 30 June 2023 so any USD LIBOR contracts maturing beyond this will need to be remediated prior to this cessation date.

It is advisable to commence the remediation in good time to allow you to set the terms for IBOR transition that best suit you and reduce any operational challenges that may arise due to the large number of contracts that may be changing nearer the cessation date. The Bank is ready to support any remediation activity if you wish to commence the transition. Please reach out to your Relationship Manager (RM) to discuss this further, if you have not already done so.

2. Who should I contact to commence remediation discussions?

If you are ready to commence remediation discussions, please reach out to your RM who can organise a meeting with yourself and the relevant deal teams to proceed with the contract remediation process.

The Bank strongly encourages clients to formulate their own views on the advantages and disadvantages of potential remediation methodologies, including the timing of transition and the alternative rate selected. Each client should be taking into account their particular needs and circumstances, and to seek independent advice, if necessary.

3. What is fallback language?

Fallback languages are the contractual provisions that determine what rate counterparties should use in the event that the initially agreed upon benchmark rate is not available. Fallback language is brought into play upon the occurrence of a trigger event, for example, a regulatory announcement that the original rate is deemed non-representative or has ceased or will cease to exist.

4. What is a switch mechanism?

A switch mechanism would provide for the benchmark rate to be automatically converted to an alternative rate on pre-agreed terms set out in the documentation on either an agreed date or the occurrence of a specified trigger event, whichever is earlier. This approach may be appropriate where the parties are able to agree on all the terms relating to the conversion prior to the relevant trigger event.

5. Is the existing fallback language in contracts sufficient?

Prior to the FCA announcement in 2017, most existing fallback language was written to address a situation where a given benchmark was temporarily unavailable (for example, due to technical reasons), rather than permanently ceased. These existing fallback arrangements may lead to unintended consequences for contractual counterparties in the event of permanent cessation of the benchmark rate (for example, serving to effectively convert floating bonds into fixed rate bonds) and will therefore need to be remediated to ensure contractual and economic continuity, and avoid any risk of frustration.

6. How can contracts be amended to include the necessary fallback language?

The availability of a market standard approach to incorporate fallback language into contracts varies based on the product type.

For derivatives, to facilitate large-scale adoption of revised fallbacks, ISDA launched its 2020 IBOR Fallbacks Protocol and Supplement, which became effective on 25 January 2021. The Protocol allows adhering parties to multilaterally introduce the new fallbacks and triggers into their existing covered master agreements, credit support documents, and confirmation that are “Protocol Covered Documents” (as defined in the Protocol). Alternatively, firms can enter into bilateral negotiations to amend existing derivative agreements to include new IBOR fallbacks or carve out those contracts for which they do not wish the Protocol to apply.

Unlike the derivative markets, the adoption of revised fallbacks in existing LIBOR loans will require amendment at an individual contract level. Industry bodies and official sector working groups, including the Loan Market Association (LMA) in the UK and the ARRC in the US, have published robust fallback templates for use in LIBOR-referenced loan agreements.

7. What is active conversion?

Active conversions initiate the pricing change from LIBOR-related pricing to the relevant Risk-Free Rate (RFR).

This is in-line with the ARRC Objectives for 2022 in which addressing legacy USD LIBOR contracts requiring remediation prior to the 30 June 2023 cessation date can be achieved through the conversion of USD LIBOR positions to SOFR or through the use of strong fallback language.

The Bank strongly encourages you to formulate your own views on the advantages and disadvantages of active conversion, considering your needs and circumstances, and to seek independent advice if necessary.
8. If a suitable replacement rate is not available, how can I remediate my existing contracts?

The Bank’s standard remediation approach is aligned to prevailing industry best practice/guidance papers. However, if these options are not suitable for you, and you require bespoke options, this will be subject to approval and will be assessed on a case-by-case basis. Please reach out to your RM for a further discussion.

9. What is the difference between Cumulative Compounded Rate (CCR) and Daily Non-Cumulative Compounded RFR Rate (NCCR)?

The CCR calculation methodology uses the compounded RFR rate from the start of the interest period applied cumulatively to each subsequent business day in the interest period up to and including to the final day in the period. It allows calculation of interest for the whole period using a single compounded rate.

The NCCR is a daily compounded rate derived from CCR where the NCCR is based on the CCR for the current day minus CCR as of the prior banking day. This generates a daily compounded rate which helps to calculate daily interest using the compounded rate for that day or days (usually it will be for one day, but on Fridays it will be three days, or more if there are bank holidays).

For more information, please refer to this link.

10. What are the advantages and disadvantages of opting for CCR or NCCR if they use the same interest calculation?

NCCR is the preferred market convention for the US and UK markets. The key difference between both methods is the handling of prepayments in which the calculations will differ marginally. More information on the calculations can be obtained from the various publicly available RFR Calculators.

11. What is a Credit Adjustment Spread (CAS) and why is it required?

Unlike RFRs, LIBOR incorporates a number of factors, including term liquidity and bank’s credit risk premium. The addition of CAS ensures economic equivalence during the transition.

For the derivatives market, ISDA has determined CAS to be used for ISDA fallbacks. The CAS is based on historical median spread between the relevant LIBOR and the adjusted RFR calculated over a five-year lookback period. Similarly, for cash products, the relevant working groups have recommended the use of the five-year historical median spread adjustment methodology using contractual fallbacks.

Please refer to ISDA and ARRC websites for more details.

12. Will there be a mismatch risk if the CAS is not identical between cash products and derivatives?

When the CAS for derivatives and cash products are not identical, the value of the derivative will not move in line with the underlying cash product exposure, resulting in mismatch risk. Therefore, where your portfolio contains both LIBOR-linked ISDA derivatives and cash products, active conversion discussions may be required to mitigate this risk, and, as part of these discussions, clients should consider aligning the CAS (and other relevant terms) for derivatives and cash products to minimise any mismatch risk.

13. How is CAS calculated?

The CAS value would be set for the conversion date and so contracts relying on fallbacks are likely to use the set historic USD CAS values, published by Bloomberg, that would apply after 30 June 2023 upon USD LIBOR cessation.

Where a client opts to actively convert their contracts prior to the 30 June 2023 cessation date, it is common for the CAS to be calculated using a forward basis swap approach between the equivalent tenors of USD LIBOR and SOFR applicable to the conversion date, which may vary until cessation. For more information on using forward basis swap as the CAS, please reach out to your RM.

14. Which of the historical and forward-looking approaches has a higher spread based on market prices? Are these spreads fixed in value or will they fluctuate over time?

The ISDA CAS, which is based on the historical approach, was fixed on 5 March 2021 whereas a CAS calculated using the forward-looking approach will fluctuate depending on the prevailing market conditions.

The ARRC has considered a dynamic CAS, but eventually did not recommend it due to market participants questioning its long-term viability. Please refer to the ARRC website for more information.
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARRC</td>
<td>Alternative Reference Rates Committee</td>
</tr>
<tr>
<td>BoE</td>
<td>Bank of England</td>
</tr>
<tr>
<td>BoJ</td>
<td>Bank of Japan</td>
</tr>
<tr>
<td>BMR</td>
<td>Benchmarks Regulation</td>
</tr>
<tr>
<td>CAS</td>
<td>Credit Adjustment Spread</td>
</tr>
<tr>
<td>CSA</td>
<td>Credit Support Annex</td>
</tr>
<tr>
<td>CCS</td>
<td>Cross Currency Swap</td>
</tr>
<tr>
<td>€STR</td>
<td>Euro Short-Term Rate</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
</tr>
<tr>
<td>EMMI</td>
<td>European Money Markets Institute</td>
</tr>
<tr>
<td>EUR RFR WG</td>
<td>EU’s Working Group on Euro Risk-Free Rates</td>
</tr>
<tr>
<td>FCA</td>
<td>Financial Conduct Authority</td>
</tr>
<tr>
<td>FMSB</td>
<td>FICC Market Standards Board</td>
</tr>
<tr>
<td>IBA</td>
<td>ICE Benchmark Administration</td>
</tr>
<tr>
<td>IBOR</td>
<td>Interbank Offered Rate</td>
</tr>
<tr>
<td>ISDA</td>
<td>International Swaps and Derivatives Association</td>
</tr>
<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
</tr>
<tr>
<td>LMA</td>
<td>Loan Market Association</td>
</tr>
<tr>
<td>MTM</td>
<td>Mark-to-Market</td>
</tr>
<tr>
<td>RFR</td>
<td>Risk-Free Rate</td>
</tr>
<tr>
<td>RFRWG</td>
<td>Sterling Risk-Free Rate Working Group</td>
</tr>
<tr>
<td>SARON</td>
<td>Swiss Average Rate Overnight</td>
</tr>
<tr>
<td>SOFR</td>
<td>Secured Overnight Financing Rate</td>
</tr>
<tr>
<td>SONIA</td>
<td>Sterling Overnight Index Average</td>
</tr>
<tr>
<td>TONA</td>
<td>Tokyo Overnight Average Rate</td>
</tr>
<tr>
<td>TORF</td>
<td>Tokyo Term Risk-Free Rate</td>
</tr>
</tbody>
</table>
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