The Working Group on
Sterling Risk-Free Reference Rates

From LIBOR to SONIA and what you need to know:

What is a credit adjustment spread?

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Moving to new rates…

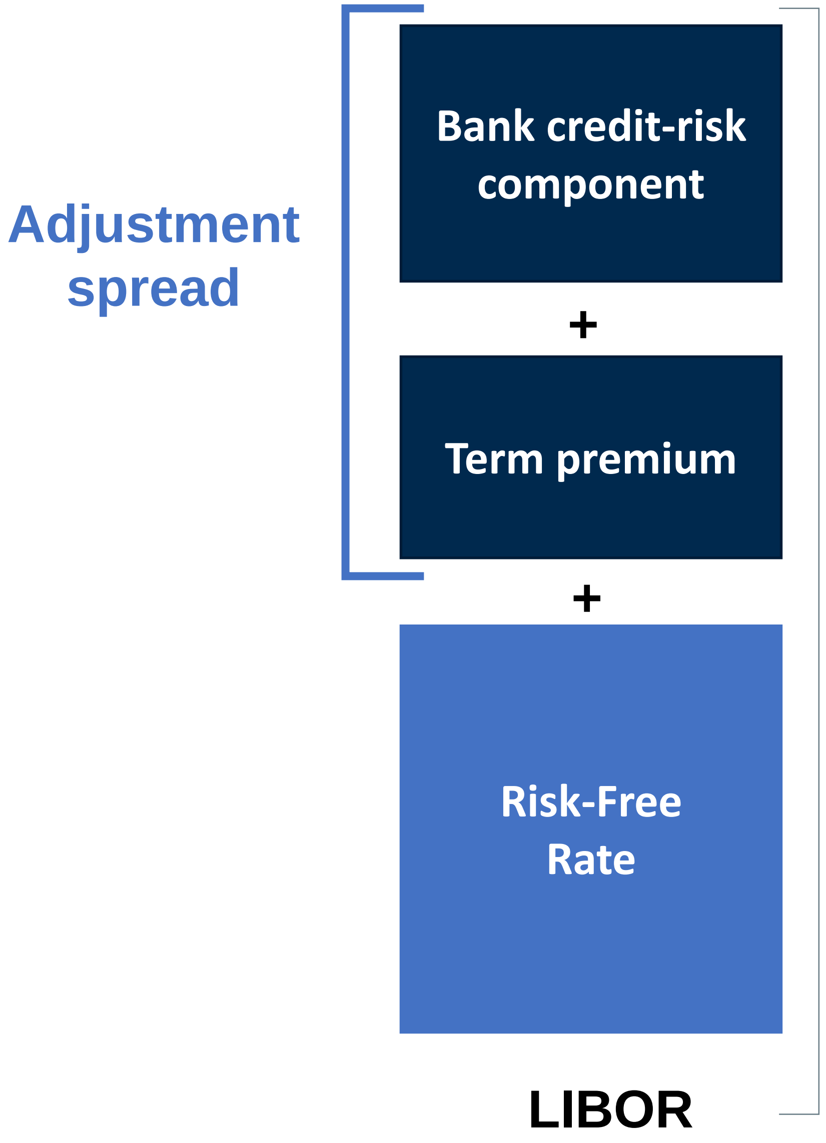
Robust alternative benchmark rates have been established to replace LIBOR, such as SONIA* in the UK.

GBP LIBOR	SONIA
Based on panel bank submissions, lacks an active underlying market	Deep and liquid underlying market, not based on panel bank submissions
Forward-looking term rate	Overnight rate
Is set daily for a range of lending periods e.g. 1 week, 3 months, 6 months, 1 year	Published daily reflecting economic reality, but needs to be aggregated for use over the lending period
Interest is known at the start of the period	Interest is not known at the start of the period
Exposes the borrower to movements in bank credit risk	Nearly risk-free rate, minimising term bank credit or liquidity premium

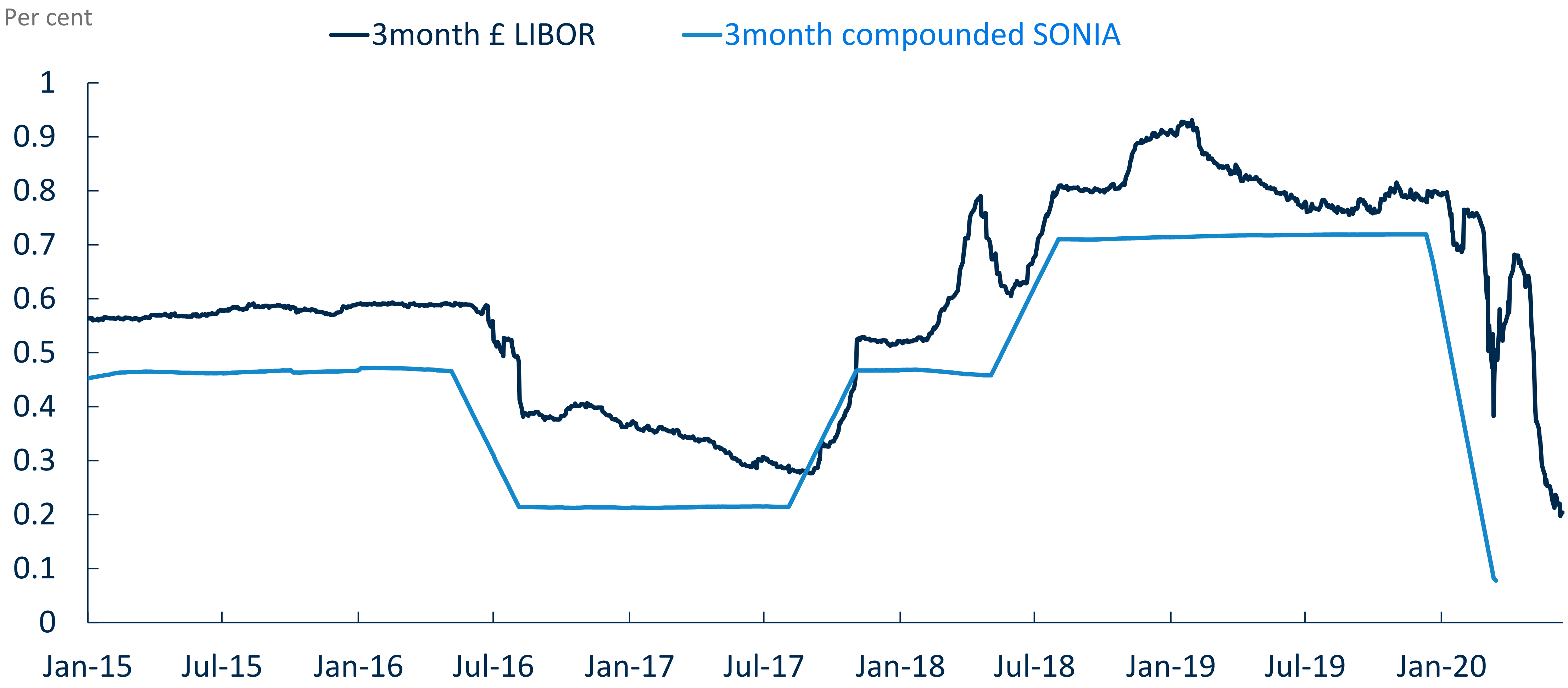
This difference creates the need for a 'credit adjustment spread' for existing contracts

What is a credit adjustment spread?

- LIBOR includes a credit element to reflect the cost and risk to banks of lending over a term period
- As SONIA is an overnight rate, the risk of lending is lower
- The SONIA rate is therefore typically lower than LIBOR
- To ensure a fair conversion of existing contracts, a small adjustment is needed to account for this difference



3m compounded SONIA and 3m £ LIBOR



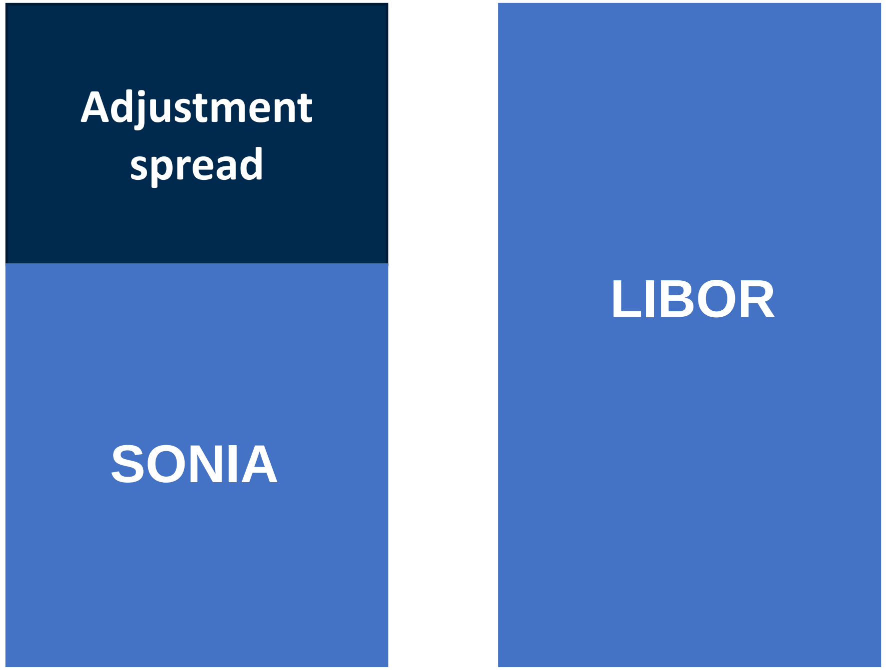
Source: Bank of England and Bloomberg L.P.

Fair treatment of customers when replacing LIBOR

An overarching concern for the FCA is whether firms have taken reasonable steps to treat their customers fairly

The FCA has made clear that:

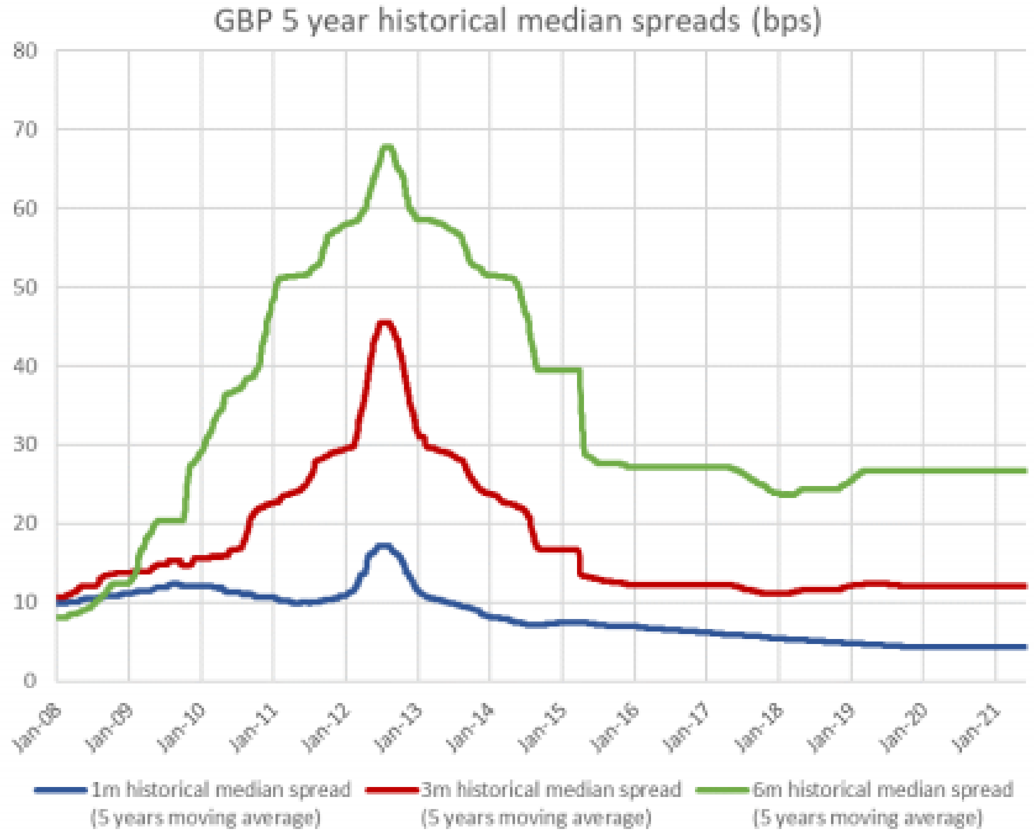
- The discontinuation of LIBOR should not be used to move customers with continuing contracts to higher rates
- We do not expect banks currently receiving interest payments based on LIBOR to give up the adjustment spread
- We are talking about existing LIBOR contracts
- Pricing of new contracts on SONIA or other alternative rates is a matter for individual firms and their customers



How to calculate a fair credit adjustment spread?

A lot of work has been done to build market consensus on how to calculate a fair replacement to LIBOR

- In the derivatives market, this work has been led by ISDA.
- Following a number of consultations, the preferred methodology is to use the median difference (spread) between LIBOR and SONIA calculated over the previous 5 year period.
- The RFRWG has undertaken a similar consultation for the sterling cash market, and found that a majority of respondents favour the same approach as ISDA.



Key resources on credit adjustment spreads

- ISDA Benchmark Reform Webpage
- ISDA Factsheet: Understanding IBOR Benchmark Fallbacks
- FCA statement on conduct risks during LIBOR transition – Nov 2019
- RFRWG Consultation on credit adjustment spread methodologies for sterling cash products – Dec 2019
- RFRWG summary of responses to consultation on credit adjustment spread methodologies for cash products - March 2020