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Goodbye Libor, Hello Sonia

Briefing note

Introduction

The publication of the London Inter Bank Offered Rate (Libor) will end by 31 December 2021. This will have major implications for housing association loan books throughout the UK. This note summarises those implications and looks at what actions housing associations need to take in preparation for the change.

Up Until Now

Libor is used as a reference rate for many financial instruments issued by financial institutions. At least $350 trillion in corporate loans, derivatives, corporate bonds, deposits and mortgages, etc. are tied to Libor. Housing associations in England alone have a combined loan book which amounts to circa £92bn and the interest on approximately 63% of this is referenced to Libor.

Libor is calculated each weekday, by leading banks around the world, each submitting a figure to ICE Benchmark Administration Limited, based on the rate at which they estimate they could borrow funds from other banks. Consequently, Libor reflects both a credit risk and term risk in the rates that are quoted.

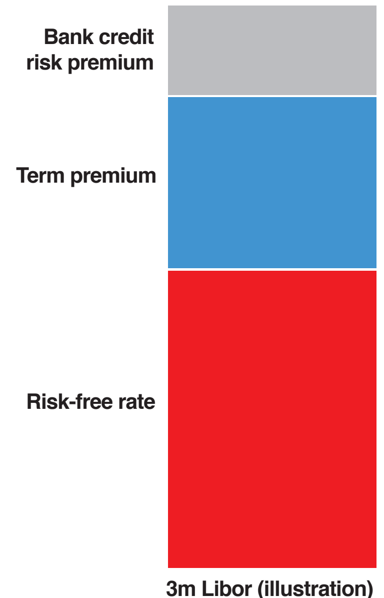
Libor is quoted in range of tenor, from overnight to 12 months and, as such, provides the basis for constructing a term yield curve that is then used in determining the price for a range of interest rate derivatives, including swaps, caps and collars.

During the global financial crisis, some international banks colluded to manipulate estimates to disguise possible credit issues. In 2013, as a response to this, the Financial Stability Board (an international body set up to monitor the stability of the world's financial markets) concluded that Libor was no longer an appropriate benchmark and recommended its replacement with an alternative Risk-Free Reference Rate (RFR).

What is the difference between Libor and RFR?

In principle, Libor for a given tenor (e.g. 3m) can be deconstructed into component parts and RFR is one of them:

- Bank credit risk premium – Libor includes term bank credit risk and has historically spiked during times of perceived stress in the banking system.
- Term premium – a 3m Libor rate will include a term premium to reflect interest rate expectations over the period and the cost of lending money for a term period.
- Risk-free rate – which reflects the general level of interest rates. Sonia is a good measure of the RFR as it does not include either credit risk or a term premium.



Current Position

In 2017, following extensive research, the Bank of England (BoE) Sterling RFR Working Group decided on the Sterling Overnight Index Average (Sonia) as the most appropriate alternative to Libor. Sonia is the mean rate at which market participants are willing to lend and deposit monies to each other from the previous day, based on the central 50% of the volume-weighted distribution of rates.

In other words, whereas Libor is based on speculation by lenders on how they might be willing to lend or borrow for a given future period, Sonia is a spot rate, based on actual reported overnight transactions. The market in Sonia is administered by the BoE and trading volumes have been increasing gradually over the past few years.

The Financial Conduct Authority (FCA) has discussed the transition to Sonia with the current panel of banks that submit Libor quotes daily. The expectation of UK authorities is for the transition to Sonia to be voluntary and market-led, with market participants identifying and developing best practice and creating an implementation plan with criteria and metrics for judging success.

However, there is now universal agreement that Libor cannot remain the sterling RFR in the long-term, following the shift in the operation of the UK financial markets, and the FCA has confirmed that it will not compel banks to submit Libor quotes after 31 December 2021. Consequently, all market participants need to be ready for the transition to the new RFR by that date.

Therefore, the key issues for housing associations are:

- The sector has a long-term business model, funded by long term debt, typically 30 years – many of these facilities, unlike commercial debt, will still be in existence post 2021.
- In addition to arranging new facilities in Sonia, many legacy facilities will need to be converted from Libor to Sonia.

With the transition being left to the markets, the evolution naturally bears a risk of inconsistency and/or the emergence of "winners" and "losers" during the transition.

The Way Forward

Given the introduction of Sonia in the UK, attention has now turned to:

- How will this work in practice in a market where participants have been seeing a range of quotes for Libor and how would they now adopt Sonia - a single overnight rate?
- Will there be equivalent Sonia rates for 3- or 6-month terms (the most common interest periods of debt arrangements)?
- How will arrangements be changed in existing legacy agreements, where the fallback position is only intended to cover short-term market disruption periods and fragility?
- How will this impact on the valuation of existing derivative contracts, given that the majority will use Libor as the benchmark for the floating rate leg?
- Do housing associations need a seat at the table to have a say in the implementation of the transition?

While there is considerable interdependency between these issues, the reality is that the solutions are being devised in parallel rather than through a single cohesive response. Current considerations include:

1) Term Sonia

The Sterling RFR Working Group issued a consultation seeking views on the development of a Term Sonia – the key aspects were:

- Operational requirement to know what the interest costs will be for a given borrowing period (to allow planning/forecasting for payments).
- A forward-looking rate to match the interest rate risk for a specific/unexpired loan.

The consultation closed on 30 September 2018.

2) International Swap and Derivatives Association

The International Swap and Derivatives Association issued a consultation on fallbacks for derivatives referencing Libor, etc. to develop its thinking in the event that Libor ceases to be published. The consultation seeks responses on:

- The preferred RFR.
- The preferred spread adjustment, intended to try and capture the term and credit risk that are inherent in the Libor rate.

The consultation closed on 12 October 2018.

3) Resisting the urge to act unilaterally

There is the daunting prospect of making fundamental changes to the basis upon which interest is calculated, which affects billions of pounds of legacy debt arrangements. Therefore, it is perhaps no surprise that funders appear to be taking policy decisions in current negotiations to empower them to act unilaterally to amend these provisions or, by fulfilling a consultation exercise, at the very least. Whilst an industry norm will need to be rolled out, housing associations should be prepared to argue for a modified safeguard that reassures both parties that neutrality will ultimately be preserved.

ATFS has been supporting the National Housing Federation and its members in dialogue with the BoE and the FCA to help influence the transition to Sonia and ensure that, as the new system is being developed, the interests of housing associations are represented.

How will this affect housing associations

The following table is intended to provide some guidance.

	Loan	Fixed Rate	Derivative
Housing association only has floating rate loan facility that matures on or before 31 December 2021	No impact	No impact	No impact
Housing association has floating rate loan facility that matures after 31 December 2021 but no fixed rates or stand-alone derivative trades	High impact	No impact	No impact
Housing association has floating rate loan facility and fixed rate loans that mature after 31 December 2021	High impact	High impact	No impact
Housing association has floating rate loan facility, fixed rate loans and stand-alone derivative trades that mature after 31 December 2021	High impact	High impact	High impact

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For all housing associations, apart from those in the first category with no high impact, the transition to Sonia is going to have an impact on their operations.

From ATFS's initial analysis, the likely impact for individual housing associations transitioning from Libor to Sonia, is significant cost increases. To illustrate the point, by applying published Sonia rates to a current housing association £10m nominal, free-standing swap deal, based upon 3-month Libor on the floating leg, increases the mark-to-mark exposure by nearly £200,000. This £200,000 increase is based upon a 10-year term to maturity, which if extrapolated for the sector would translate to:

- Circa £170m increased exposure for the sector's £8.4bn nominal free-standing derivatives.
- Circa £900m increased exposure for fixed rate debt referenced to Libor, assuming very conservatively, 75% of the sector's £58bn bank debt is fixed.

What do you need to do now and what support is available?

Depending upon where housing associations sit in relation to the table above, then a range of action can be taken:

1) Get involved and keep abreast of developments.

2) Incorporate the issue into your treasury workplan and ensure that it is clearly flagged on the organisation's risk map.

3) Review your portfolio and determine the elements that will affect your organisation and quantify the impact.

4) Engage with lenders and derivative counterparties to discuss what those parties are planning to do when Libor ceases to be published after the end of 2021.

5) Take legal advice – where on the surface some amendments may appear benign and immaterial, the sector is quickly advancing towards a position where lawyers acting for borrowers and lenders can agree a mutual way forward.

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The move from Libor is inevitable. It will impact the loan books and calculation of future interest liabilities across the sector. It is vital that housing associations:

- Engage and fully prepare for the change.
- Assess the impact that this may have on individual loan books and business plans.
- Take the opportunity to influence the way forward.
- Navigate through these unchartered waters with the appropriate financial and legal advice to hand.

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Contributors to this briefing

This briefing has been produced by staff of ATFS with contributions from Devonshires solicitors. ATFS has been supporting the NHF and housing associations more generally in dialogue with the BoE and the FCA to help influence the transition to Sonia and ensure that as the new system is being developed, the interests of housing associations are represented.

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Our team comprises practitioners from the banking, commercial and housing sectors. This means that our advice is based on real world expertise and as independent advisers we hold protection of our clients' interests as a primary objective.

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