LIBOR vs RFR'S

IMPACT OF THE TRANSITION FROM LIBOR TO RFR'S ON THE CALCULATION OF NPI PREMIUMS

LIBOR

LIBOR	Margin
	Premium = x% of Margin

- Historically LIBOR has been used as the **benchmark rate** component of a lender's interest rate.
- Premium payable to insurers of Non-Payment Insurance (NPI) has been calculated as a **percentage of an insured lender's margin**.
- Since 1 January 2022 **no new lending in USD should use a LIBOR benchmark rate**. Use of LIBOR as the reference rate was phased out earlier for new loans in other currencies.

RFR + CAS

RFR (SOFR, SONIA etc.)	CAS	Margin
		Premium = x% of Margin

- Many legacy loans have transitioned onto a new benchmark rate under express provisions for this in the loans, or by amendment.
- Loan Market Association template documentation provides for legacy loans to **transition from LIBOR to a Risk Free Rate (RFR) plus Credit Adjustment Spread (CAS)**.
- The CAS is the average difference between LIBOR and the relevant RFR, where LIBOR is higher than RFRs (which do not include a credit risk component). It can be a backward looking comparison (like the ARRC's recommended 5 year average CAS calculated to March 2021), or a forward looking one, and it can be a static value or an agreed formula.

ARRC 5 year USD LIBOR spread adjustments, set on March 5 2021

1M USD LIBOR v SOFR Differential	3M USD LIBOR v SOFR Differential	6M USD LIBOR v SOFR Differential
0.11448%	0.26161%	0.42826%

- Where the interest rate in the insured agreement comprises RFR + CAS + margin, **premium payable for NPI is unaffected**, still calculated as the same percentage of margin as before the benchmark switch. This is likely to apply to legacy loans which have undergone a reference rate switch more so than new loans.

RFR

RFR (SOFR, SONIA etc.)		Margin
		Premium = x% of Margin - CAS

$$\text{Percentage } (y\%) = \frac{x\% \text{ of } (\text{Margin} - \text{CAS})}{\text{Margin}}$$

- For **new loans**, lenders may not reference the CAS as a separate component of the interest rate. Instead a **higher margin may be negotiated**, commensurate to the appropriate CAS.
- In such cases, NPI insurers should **expect lenders to ask for their traditional premium rates to apply to net margin** (total margin less the CAS that has been factored in) **OR for a lower premium rate to be quoted on the total margin**.
- This is so that banks, as the funders, continue to retain their cost of funds (historically represented by LIBOR) and to share only their earnings with insurers.
- The **take home amounts for lenders and insurers are unchanged** where the margin increases to incorporate the CAS and the premium calculation differs as explained.

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