LIBOR TRANSITION

Background

Our Q4 2018 Corporate Borrower Update introduced information on the upcoming replacement of the London inter-bank offered rate (**LIBOR**), setting out its proposed replacement (**SONIA**, being Sterling Overnight Index Average, a risk free rate (**RFR**)) and some of the perceived issues and challenges with the use of SONIA.

Given the fundamental differences between LIBOR and SONIA, and the fact that LIBOR is expected to be phased out by the end of 2021, this transition is one of the biggest changes to the loan market in recent years and one that requires engagement and planning by those that currently rely on LIBOR.

In the UK, a group (the Working Group on Sterling Risk-Free Reference Rates) is looking to agree a way forward for the implementation of SONIA across all product areas. That group was initially made up of the Bank of England and the Financial Conduct Authority, but now incorporates representatives from over 100 investment managers, non-financial corporates and other sterling issuers, infrastructure firms and trade associations, alongside banks and dealers.

Some markets have moved decisively towards the new rate (for example, the derivatives market where the amount of new issuances using SONIA is roughly equivalent to that for LIBOR and fixed rate notes where most new issuances use SONIA) whereas others (for example, the loan market) still heavily rely on LIBOR. In his speech on 15 July 2019[1], Andrew Bailey, Chief Executive of the FCA, highlights the need for lenders to begin engaging with borrowers about lending based on RFRs. He urges that transition is not just about new business but about converting outstanding, or legacy, LIBOR contracts, however, he acknowledges that this will be harder in some markets than in others. The loan market is now the key focus and where there is a "major transition programme to be undertaken".

Although NatWest announced on 1 July 2019 that it had provided its first loan using SONIA to National Express, generally speaking, LIBOR is still being retained in most sterling-denominated loans due to the questions that remain with regard to calculation, administration and operation of SONIA that have the potential to cause problems for lenders and borrowers. We have considered some of those issues in this briefing.

What is being done to address the concerns of using SONIA?

Pricing

One of the concerns across the market, which we highlighted in our previous LIBOR transition article, relates to pricing. As SONIA is a RFR, unlike LIBOR, it does not contain any term or credit premium to reflect the risk of longer dated funds and market volatility risk respectively. This means that, for legacy loans, there may be a pricing gap which could need to be dealt with on transition and, for new loans, term and credit risk will need to either be priced separately or included within the margin.

This is an important issue because, in a credit stress market, an RFR could remain stable or go down which means that, whilst a lender's costs of funds is increasing, the interest it receives under its loan is decreasing. Obviously this pricing gap needs to be addressed and, although there are various ongoing discussions, there is not yet a consensus as to how this issue will be dealt with.

How to calculate interest payable

The market needs to agree upon a standard method for the calculation of SONIA taking into account (for example):

(i) whether interest would be calculated using a simple averaging methodology, or compounded on a daily basis;

(ii) whether the margin should be included on a daily basis or added at the end of the relevant term; and

(iii) in order to allow for calculations to be made in time for interest to be paid on each interest payment date, whether the SONIA for the relevant term would be calculated a few days before the relevant interest payment date:

(A) using a look-back starting an equivalent period prior to the start of the term (a "lag" mechanism) or

[1] https://www.fca.org.uk/news/speeches/libor-preparing-end

(B) by repeating a daily rate for the last few days of a term (a "lock-out" mechanism).

A fall-back mechanism in the event of the unavailability of SONIA would also need to be adopted.

Whilst there appears to be a market preference for the 'lag' option, and the National Express facility, referred to in the introduction to this article, used this methodology to calculate the interest payable, all options present operational issues that will need careful consideration. Whichever calculation methodology is used, it is agreed by market participants that it would be preferable to have the relevant rates calculated by a third party. As of yet, this is not available.

Forward looking term rate

One of the perceived advantages of LIBOR, as a forward looking term rate, is that it provides cost certainty for borrowers. Critics of SONIA and other RFRs reference its lack of cost certainty (due to the fact that it is a backwards looking daily rate) as one of the disadvantages.

To address this issue, and for ease of transition, the market considers that the creation of a forward-looking Term SONIA Reference Rate (**TSRR**) would be beneficial. Three benchmark agencies in the UK are looking at this, however, the provision of a forward looking term rate relies on liquidity in the underlying derivatives market, which, for many of the RFRs, isn't possible at the moment. It is for SONIA but there needs to be data available from the derivatives markets to enable the relevant benchmark agencies to set the rate. At the moment the derivatives market is not established in a way which makes the delivery of this data possible and so, whilst there is a possibility of a TSRR being developed, the timeline of this is not certain. Indeed, the advice from the Bank of England is not to rely on the establishment of a TSRR (and certainly not to wait for this to transition) and so, it may be that it will be easier to proceed with the overnight rate, SONIA, in which case market participants would need to get themselves comfortable with the issues noted above.

Legacy Loans

Unfortunately, for the cash markets, there is no ISDA style protocol which will enable a wholesale change across the market. This means that individual facility agreements will need to be amended on a case by case basis. Consideration needs to be given to whether the existing documentation provides for replacement of screen rate and also to the required consent levels to amend the documents.

We understand that the Loan Market Association (**LMA**) has indicated that it is working on a form of amendment agreement, which will be designed to allow lenders and borrowers to agree the high level changes required to a facility (e.g. the alternative rate and the adjustment spread) and then delegate discretion to the Agent to implement the necessary changes. Whilst this will be helpful, given the number of LIBOR reliant loans in existence, there is still a significant amount of work to be done to ensure an effective transition within the proposed timescale.

New Loans

The sterling-denominated loan market in the UK has not really progressed this issue within the last 12 months and most new facility agreements still retain LIBOR as the basis for interest calculations, even where the term of the loan goes beyond the end of 2021.

We also understand that the LMA is currently preparing a draft facility agreement which uses a 'compounded in arrears' SONIA rate as the basis of calculating interest, however, the publication of this is a long way off. For the moment the best option appears to be including a form of the LMA-recommended replacement of screen rate language within any new facilities agreements, but this is in effect just pushing resolution of the problem further towards the 2021 deadline.

What next?

There are still a number of outstanding questions and, at the moment, there is a perception amongst the regulators that there has been a "wait and see" attitude until the financial services industry as a whole has more clarity on the final position as to whether SONIA or a TSRR will be adopted for loans. To that end, in September 2018, the FCA and Prudential Regulation Authority wrote to CEOs of major banks and insurers supervised in the UK asking for details of the preparations and actions they are taking to manage transition from LIBOR to alternative interest rate benchmarks including SONIA. The range of responses received was mixed, but it does seem that this has encouraged market participants to accelerate their plans to deal with the transition. 2021 is fast approaching and a successful transition will need an industry-led solution to what will be one of the most significant changes to impact on the loan market.

What can you do?

While it seems that currently there is little that can be done in terms of documenting new plans to reflect the position after the LIBOR transition (beyond ensuring that the LMA Replacement of Screen Rate language (or equivalent) is included when new facility agreements are entered into (and ideally when amending and/or restating existing facility agreements)) borrowers and lenders should both look to consider their existing loans and what (if anything) needs to be done with them.

To avoid disputes it would be sensible to address this early on. The fallback provisions in existing LMA loan agreements are not designed to work long term so it is much more beneficial to a borrower to address the replacement of LIBOR as soon as practicable rather than wait until LIBOR is no longer available. A borrower could consider repaying or prepaying any LIBOR linked loans if this is a possibility and if no agreement on an alternative can be reached.

Being aware of the issue, engaging with your lenders and considering the implications of LIBOR transition in any financial planning will assist with ensuring that you are as prepared as you can be for what the future of LIBOR/SONIA will hold.

If you have any questions around the impact of the LIBOR transition and if there is anything that we can do to assist with your management of LIBOR transition please do not hesitate to contact your usual AG contact or one of the lawyers listed below:

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