CLIFFORD CHANCE

LIBOR – LOAN MARKET UPDATE

– THOUGHT LEADERSHIP

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With just over two years to go until the FCA no longer compels banks to submit quotes for LIBOR, regulatory pressure towards transition away from LIBOR continues. In November 2019, Edwin Schooling Latter, Director of Markets and Wholesale Policy confirmed the FCA's position and commented that:

"LIBOR continues to be common in corporate lending, including in syndicated loans. The sterling RFR Working Group has set a target of Q3 2020 to stop new lending using LIBOR. This will involve significant infrastructure and documentation preparation, customer communication and staff training exercises for some banks."

Compared with other financial markets in which issuances in risk-free rates (RFRs) are moving towards becoming the norm, there have been relatively few transactions based on RFRs in the loan markets. The first shoots of growth are appearing, particularly in the bilateral space, but in a market dominated by precedent and with a lack of operational infrastructure and market convention, this has been relatively limited. However, the recent issuance of LMA exposure draft documentation may be the catalyst for movement towards resolution of the outstanding questions and further movement towards use of RFRs.

In this note, we consider the LMA documentation and some of the other issues relating to transition in the loan market.

New product or evolution?

The syndicated loan product has evolved over time. LIBOR developed because in the early days of the syndicated loan market, banks actually funded their participations in loans by taking deposits in the interbank deposit market for the relevant currency of the loan (see our briefing on the history of LIBOR). Transitioning from LIBORs to RFRs requires the creation and structuring of a new form of lending product which needs to be tailored to the particular characteristics of the RFRs. If the 2021 deadline is to be met, there is no time for gradual evolution.

Whilst the loan market is anticipating the creation of forward-looking term rates for at least certain currencies[1], it is unclear when these will be available and regulators have emphasised that the markets should not be waiting for such term rates in order to commence transition. Although the Bank of England has suggested that a SONIA term rate could be available in Q1 2020, in the US, the ARRC has indicated that a term rate for SOFR may not be available until 2021. Regulators have made it clear that in terms of new business (as opposed to the transition of legacy transactions), the markets should not be waiting for term rates because their expectation is that future rate products will be based on overnight rates. Therefore, the loan markets have been considering how to make loans available on the basis of backward-looking, compounded RFRs.

The LMA-recommended forms of syndicated facility agreement are usually revised when the syndicated loan market coalesces around a certain practice. Movement towards an interest rate based on an RFR requires the creation and structuring of a new form of lending product (which currently shows few signs of emerging). So, with little market practice to date and suggestions that the syndicated loan market cannot evolve practice without documentation, the LMA published exposure drafts of Compounded SONIA/SOFR based Facility Agreements (the

1 In Switzerland, the authorities have indicated that there will be no term rate for SARON, the swiss franc risk-free rate.

Exposure Drafts)[2] in an attempt to break this "chicken and egg" scenario. Inevitably, however, the Exposure Drafts highlight a number of structuring issues which represent key commercial choices for the market. It is hoped that these may be easier to identify and understand when set out in documentary form and that, following market feedback, the LMA will be able to publish the Exposure Drafts as recommended forms in due course.

Key commercial choices

Probably the most important aspect of the new product and documentation is the rate itself: the characteristics of the RFRs – overnight, backwards-looking and risk-free – lead to a number of structuring points for the market to consider. These are explained in more detail in the Commentary to the Exposure Drafts.

Overnight rates – in order to adapt an overnight rate for use over a period, the Exposure Drafts use a compounded average of the rate. This reflects precedent in the FRN market, but the mathematical formula is not yet included in the Exposure Drafts as there are a few detailed points which the market needs to determine – such as the days on which the RFR should be compounded, and whether this should include weekends or holidays.

Backwards-looking – for the purposes of establishing the amount of interest to be paid sufficiently in advance of the interest payment date, the Exposure Drafts use a "lag" structure which involves using an average RFR that is calculated over an earlier period equal in length to the relevant interest period. Again, this reflects precedent in the FRN market but there are detailed points which need to be determined, particularly the appropriate "lag" period which may need to differ depending on the market (for example, some emerging markets borrowers require more notice of payments than others).

Risk-free – as an interest rate based on an RFR will likely be lower than the equivalent LIBOR, how will parties avoid a value transfer? The answer to this question is a key choice – market participants could choose to retain the current foundational structure of the lending product based on the lender's cost of term funding plus a margin, which is likely to require the construction of some sort of adjustment spread. Alternatively, market participants could move to a foundational structure comprising simply the relevant RFR plus a margin. Economically, it is likely that both options would result in a similar position as in the second option, the margin is likely to be higher to include funding costs and the difference between LIBOR and the relevant risk-free rate. This choice also has an effect on other structuring questions within the documentation, including cost of funds and break costs provisions, which are likely to be relevant only if the RFR is adjusted to act as a proxy for the lenders' funding costs.

Fallbacks

Another key provision of the documentation is the fallbacks that could apply if the benchmark rate is not available. Given the potential for LIBOR to cease to exist, and given that the current fallbacks set out in the LMA recommended forms have (in the case, for example, of reference banks) proved to be unpopular or (like cost of funds) are unlikely to be practicable other than on a short-term basis, these have received renewed focus. The key fallback in the Exposure Drafts (if the compounded RFR is not available on a screen or by way of calculation by the Agent) is a central bank rate; this is not without its complexities though in terms of working out which rate would be the most appropriate and determining any credit spread between the RFR-derived rate and the central bank rate.

It is interesting to note that it is the fallbacks and their triggers that have received a lot of focus in terms of concerns about consistency across products. Whilst clearly the rate used on linked transactions needs to be the same, do the fallbacks and their triggers also have to follow? At present, fallbacks and their triggers are certainly not aligned

2 The Exposure Drafts are English law documents. The application of the concepts set out the Exposure Drafts to documentation governed by laws other than English law must be considered carefully in the context of those laws.

across product types. Historically, rate cessation was not seen as a risk and different products may have had to take into account different concerns, such as whether the requirements of the Benchmarks Regulation are applicable. However, to the extent that indices are set in the documentation as fallbacks, it would be difficult if interlinked transactions did not work together. There may be scope to work this through at the relevant time if it became apparent that a different rate should be used (for example, through the LMA's Replacement of Screen Rate clause). Triggers to the fallbacks do not necessarily need to be identical across products, but interlinked products will need a degree of consistency to ensure they are capable of moving to an alternative interest rate at the same time to reduce any element of basis risk.

EURIBOR

The Exposure Drafts only reference SONIA and SOFR. However, the LMA-recommended forms of facility agreement have the capacity to be used for other currencies, most notably EURIBOR. The indications are that EURIBOR (which is currently being transitioned towards the hybrid methodology) will continue to be published at least in the short and medium term, but the Euro risk-free rate working groups are considering making recommendations in relation to fallbacks to EURIBOR to ensure there is smooth transition in the event that EURIBOR is ever discontinued, particularly in the context of the Benchmarks Regulation, where applicable. It is likely that those recommendations will look to the Euro Short Term Rate (€STR) (which replaced EONIA as the euro overnight rate in October 2019). Term rates based on €STR are being considered – as a fallback to EURIBOR, a forward-looking term rate would certainly be a less complex transition than a fallback from a term rate to a compounded backwards-looking rate which would require significant changes to the loan documentation and operation of the transaction.

LSTA

In the US, the LSTA has also released a form of documentation – the draft SOFR Concept Credit Agreement. This has a number of similarities to the LMA SOFR Exposure Draft although, as is the case now with US and English law documentation, there are differences given that they cater to different constituencies and markets. The SOFR Concept Credit Agreement includes the formula for calculating compounded SOFR – and follows the conventional approach which originated from ISDA whereas the Exposure Drafts envisage following a similar formula but leave some questions open for determination (see Overnight rates above). In relation to the "Risk-free" point mentioned above, the SOFR Concept Credit Agreement provides for interest to be calculated on the basis of compounded SOFR plus the margin – the cost plus basis for funding has been removed, reportedly in response to market feedback. Therefore provisions relating to break costs and market disruption have not been included. It remains to be seen whether market participants in Europe will take the same view – to date, it seems the feedback has been divided.

Legacy transactions

Whilst the Exposure Drafts focus on new transactions, there are also a large number of legacy transactions which need to be taken into account. In the absence of an ISDA-style protocol mechanism, each loan transaction which currently refers to LIBOR will need to be amended – a potentially onerous process. The LMA has published an exposure draft of its "Reference Rate Selection Agreement" – this aims to streamline the amendment process by allowing the parties to agree the main commercial terms relating to transition and authorise the Agent and the Obligors to agree the detailed amendments to the underlying facility agreement to reflect those commercial terms and the relevant recommended form of LMA documentation. It is anticipated that by the time wholesale amendments are being made to legacy transactions the LMA will have published recommended forms of syndicated facility agreement referencing RFRs: this means that the discretion given to the Agent to agree changes to the underlying facility agreement is actually more limited than it would otherwise appear, as such changes would need to follow the LMA wording. However, this does seem to impose new duties on the Agent and the question of who would start the process for (and indeed pay the costs of) amendments to the transaction remains something that would need be determined. Parties will, however, need to work together and take a pragmatic approach to amendments to legacy loan transactions in order to meet the 2021 deadline and avoid the interest rate falling back to cost of funds.

Other issues

LIBOR transition raises many issues beyond the face of the documentation. There is much discussion on the desire to avoid any value transfer on transition to an RFR for a particular transaction, but the financial reporting and tax implications of transition also need to be considered carefully.

In terms of financial reporting, specific challenges include hedge accounting and the valuation of instruments. The IASB has already offered some relief through amendments to IFRS 9 and IAS39 (which modify some specific hedge accounting requirements to provide relief from potential effects of LIBOR-related uncertainty) and is entering the second phase of its work to consider the potential consequences on financing reporting for the replacement of an existing benchmark rate.

An amendment to a transaction could, potentially, have tax consequences. In the US, the Treasury and IRS have, following a request for clarification from the ARRC, released proposed regulations allowing taxpayers to avoid adverse tax consequences that may otherwise arise as a result of the modification of financial contracts in the context of transition away from LIBOR. Whether this will be replicated in other jurisdictions has yet to be determined.

What's next ?

There have been a few bilateral transactions referencing SONIA, with more in the pipeline. Syndicated transactions have been discussed but have been slower to develop given the added complexities they bring. As more transactions are executed and parties consider the issues relating to the use of an RFR rather than following precedent, the hope is that the market will coalesce around settled conventions and infrastructure. Once this happens, systems can begin to be built – it would not be worthwhile to invest in a system which did not reflect market convention. Meanwhile, currency and jurisdiction-specific working groups continue to do what they can to assist with the transition – for example, work is underway on a consultation for an adjustment spread between LIBOR and RFRs for the loan markets. Transition is clearly happening but, with just over two years to go, progress needs to accelerate such that the moving parts of market practice, systems and documentation can align so as to create a new product.

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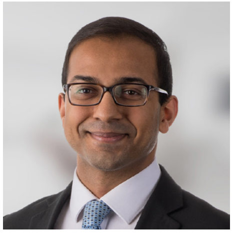

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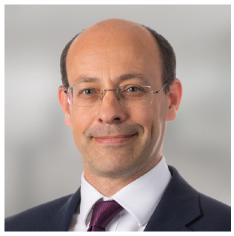

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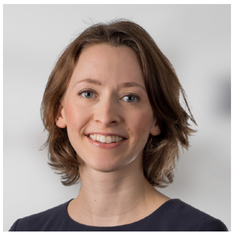

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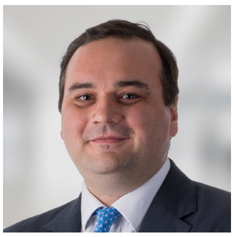

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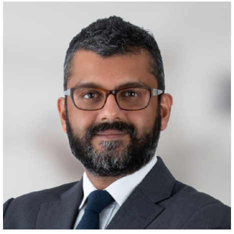

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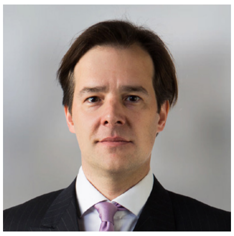

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