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LIBOR AND THE SYNDICATED LOANS MARKET – MILESTONES AND DOCUMENTATION

– THOUGHT LEADERSHIP

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In the UK, regulators and the Working Group on Sterling Risk-Free Reference Rates (£RFR Working Group) have long been urging loan market participants to transition away from using LIBOR on transactions. Whilst, to date, such transition has been challenging for the loan markets, recent publications such as conventions for the use of SONIA and the LMA documentation discussed below, will help generate impetus for transition.

£RFR Working Group milestones and recommendations

In April 2020, the £RFR Working Group revised its previous milestones for transition with the new **statement** requiring that by the end of Q3 2020, "*lenders should be in a position to offer non-LIBOR linked products to their customers*". Acknowledging that it may take further time to transition to such products[1], the £RFR Working Group further recommended that "*after the end of Q3 2020 lenders, working with their borrowers should include clear contractual arrangements, in all new and re-financed LIBOR referencing loan products to facilitate conversion ahead of end-2021, through pre-agreed conversion terms or an agreed process for renegotiation, to SONIA or other alternatives.*" The July 2020 **Q&A**, which clarifies this statement, makes clear that parties must agree as much detail as possible in such contractual arrangements. This means that market participants, to the extent that they are unable to move immediately to transactions based on alternative risk-free reference rates, must decide how to approach this issue: there is a spectrum of certainty ranging from the LMA's suggested supplement to its Replacement of Screen Rate Clause which would set out an "*agreed process for negotiation*" to a document which sets out "*pre-agreed conversion terms*".

This has, until now, been a relatively difficult concept for market participants (despite some market precedent in terms of the Shell and BAT transactions) not least due to a lack of market agreement on the conventions for use of SONIA in loan transactions. Whilst it would be perfectly possible for each transaction to adopt its own conventions, administratively and operationally this could become unworkable across volumes of transactions.

Publication of a set of **recommendations** by the £RFR Working Group in September 2020 for SONIA Loan Market Conventions (the £RFR WG Conventions) will (combined with the LMA documentation referred to below) hopefully be the catalyst for a seismic shift.

The £RFR Working Group recommends in the £RFR WG Conventions that:

- use of SONIA as the recommended alternative to Sterling LIBOR is implemented via a compounded in arrears methodology;
- use of a five banking days lookback without observation shift is implemented;
- where an interest rate floor is proposed, it may be necessary to apply the floor to each daily interest rate before compounding; and
- accrued interest should be paid at the time of principal repayment.

The **supporting documents** to the £RFR WG Conventions set out more details and examples of how they will work in practice.

1. The £RFR Working Group has recommended a target of all new issuances of sterling LIBOR-referencing loan products that expire after the end of 2021 ceasing by the end of Q1 2021.

LMA Rate Switch Agreement

In order to further support the loan market in its move away from LIBOR, the **LMA** has recently published its English law Exposure Draft of Rate Switch Facilities Agreement (the Rate Switch Agreement) together with an accompanying commentary. This aims to set out “pre-agreed conversion terms” by providing that on a pre-agreed date or upon a LIBOR cessation or pre-cessation trigger event, the reference rate for the transaction will change from LIBOR to a risk-free reference rate. The Rate Switch Agreement sets out a framework which enables parties to agree such terms applicable to loans for which the reference rate would be a risk-free reference rate such that on the “switch”, no further amendments to the documentation would be required. Given that many market participants are not, at this stage, operationally ready to participate in new transactions based on risk-free reference rates, the Rate Switch Agreement may be a useful tool to allow parties to switch away from the use of LIBOR at a time when their operational preparations for transition are complete.

The Rate Switch Agreement contains provisions for loans in all relevant currencies to reference compounded risk-free reference rates which are based on the £RFR WG Conventions. Given that the Rate Switch Agreement contains multicurrency facilities and the £RFR WG Conventions relate to sterling and SONIA only, is this the correct approach? Whilst the market may regard this as appropriate, the Rate Switch Agreement notes that parties will have to make an assessment on the conventions most suitable to their transactions and that reference to the £RFR WG Conventions for all currencies is for reasons of simplicity (particularly operational) and ease of illustration.

US ARRC recommendations

Other currency specific working groups have also made recommendations for the use of risk-free reference rates in the syndicated loans markets. In particular, the US Alternative Reference Rates Committee has made **recommendations** in relation to US dollars and SOFR and has published **updated fallback language** to reflect this. Although the first fallback in this language is to a term SOFR rate which does not exist yet (vendors are currently being sought) and the second is to daily simple SOFR, SOFR compounded in arrears is noted as a robust alternative. Whilst there are similarities between the ARRC conventions for SOFR compounded in arrears and the £RFR WG Conventions, if parties do choose daily simple SOFR (or indeed term SOFR as and when it is available) then clearly alternative risk-free reference rate related provisions different to those set out in the Rate Switch Agreement would be needed. The terms of the Rate Switch Agreement could be amended for the purposes of transactions to include alternative conventions for the use of risk-free reference rates.

EURIBOR

Although provisions relating to the transition from EURIBOR to a rate based on €STR have been included in the Rate Switch Agreement, as EURIBOR will continue for the time being, decisions will need to be made on transactions as to whether the “switch” provisions should apply to euro denominated loans. If a pre-agreed date for a “switch” is not included, the document could operate to set out fallbacks to EURIBOR on the occurrence of the cessation, or pre-cessation, triggers to a switch. It should be noted that the **working group on euro risk-free rates** is looking at identifying fallbacks for EURIBOR based on €STR and is intending to consult on potential rates in Autumn 2020.

Market determination

There are, however, a number of factors that parties will need to take into account in determining the conventions most appropriate for their transactions: operational and administrative (can Agents administer multicurrency facilities with different rate calculation methodologies for different currencies?); ease of intra-period payments (either for secondary trading or prepayments); linked transactions (such as hedging transactions); and market practice. There is no reason why market practice cannot differ between geographies as is the case now, where, for example, eurodollar loans often have different terms to domestic US dollar loans. Market practice will also need to develop in relation to linked products – if a loan transaction based on the Rate Switch Agreement is hedged, consideration will need to be given as to whether and how the hedging documentation should be adjusted to reflect the compounding rate and spread adjustment methodologies set out in that loan transaction (or vice versa) or if an alternative approach may be required. **ISDA** is intending to publish shortly its IBOR Fallbacks Supplement and Protocol which detail fallbacks to LIBOR – whilst, in essence, both the methodologies set out in the £RFR WG Conventions and ISDA risk free rate fallback definitions are based on a backwards-looking compounding approach, there are necessarily some differences to reflect the needs of the different products and their respective market conventions.

Legacy transactions

The £RFR Working Group has also published a **paper** (the Legacy Loans Paper) to encourage the active transition of legacy GBP referencing loans (other than "tough legacy loans") from LIBOR to a risk-free reference rate. Although parties have long been aware of the wall of transactions that will need to transition and, in many cases, have started diligence exercises on their books, given a lack of precedent and recommended conventions for the use of risk-free reference rates, there have been very few transactions which have actively transitioned. In the Legacy Loans Paper, the £RFR Working Group emphasises that "*market participants should be looking to amend their legacy GBP LIBOR referencing loans now where feasible*". Steps towards documenting the transition are set out and the Legacy Loans Paper acknowledges that "*The time required for, and considerations around, amending existing GBP LIBOR referencing loans should not be underestimated.*" Although the Rate Switch Agreement is aimed at new transactions, its provisions address use of risk-free reference rates and the £RFR WG Conventions will provide market participants with food for thought on the terms of the risk-free references rates to which their transactions may transition.

Moving forward

With the end of 2021 getting ever nearer, it appears that crunch time in the loan markets is fast approaching. Currency specific working groups have issued milestones for transition and equipped the markets with recommendations for conventions for the use of risk-free reference rates in loan transactions. It is now up to market participants to forge ahead and structure transactions based on reference rates which are alternatives to LIBOR.

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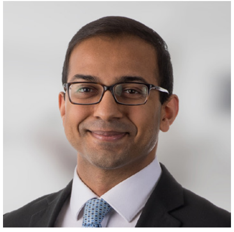

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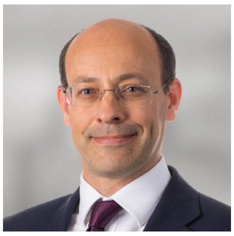

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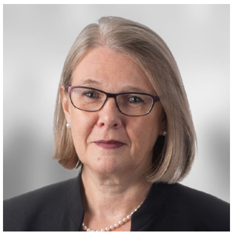

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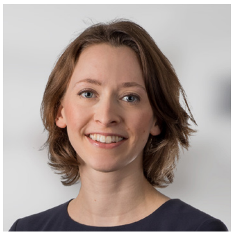

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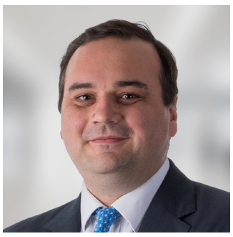

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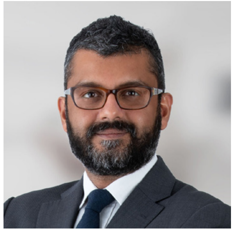

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