Changes are on the horizon
A borrower’s perspective on the abolishment of LIBOR in 2021
Sterling LIBOR transition
Focus on the loan markets – What’s on the horizon in 2020?

Background

The London Interbank Offered Rate ("LIBOR") is one of the Interbank Offered Rates ("IBORs") widely used in the global finance markets. LIBOR is calculated and published daily across sterling, US dollars, Euro, Japanese yen and Swiss francs for overnight, one week and 1, 2, 3, 6 and 12 months. It is the average rate at which banks lend to each other (on an unsecured basis) in the London interbank market for the specified currency and period. In many finance arrangements the interest rate is calculated by adding LIBOR to the Margin. LIBOR is also used as a reference interest rate (also referred to as a benchmark rate) in many other contracts.

Due to a decline in unsecured interbank lending the Financial Conduct Authority ("FCA") announced in 2017 that market participants should not rely on LIBOR being available after 2021.

What are the transition milestones for the loan market?

In light of the COVID-19 pandemic, transition in the loan markets is likely to be slower than the regulators previously hoped. As a result, the Working Group on Sterling Risk-Free Reference Rates in April 2020 recommended the following transition milestones for the loan market:

- by the end of Q3 2020 lenders should be in a position to offer non-LIBOR linked products to their customers;
- after the end of Q3 2020 lenders, working with borrower’s, should include clear contractual arrangements in all new and re-financed LIBOR-referencing loan products to facilitate conversion ahead of the end of 2021, using pre-agreed conversion terms or an agreed process for renegotiation, to SONIA (see below) or other alternatives. Something to keep in mind in respect of any facility amendments happening in the second half of 2020; and
- all new issuance of sterling LIBOR-referencing loan products that expire after the end of 2021 should cease by the end of Q1 2021.

What will replace sterling LIBOR?

SONIA (Sterling Overnight Index Average) is the risk-free rate that has been chosen to replace sterling LIBOR. It is a backward-looking overnight interest rate. SONIA is based on actual transactions in overnight indexed swaps for unsecured transactions in the sterling market rather than submissions by banks, which is why it is viewed as being (nearly) risk-free. Unlike LIBOR, the rate does not include any element of bank credit risk.

The other currency LIBORs will be replaced by different risk-free rates (for example, SOFR (Secured Overnight Financing Rate) for US dollar LIBOR). Some currencies are retaining an IBOR, for example EURIBOR is undergoing a process of reform rather than replacement.

There remain other interest rate options such as using a fixed interest rate or using the Bank of England base rate.
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What are some of the issues with moving from sterling LIBOR to SONIA?

– LIBOR is a look forward term rate and therefore it is possible to calculate the interest amount at the start of the interest period. The loan market is being encourage to adopt SONIA compounded in arrears, which cannot be calculated at the start of the interest period. The way around this is that the interest rate is calculated before the end of the interest period and so the interest period and interest reference period are different.

– The loan market needs to develop conventions, such as what exactly is compounded (the rate or the balance), the number of decimal places for rounding, business day conventions and several others for the use of SONIA compounded in arrears.

– Currently there are no standard tools or calculators for calculating SONIA compounded in arrears (although a Bank of England consultation on its intention to publish a daily SONIA compounded index closed in April 2020 and we anticipate an index being available later in 2020).

– SONIA is generally lower than LIBOR as there is no credit risk element. The market is considering how to calculate the economic differences between SONIA and LIBOR to minimise any transfer of economic value from one party to the other. The method may vary depending on what the trigger is for the move to SONIA.

– The need to deal with legacy LIBOR transactions that mature after the end of 2021 (fallback to cost of funds may not be an option, particularly if it would increase costs for the borrower).

– How multicurrency facilities will work given that there will be different rates for different currencies published at different times.

– The need for market standard documentation (which is something the LMA are addressing by the publication of various exposure drafts for comment and discussion by the market).

What are some of the things I can be doing to prepare?

– Be aware of the issue if you are working on a facility (whether a new facility or an amendment) that terminates after 2021 (or could if extended) and know how many legacy LIBOR transactions you have that mature after the end of 2021.

– Be aware of interest fallback provisions in facility agreements (and their triggers). Should they be amended?

– Be aware of consent thresholds for amendments to reflect a different reference rate.

– Don’t forget about hedging – similar issues arise under ISDA documentation.

– Consider any other customer or intra group contracts using LIBOR as a reference rate.

– Are there penalties for redeeming a facility if amendments cannot be agreed?

– Consider when to start discussions with counterparties about amending legacy LIBOR transaction documentation.

There is a recognition that, in light of the current pandemic, many borrower’s may not have the same time and resources to dedicate to LIBOR transition as they did earlier in the year. This is recognised in the revised transition milestones referred to at the start of this note.
Term SONIA

What is Term SONIA?

Term SONIA refers to a forward-looking term reference rate based on overnight SONIA. This is currently in development and may be available by the end of 2020/early 2021 (although timelines are subject to change). There has been significant interest in the development of Term SONIA in the loan market, in the hope that it will be a lower risk equivalent to LIBOR (LIBOR also being a forward-looking term reference rate). From both an operational and a drafting perspective Term SONIA feels like a more straightforward replacement to LIBOR than Compounded SONIA. However, the regulators have made it clear that SONIA compounded in arrears is to be pushed as the LIBOR replacement for the majority of loan market transactions.

The regulators prefer SONIA compounded in arrears, why?

- Compounded SONIA is viewed as being more robust than term SONIA as it is based on more transactions on an average day.
- If a loan has the same reference rate as a derivative used to hedge the loan it will ensure that the loan is hedged effectively and cost efficiently.
- Compounded SONIA can be used across multiple markets – derivatives, bonds and securitisation.
- For each currency where there is a risk-free rate it is possible to calculate that rate compounded in arrears. The equivalent to term SONIA may not be available for all currencies, which could be a key factor for a multi-currency borrower to ensure a consistent approach.
- There is concern about reintroducing structural vulnerabilities if term SONIA use is widespread.

If Compounded SONIA is the preferred LIBOR replacement, why is Term SONIA needed?

The regulators recognise that Compounded SONIA may not work for certain limited types of borrower and transaction. For example:

- Borrower’s with straightforward lending requirements (ie no hedging and not multi-currency) who don't have the treasury function / technology to switch to Compounded SONIA.
- Trade and working capital where a look-forward term rate may be required to calculated forward discounted cash flows.
- Export finance / emerging markets where borrower’s may need more time to make payments of interest and principal and so need certainty of interest payments at the start of an interest period.
- Islamic finance, where the variable rate of return needs to be pre-determined.
- Certain legacy LIBOR transactions where a change to Compounded SONIA would be too complicated or, given the remaining term, not cost effective.
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How can Eversheds Sutherland help?

Eversheds Sutherland can support you on the full spectrum of LIBOR transition-related issues. Eversheds Sutherland is able to draw on the expertise of Konexo (its technology-driven alternative legal services arm) and a market-leading team of partners and other legal experts in finance, regulatory, derivatives and other relevant areas, both in the UK and across the globe.

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