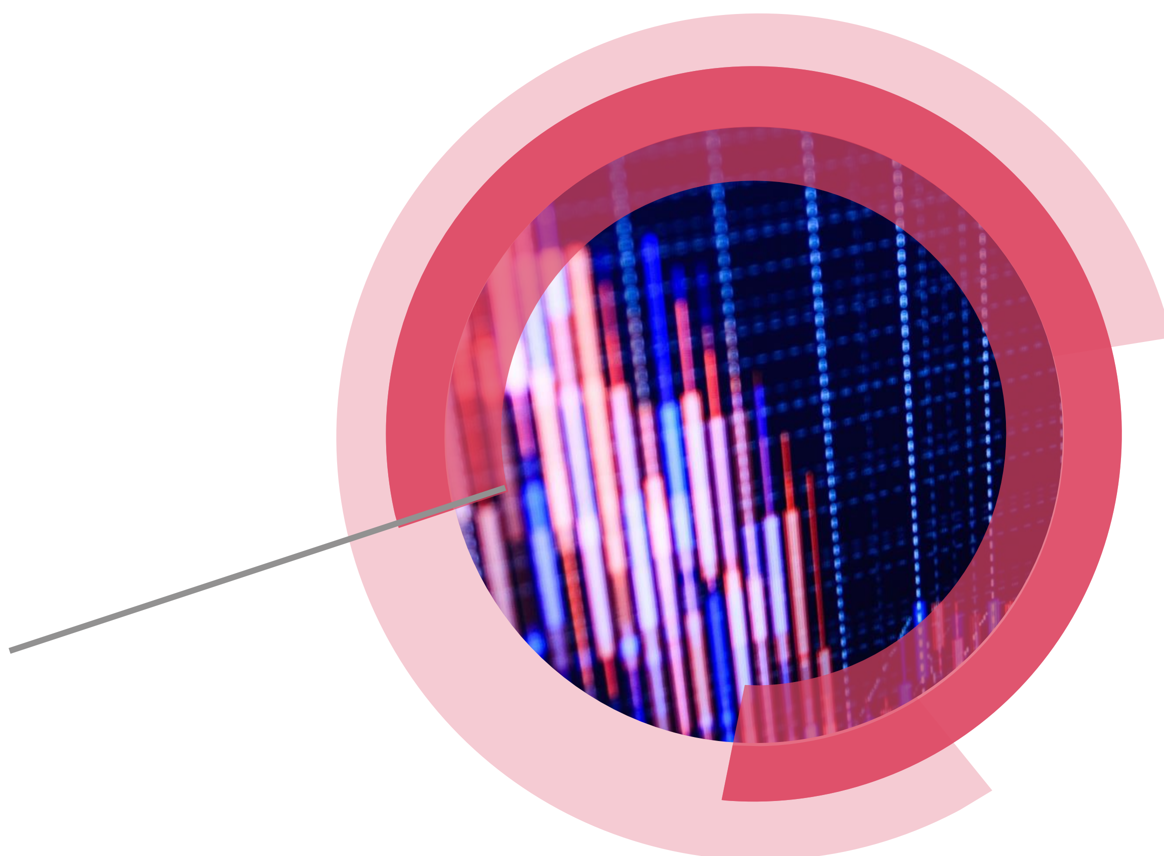
DAC BEACHCROFT

LIBOR TRANSITION:

SOME KEY BORROWER CONSIDERATIONS

July 2020



SO LONG, LIBOR

For over 40 years, LIBOR has constituted the 'floating rate' benchmark for virtually all commercial lending. However, from the end of 2021 LIBOR will disappear and floating rate commercial loans that currently reference LIBOR (for the purposes of this note, references to "commercial loans" are references to such loans) are expected to transition to a floating rate based on so-called "risk free reference rates" (**RFRs**). In the case of Sterling denominated commercial loans, the relevant RFR is the Sterling Overnight Index Average (**SONIA**). The transition away from LIBOR represents a fundamental shift in the debt finance landscape, will materially change the way interest on commercial loans is calculated and will require a change of approach by the finance and treasury functions by borrowers.

In addition, borrowers with existing commercial loans with a tenor beyond the end of 2021 will likely need to amend their facilities to transition to the appropriate RFR. Although lenders may present the transition away from LIBOR as mechanical/administrative, the change will impact interest calculation and borrowers should take detailed legal advice before agreeing to provisions purporting to cater for a transition to SONIA (or any other RFR).[1]

This briefing sets out a high-level summary of the implications for LIBOR transition and some key considerations for borrowers.

HELLO, SONIA

There are a number of key differences between SONIA and LIBOR which will impact how the rates are used to calculate interest under commercial loan facilities:

Historic vs predictive: SONIA is a backward-looking single-day rate; it is the interest rate paid yesterday on 'risk free' overnight deposits between financial institutions as published by the Bank of England. By contrast, LIBOR reports the rate at which funds are made available between certain banks today for the specific forward-looking tenors (one week, one month, three months etc).

Calculation: Broadly, LIBOR is determined by calculating the average rate at which a group of specified leading banks can borrow money from each other in the wholesale London lending markets. A compounded average of SONIA seeks to reflect as a single percentage rate per annum the cumulative effect of the application of a series of individual daily readings of SONIA to any notional sum over a given period.

Economic concept measured: SONIA is designed to be a (nearly) risk-free rate. As a consequence, SONIA does not incorporate any credit or liquidity premium. By contrast, LIBOR is designed to provide an indication of the average rates at which submitter banks could obtain wholesale unsecured funding for set periods and incorporates both a credit premium (to reflect term bank credit risk) and a term liquidity premium (to reflect the risk inherent in longer-dated funding).

Rate differentials: As a result of the above, SONIA is, in most cases, a lower rate than LIBOR.

WHAT DOES THIS MEAN FOR THE CALCULATION OF INTEREST?

Currently, the LIBOR element of the interest calculated on a loan for any period under a loan facility (an **Interest Period**) is determined at the start of the relevant Interest Period based on the matching forward-looking LIBOR rate. The interest payable for that Interest Period will therefore be known in advance. This provides cash flow certainty for all parties.

This will no longer be possible as SONIA is a backward looking overnight rate rather than a published forward-looking rate. Instead, the floating element of interest for an Interest Period is determined by reference to a compounded average of SONIA during that Interest Period. This gives rise to the obvious issue that if interest is determined 'in real time' during an Interest Period, the amount of interest payable by the borrower will not be known until the end of the Interest Period (or, in fact, the day after). Given that interest is payable on the last day of the Interest Period, this approach is not practically or administratively workable for either lenders or borrowers.

In order to deal with this issue, the market at present seems to be moving towards a so-called 'lag approach' whereby the compounded average of SONIA for an Interest Period is calculated not over that period but over a lagged period (often called the

[1] For the basis of this note, we have focused on SONIA (as the Sterling RFR) although similar issues apply to other currencies calculated on the basis of alternative RFRs.

Observation Period) which begins a specified number of days (e.g. 5 Business Days) before the first day of that Interest Period and ends the same number of days before the last day of that Interest Period. The effect is that the compounded average SONIA rate applicable to the Interest Period (and therefore the interest payable in respect of that Interest Period) is known on the last day of the Observation Period, a specified number of days before the last day of the Interest Period. This is intended to give the borrower sufficient time to arrange its interest payment.

BORROWER CONSIDERATIONS

The transition to SONIA presents a number of borrower-specific considerations:

Existing/legacy loans: borrowers should review their existing facility agreement(s) to confirm:

(i) *transition mechanics:* whether the loan facilities already include any pre-emptive provisions catering for the transition to SONIA and, if so, whether these are appropriate (and whether they will work in practice). To the extent that transition provisions give lenders a wide-degree of discretion to unilaterally impose a LIBOR replacement methodology, borrowers should take legal advice to understand the implications and their options. In any event, borrowers should proactively engage with their lenders to discuss next steps and agree an acceptable way forward; and

(ii) *fallback provisions:* the relevant fall back provisions which will apply if LIBOR ceases to be available and no alternative rate is adopted. Absent effective transition provisions and/or a consensual transition, the floating rate element under syndicated and bilateral loans may fall back to each individual lender's cost of funds. This is problematic for a variety of reasons, including the difficulty of calculating the relevant cost to the lender of a particular loan.

Adjustment spread: As noted above, compounded SONIA is likely to result in a lower floating rate than LIBOR (as SONIA (unlike LIBOR) does not incorporate any liquidity or credit risk premium). Lenders may therefore seek to increase the margin or add a "credit adjustment spread" to cover the difference between SONIA and LIBOR in order to maintain their "all in" interest rate return. The methodology for the calculation of the appropriate adjustment spread will be a matter of negotiation although the market appears at present to be coalescing around a spread calculated on the basis of the median difference between the SONIA and LIBOR rates over a historic five year period (this approach reflects the methodology adopted in the derivatives market).

Hedging: Changing the floating rate interest benchmark within a loan facility could cause a mismatch of payments under any connected interest rate hedging arrangements and so it is critical that borrowers stay on top of any changes that are required across all their financial products. Equally, as we get closer to the 2021 cut-off, it is likely that it will become increasingly difficult to hedge floating rate LIBOR loans.

Operational and Treasury functions: Borrower's corporate treasury teams will need to ensure they understand and accommodate the new methodologies for the calculation and payment of interest. In particular, borrowers may need to manage their cash more actively towards the end of Interest Periods to ensure they have sufficient funds to meet their interest payments. "Borrowers should also be aware that the methodology for interest calculation will vary between currencies depending on the relevant RFR involved and, in the case of Euro denominated loans, whether interest continues to be calculated by reference to EURIBOR (which, unlike LIBOR, will continue to be published)."

Break costs: Break costs, currently charged when borrowers repay an amount during an Interest Period, will (in theory) no longer be relevant if loans will no longer be priced against a forward-looking term interest rate benchmark. In place of break costs, lenders may require additional or increased prepayment fees to compensate them. The extent of any prepayment fee will remain a point for individual negotiation.

Other options? Given the complexity in calculating a LIBOR equivalent SONIA rate, in certain circumstances some borrowers may wish to consider using alternative base rates such as Bank of England base rates as the underlying benchmark for floating rate loans or switching to a fixed rate of interest in order to maintain certainty.

CONCLUSION

With 2021 fast approaching, now is the time for borrowers to embrace compounded rates, review their operations and documentation and focus on making the transition away from LIBOR.

This is a developing and complex area with numerous pitfalls and borrowers should therefore obtain expert legal advice before making fundamental amendments to their loan facilities. We would be happy to arrange a call to go through these key considerations and other questions you have on this briefing or other debt finance related issues in further detail.

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