SLAUGHTER AND MAY

Transforming Interest Rate Benchmarks

30 September 2020

Twist or stick? New LMA drafting to future-proof LIBOR-referencing loans

The Working Group on Sterling Risk-Free Reference Rates (the **Sterling Working Group**) has recommended that from the end of Q3 2020 (in other words, from now on), all new and refinanced LIBOR-referencing loans maturing beyond end-2021 should include "clear contractual arrangements" to facilitate conversion to SONIA or other alternatives ahead of end-2021. This must be achieved by specifying "pre-agreed conversion terms or an agreed process for renegotiation".

The LMA has recently published draft documentation designed to meet these requirements. A new exposure draft multicurrency facility agreement incorporates "pre-agreed conversion" terms, otherwise known as "rate switch" provisions. The LMA has also adapted its Replacement of Screen Rate clause to provide "an agreed process for renegotiation".

This briefing discusses the new LMA drafting. It also includes a checklist of issues that borrowers will need to work through if entering into a LIBOR loan that converts to a risk-free rate (**RFR**) in the future (most of which are also relevant to loans that reference RFRs from the outset).

Official sector recommendations

The Sterling Working Group's recommendation for new or refinanced LIBOR loans to contain "pre-agreed conversion terms or an agreed process for re-negotiation" applies for a transitional period between now and the end of Q1 2021. From April 2021, its recommendation is that new sterling LIBOR business should cease altogether. After that date, it is likely that deals extending beyond the end of 2021 will only be available on terms that reference RFRs or other alternatives to LIBOR, such as fixed rates or central bank rates.

These recommendations were set out in a statement issued in April 2020. This statement was followed by a further statement, issued in July 2020. This included a Q&A document, prepared by the Loan Enablers Task Force, a sub-group of the Sterling Working Group, which provides clarification on what these contractual arrangements might look like in loan documentation.

Borrowers looking for finance in the coming months need to consider their readiness to adjust to alternative rates. Some may be ready and willing to adapt to RFRs now. Others will either need more time to prepare operationally, or may wish to see how market practice beds down a bit further before making the switch. Those who decide to continue with LIBOR for the time being, must expect that lenders will require documentation to include provisions that reflect one of the two "future-proofing" options identified by the Sterling Working Group for LIBOR-referencing loans.

LMA Replacement of Screen Rate clause

The LMA's Replacement of Screen Rate clause aims to streamline the process of amending syndicated loan documentation to transition from LIBOR to RFRs, by providing for relevant amendments to be made with the consent of a specified group of lenders (most often, Majority Lenders). This provision has been widely adopted in the syndicated loan market.

The Sterling Working Group confirmed in the July 2020 Q&A document, that the LMA's clause, in its then current form, did not satisfy the Sterling Working Group's recommendation for "an agreed process for renegotiation". In response to this, on 24 August 2020, the LMA published a guidance note containing a supplement to its Replacement of Screen Rate clause designed to meet the Sterling Working Group's recommendation. The revised clause provides that if LIBOR is still being referenced on a specified date ahead of end-2021, then the parties will enter into negotiations in good faith at that time to agree a replacement rate to apply from and including a specified date ahead of end-2021.

LMA Rate Switch Agreement

Following the conclusion of a handful of syndicated loans including "pre-agreed conversion terms", the LMA published an exposure draft multicurrency "rate switch" facility agreement (the **Rate Switch Agreement**), which provides a framework for "pre-agreed conversion terms" in LIBOR-referencing loans, on 11 September 2020.

The Rate Switch Agreement is based on the LMA recommended form of multicurrency term and revolving facilities agreement referencing LIBOR, but incorporates provisions pursuant to which the facilities automatically switch to reference the relevant RFR on a specified date or following the occurrence of specified trigger events.

It contemplates a switch from LIBOR to SONIA/SOFR/SARON (the RFRs for sterling, US dollars and Swiss francs respectively) compounded in arrears + a credit spread adjustment. While the agreement makes similar provision for euro loans to switch from EURIBOR to €STR, as there are no plans to replace or discontinue EURIBOR at present the parties will need to consider the application of the rate switch mechanic to loans in euros.

The switch to RFRs takes place on the earlier of a specified date, any date agreed between the parties, the date on which LIBOR is discontinued (known as the "cessation trigger") and the date on which LIBOR ceases to be representative of the underlying market it is intended to measure (known as the "pre-cessation trigger").

Once the rate switch date has occurred in respect of a given currency, all new advances in that currency will reference the relevant RFR. All existing LIBOR advances will run their course to the end of the interest period and switch to the relevant RFR thereafter.

The Rate Switch Agreement incorporates updated benchmark provisions which will apply following the rate switch. These are set out by currency in a new schedule to the agreement. They are based on the RFR-related terms included in the single currency facilities agreements referencing SONIA and SOFR which were published by the LMA in exposure draft form in September 2019. However, they have been updated to reflect the Sterling Working Group's recently published Recommendations for SONIA Loan Market Conventions (the **Recommended SONIA Loan Conventions**), feedback from market participants on the single currency exposure drafts and the multicurrency nature of the Rate Switch Agreement. As such, the benchmark provisions in the Rate Switch Agreement might be considered the current "state of the art" with regard to RFR-linked facilities.

It is important to emphasise that the Rate Switch Agreement, like the LMA's single currency RFR-linked templates, is in exposure draft form. Further, a number of the decisions to make with regard to the applicable RFR-linked terms are commercial points that must be addressed on a case-by-case basis. Accordingly, for those approaching their first RFR-linked deal, there are a number of issues to work through and discuss with lenders.

A checklist of key points for borrowers is set out below. All of these issues, other than those relating to the rate-switch trigger, are relevant to loans that reference RFRs at the outset, as well as rate switch deals.

Checklist for borrowers

RFRs, rate switch or agreed process for re-negotiation: The key reasons for choosing RFRs or LIBOR, and if LIBOR, rate switch terms or an agreed process for re-negotiation are outlined above. The main issues for borrowers to consider are operational readiness - and their willingness to take a view on the issues outlined below relating to RFR-linked terms.

Control of "early opt-in" trigger: If the parties choose the rate switch route, the triggers for the switch must be considered. The Rate Switch Agreement makes provision for the rate switch to occur on a specified date prior to LIBOR cessation/pre-cessation (when the switch must occur). Any change to this early opt-in trigger

Checklist for borrowers

- RFRs, rate switch or agreed process for re-negotiation?
- Control of "early opt-in" trigger (rate switch deals)
- Compounding methodology
- Observation shift or not?
- Length of lookback period
- Credit spread adjustment
- Application of zero floors
- Multicurrency considerations
- Other issues:
    - Break costs
    - Fallbacks
    - Market disruption
- Do other terms require updating?
- Linked products

must be agreed with lenders. Borrowers may wish to consider negotiating the right to change this date unilaterally, on notice. If the borrower (or indeed any of the lenders) are not ready on the specified date, it will make sense to defer the switch. The process of obtaining lender consent to do so might be viewed as unnecessarily cumbersome to address what is in essence, a practical consideration. The right has been negotiated by borrowers in syndicated rate-switch deals already completed. Where included, consideration will need to be given to the period of notice required to exercise the right, as well as how many times the right can be exercised.

Compounding methodology: The Recommended SONIA Loan Conventions recognise that several methods exist to calculate SONIA compounded in arrears and leave implementation choice to individual market participants. The Rate Switch Agreement provides for the use of the relevant RFR compounded in arrears following the switch. The specified mathematical formula is intended to reflect the non-cumulative compounding methodology set out in the Recommended SONIA Loan Conventions. The LMA has taken this approach because daily non-cumulative compounding (pursuant to which interest varies on a daily basis rather than being a static average rate determined by reference to the entire interest period) is helpful to support the distribution of interest impacted by intra-period activity such as prepayments and secondary trading.

The compounded RFR is calculated daily as the percentage rate per annum which is the aggregate of the “Daily Non-Cumulative Compounded RFR Rate” for that day and the applicable credit adjustment spread (if any).

Observation shift or not? The formula in the Rate Switch Agreement for calculating the “Daily Non-Cumulative Compounded RFR Rate” reflects the lookback without observation shift approach, in line with the Recommended SONIA Loan Conventions. Whether to calculate the compounded RFR with or without an observation shift has been debated in the context of transitioning sterling LIBOR loans to compounded SONIA. The Sterling Working Group has recommended the adoption of a lookback without observation shift, as the majority of respondents to its consultation were in favour of that approach (which is in line with the ARRC’s recommendations for the US dollar market).

There may, however, be instances where the preference is for a lookback with observation shift and the Sterling Working Group has recognised that this can be a viable and robust alternative. For example, if parties wish to use the Bank of England’s Compounded SONIA Index to calculate compounded SONIA rather than a specified mathematical formula, this would require the use of a lookback with observation shift.

The LMA are planning to publish a further Rate Switch agreement based on the lookback with observation shift approach.

Length of lookback period: The Rate Switch Agreement adopts the “lookback” convention. This means that the compounded RFR is calculated over a reference period which starts a certain number of days prior to the start of the interest

period, and ends a certain number of days prior to the end of the interest period. The Rate Switch Agreement suggest a lookback period of five Banking Days, in line with the Recommended SONIA Loan Conventions. This is, however, presented as optional.

The Sterling Working Group has recognised that the lookback period can vary based on borrower/lender needs. Parties will need to weigh up the extent of the advance notice of interest amounts required against how precisely they wish to track the relevant RFR over the period. For very short interest periods, for example, a 5 Banking Day lookback may mean that the reference period overlaps only minimally with the interest period or even (if the interest period is less than 5 Banking Days), not at all. The key for borrowers will be to ensure that the length of the lookback provides sufficient advance notice to mobilise interest payments efficiently.

Credit spread adjustment: The pricing of new RFR-linked loans, like any loan transaction, is to be agreed between the lender and the borrower. Lenders will most likely look to maintain the yields achieved in the days of LIBOR-linked pricing. The economic difference between LIBOR and the RFR could be compensated simply by increasing the Margin. In other words, the credit risk premium inherent in LIBOR is absorbed into an increased Margin. The majority of English law RFR-linked loans completed so far have, however, adopted a “spread adjustment” component in their pricing instead, such that the loan is priced as the compounded RFR + credit spread adjustment + Margin.

The Rate Switch Agreement assumes the inclusion of a separate credit spread adjustment and no change to the Margin, but does not specify how it should be calculated. The recommendation of the Sterling Working Group is that a spread adjustment, based on the historic median between LIBOR and the relevant RFR over a five-year lookback period, is added to the relevant RFR, in line with the approach being taken by ISDA to fallbacks for derivatives.

This approach has been adopted in a number of the RFR-linked loans completed so far, at the point they are entered into, to provide a fixed spread. It has also been used in the publicised rate switch loans. Alternative approaches have, however, also been used in some sterling deals, for example basing the spread adjustment on the forward-looking basis swap market.

In rate switch deals, the parties also need to consider whether the credit spread adjustment should be fixed at the date of signing of a rate switch deal, or whether a calculation formula should be included which is then used to calculate the adjustment at the point of the switch. Agreeing the adjustment at the point of signing provides certainty for the borrower and removes the need for future calculations. Calculating the adjustment at the point of the switch, however, takes into account potential basis volatility between the signing date and the rate switch date, and supports the rationale for including a credit spread adjustment in the first place (i.e. to ensure that transition is economically neutral).

The Rate Switch Agreement is silent as to how and when the credit spread adjustment is calculated, leaving a blank placeholder for the parties to complete on a case-by-case basis.

Application of zero floors to RFRs: The Rate Switch Agreement reflects the Sterling Working Group's recommendations in respect of zero floors. Interest rate floors are calculated daily (rather than at the end of an interest period) because loans accrue interest daily. The zero floor provisions in the Rate Switch Agreement also reflect the Sterling Working Group recommendation that for legacy LIBOR contracts containing a floor, where the aggregate of SONIA plus the credit spread adjustment is less than the legacy floor value, the credit spread adjustment should remain unchanged, with SONIA adjusted to ensure that the aggregate of SONIA plus the credit spread adjustment is equal to the legacy floor value.

Multicurrency considerations: The Rate Switch Agreement applies the Recommended SONIA Loan Conventions to each referenced currency and RFR which corresponds to that currency, rather than reflecting the recommendations of the different currency-specific working groups. The LMA has done this for reasons of simplicity and ease of illustration. While there are similarities between the recommended conventions of the different currency-specific working groups (where available), there are also a number of key differences. The recommendation is that when entering into a multicurrency facility, parties should consider the extent to which the Recommended SONIA Loan Conventions, and the recommendations of other currency-specific working groups, are appropriate for use. For borrowers, it will be important to make sure that all relevant lenders provide information on their preferred approach and the extent of any flexibility to work with other conventions. Any inconsistencies – or approaches that the company finds challenging - will need to be managed.

Other issues: The issues surrounding calculation conventions and pricing are likely to be the most important discussion points in rate switch and RFR-linked loans. There are also however, a number of important secondary issues to be settled which should not be overlooked. These include:

- *Applicability of break costs:* The Rate Switch Agreement contains a blank, optional placeholder for break costs, leaving their inclusion and, where included, their calculation, to be determined by the parties on a case-by-case and currency-specific basis. As far as we are aware, emerging practice suggests that break costs are not a feature of most RFR-linked deals.

- *Fallbacks from RFRs*: If the daily RFR is unavailable, the Rate Switch Agreement substitutes a specified central bank rate (plus an optional spread adjustment) for the daily RFR in the compounded RFR calculation formula. For sterling loans, for example, where daily SONIA is unavailable, the Bank of England Bank Rate (plus an optional spread adjustment) will be used instead. Parties might take the view that an ultimate fallback beyond a central bank rate is unnecessary, given the very remote possibility of it ever being triggered. On the other hand, the very fact that

it is so unlikely to be triggered may mean that borrowers are not too concerned should lenders believe it is necessary.

- *Applicability of market disruption provisions and trigger*: The Rate Switch Agreement presents the market disruption provisions as optional after the rate switch and capable of application on a currency-specific basis. As noted in a previous briefing on this topic, these clauses will become increasingly difficult to frame if RFR-linked loans move away from spread adjustment pricing.

  If market disruption provisions continue to be included for the time being, there is a timing point that should be considered. The LMA drafting allows lenders to trigger the market disruption clause at any time before the end of the lookback period (the period over which the Compounded RFR is observed). This means that the borrower could find itself notified only a few days before an interest payment is due that it is payable on a cost of funds basis for the interest period just finished and giving it no option but to pay cost of funds. Borrowers may wish to discuss with their lenders why the clause needs to operate in this way and suggest that the deadline for triggering the provision should occur earlier than provided for in the LMA terms.

Do other terms require updating? Parties contemplating a RFR-linked or rate switch loan will also need to consider whether other terms require updating when the rate switch occurs/in light of the transition from LIBOR. For example, some loans may contain financial covenants that measure projected debt service or interest cover that need to be updated to accommodate alternative rates.

Linked products: The terms of any RFR-linked or rate switch facility will also need to be considered in the context of their interaction with any linked products such as related hedging.

Approach to bilateral loans

The approach to RFR-linked bilateral loans is not anticipated to be significantly different to that applicable to syndicated loans, save that smaller bilateral loans may transition to fixed rates or central bank rates, as simpler alternatives to compounded RFRs. The Sterling Working Group's recommendations apply equally to bilateral loans. During this transitional period, all LIBOR loans, whether syndicated or bilateral, will need to incorporate "pre-agreed conversion terms" or an "agreed process for re-negotiation".

As regards "pre-agreed conversion terms", it is anticipated that the thinking reflected in the LMA's Rate Switch Agreement will be influential across the loan market, in the normal way. An "agreed process for re-negotiation" will need to be agreed on a case by case basis in the context of bilaterals.

Borrowers with multiple bilateral loans will be familiar with the benefits of ensuring that their obligations are consistent across all of their facility agreements.

It will be particularly important in the context of transitioning to RFRs to ensure that each lender is willing to agree to the same methodology for calculating and using RFRs.

Comment

The Sterling Working Group and UK regulators have made clear that the inclusion of “pre-agreed conversion terms” is their preferred approach to future-proofing LIBOR-referencing loans. The July 2020 Q&A document emphasises that “the greatest certainty for borrowers and lenders will be achieved by setting out in advance the terms for conversion at a future date” i.e. including “pre-agreed conversion terms”.

While the “agreed approach to re-negotiation” remains an option in appropriate cases, our expectation is that the volume of “rate switch” loans will increase significantly in the coming months. The publication of the Rate Switch Agreement is therefore a positive development for the loan market, providing template drafting for a mechanic which is already being successfully used.

ACT Practical Guide to LIBOR Transition for treasurers

The topic of LIBOR transition, including the issues highlighted in this briefing, is explored in more detail in the ACT’s new Practical Guide to LIBOR transition, which will be published shortly. If you would like to receive a copy when published, please contact FinancingBD@slaughterandmay.com.

Slaughter and May are monitoring closely developments in relation to transition from LIBOR, EURIBOR, EONIA and other major benchmarks across all of the major financial products. For further information, please contact any of the lawyers listed below or your usual adviser at Slaughter and May.

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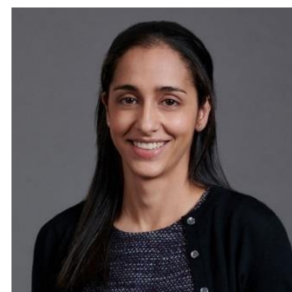

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September 2020