SLAUGHTER AND MAY

The loan market is transitioning to risk-free rates

January 2021

We have observed a fairly sharp increase in the number of risk-free rate (RFR) linked and rate switch facilities over the last three months. As the number of completed transactions grows, banks are in general becoming more confident with RFRs and the points requiring negotiation on these transactions are gradually narrowing. The transition of the LIBOR loan market to RFRs is well underway.

So what has changed?

In the UK market, the milestones set by the UK regulators have served to focus the minds and efforts of market participants. In April 2020, the FCA, Bank of England and Working Group on Sterling Risk-Free Reference Rates (**RFRWG**) recommended that:

- by the end of Q3 2020, lenders should be in a position to offer non-LIBOR linked products to customers;
- after the end of Q3 2020, all new and refinanced sterling LIBOR-referencing loans should include clear contractual arrangements to facilitate conversion to SONIA or other alternatives ahead of end-2021; and
- all new issuance of sterling LIBOR-referencing loans expiring after the end of 2021 should cease by the end of Q1 2021.

These targets have accelerated developments over the last six months. In September 2020, the RFRWG issued its recommendations for SONIA loan market conventions. These recommend a number of conventions in relation to which there had previously been a variety of potential approaches, including the most appropriate compounding methodology and the use (or not) of an observation shift. The recommendations have been broadly embraced by market participants. While the recommendations still need to be understood and digested by those in the early stages of working with RFRs, the universe of discussion points is, in most cases, narrower than previously.

The RFRWG recommended conventions were complemented by the LMA's subsequent publication of facility documentation incorporating rate switch provisions, which reflect the RFRWG recommended conventions and aim to raise awareness of the issues involved in structuring a RFR-linked loan. As with the recommended conventions, the LMA documentation (albeit still in exposure draft form) is being widely used. The LMA documentation is quite complex and may take some time for those coming to it for the first time to understand, but in transactions where the conventions reflected by the LMA's drafting are accepted, the aspects that require negotiation are reasonably limited. The key commercial point in most deals is how the pricing should be structured: should there be a credit adjustment spread or not and if so, how should the spread be calculated? The RFRWG has recently published a paper on spread adjustment options which is helpful in terms of informing discussions on this point.

In broad terms, the interest rate provisions relating to facilities in sterling, dollars and euro are likely to be somewhat easier to settle than those in other currencies, as a result of the LMA framework. The LMA's facility documentation, for ease, applies the RFRWG recommended conventions to dollars as well as sterling, an approach which is generally being accepted in most English law dollar deals we have seen so far. Euro facilities are generally sticking with EURIBOR rather than transitioning to €STR, so euro loans remain straightforward to document where that is the case. There is perhaps less experience in the London market with other currencies, the terms applicable to which may require a little more work, depending on the banks involved.

Treasurers contemplating the move to RFRs will also be considering the wider operational, tax and accounting implications of doing so. Information and guidance is also now available on these issues to facilitate analysis. In relation to UK tax, note that HMRC's guidance on LIBOR transition for businesses has recently been updated (and refers specifically to the LMA's recommended drafting for the loan market).

So what now for borrowers?

The extent to which RFR terms need to be discussed turns on levels of experience within the banking group, but the position is improving as the number of transactions grows. As the recommended conventions and LMA terms, as well as the residual open issues, become better understood, borrowers can feel more confident about approaching the move away from LIBOR. As always, early engagement with your lending group and advisers will be key. For further information, please speak to your usual Slaughter and May contact or one of the individuals listed below.

Contacts

Philip Snell
T +44 (0) 20 7090 3105
M +44 (0) 7776 240 275
E philip.snell@slaughterandmay.com

Matthew Tobin
T + (0) 20 7090 3442
M +44 (0) 7789 980 325
E matthew.tobin@slaughterandmay.com

Richard Jones
T +44 (0) 20 7090 4733
M +44 (0) 7736 045 271
E richard.jones@slaughterandmay.com

Oliver Wicker
T +44 (0) 20 7090 3995
M +44 (0) 7717 505 155
E oliver.wicker@slaughterandmay.com

Kathrine Meloni
T +44 (0) 20 7090 3491
M +44 (0) 7717 691 987
E kathrine.meloni@slaughterandmay.com

Latifah Mohamed
T +44 (0) 20 7090 5093
M +44 (0) 7795 656 670
E latifah.mohamed@slaughterandmay.com

January 2021