SONIA: A Primer

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As we approach the end of LIBOR, the next phase of the transition is already upon us: incorporating the new fallback rates and market conventions into our transactions. This article highlights SONIA, the Bank of England's recommended alternative for Sterling LIBOR. We explain everything you need to know about the differences between SONIA and SOFR and how they both differ from LIBOR, discuss expected variation on how SONIA will be used in the UK versus U.S. markets, and provide a cheat sheet of key terms that you'll soon start seeing in your loan documents (if you haven't already).

What is SONIA?

With the March announcements that our colleague Leah Edelboim so eloquently elucidated **here**, both the UK Financial Conduct Authority and the ICE Benchmark Administration signaled a benchmark transition event for Sterling LIBOR and the other LIBOR-quoted currencies. At the end of this year, Sterling LIBOR will permanently cease for overnight, one-week, two-month and twelve-month tenors, and will no longer be representative for one-, three- and six-month loans.

Enter SONIA, the Sterling Overnight Index Average. SONIA is the risk-free reference rate being promoted as the preferred post-LIBOR benchmark for sterling. SONIA reflects the average interest rate that banks pay to borrow sterling overnight from other lenders. It represents a robust benchmark based on a tremendous volume of roughly £45 billion in real transactions each day. As a risk-free reference rate, SONIA doesn't contain any liquidity or credit premium charged by lenders to the borrowing banks.

SONIA vs. SOFR vs. LIBOR

Like SONIA, SOFR is a risk-free overnight rate. SOFR is the Secured Overnight Financing Rate recommended by the Federal Reserve Bank to replace LIBOR for U.S. Dollar-denominated loans. Each is calculated looking backward to the prior day's deals, and so is reset on a daily basis. While SONIA is an unsecured rate determined by underlying interbank money market trades, SOFR is a secured rate underpinned by repo transactions.

Basic SONIA and SOFR differ from interbank offered rates, such as LIBOR, which are available in different tenors (one-month, three-month, six-month, etc.). LIBOR is inherently forward-looking, with the interest rate being agreed at the beginning of an interest period that lasts for a precise length of time. Because of that, LIBOR may offer greater certainty, as the interest rate is preset for a particular tenor. SONIA and SOFR are generally less predictive, as daily overnight rates determined by looking back at the prior day. LIBOR also contains credit and liquidity premiums charged to reflect bank credit and tenor risk, which are not present in risk-free rates like SONIA and SOFR. As such, SONIA and SOFR display differences in supply and demand and liquidity fluctuations compared to an interbank offered rate like LIBOR.

While SONIA and SOFR are fundamentally different than LIBOR, the goal of the benchmark administrators, the interest rate regulators and our market generally is to ensure that the economics of the risk-free rates are as close to those with LIBOR as possible. Market participants do not want a transfer of value to occur because of the transition from one reference rate to another. Loans based on SONIA and the other risk-free rates cost less because they do not contain the LIBOR risk premiums, so lenders are expected to increase the margin or add a credit adjustment spread to balance the change. Transactions based on LIBOR also contain provisions to cover breakage costs incurred by a lender if the borrower early prepays a loan period. That is inapplicable when using a daily rate like SONIA, so lenders may institute other provisions to compensate their costs for early repayment by borrowers. Lenders should also seek to adapt SONIA in a way that the amount to be paid at the end of an interest period can be determined at an earlier date.

SONIA in the UK

With the inherent disparity of LIBOR being a term rate and SONIA being a daily rate, market participants in the UK have sought to mitigate the discrepancy by formulating SONIA to function over a similarly set period of time. Based on the advice of the Bank of England, the vast majority of the UK market is expected to calculate SONIA compounded in arrears. To do so, the daily SONIA rate is compounded over a certain timeframe, such as a three-month tenor that is made up of three months' worth of daily compounded rates. To permit a borrower to know what its payment will be before the very end of the term, a "lookback" period is used. The period over which SONIA is compounded is moved, say, five business days before the beginning and end of the interest period. That makes the total interest payment known five business days prior to the interest payment date at the end of the term.

The Bank of England's Working Group on Sterling Risk-Free Rates (the "Working Group") and the Loan Market Association (the "LMA") have each endorsed certain conventions for determining SONIA. The total rate is composed of two elements: the compounded rate and a spread adjustment. For compounding methodology, they recommend using a "non-cumulative" approach. Rather than a cumulative rate being measured for the interest period as a whole, a cumulative rate is fixed for each day during the period and then is compounded. That enables a precise calculation of accrued interest for any point of time during the term. If an early prepayment ever needs to be made or a lender moves to assign its loan mid-term, the compounded rate can be ascertained.

The Working Group and the LMA also recommend a lookback "without observation shift." With that approach, SONIA is derived from the lookback period but is weighted according to the days in the interest period. This prevents a situation where the daily accrued interest could ever be negative. Alternatively, it is expected that some market participants may assess SONIA via a lookback "with observation shift." That sets the rate based on the lookback period but is weighted per the days in the observation period. As with the general convention for determining sterling interest rates, in either scenario interest is based on the actual number of days that have elapsed and a year consisting of 365 days.

The second component of the aggregate rate is the credit adjustment spread. The spread is meant to bring the final interest rate using SONIA to be as near to the LIBOR rate as practicable. Market participants should analyze the timing of when the credit adjustment spread is calculated, if they prefer to use a dynamic or static construction, whether the spread adjustment should be modified depending on the length of an interest period and the exact method for tallying the spread. Other aspects of applying SONIA compounded in arrears that transacting parties should consider are a reference rate floor, mechanics for voluntary prepayments, interest period durations and how the administrative agent or lender would notify the other parties of a change to the interest rate.

While it has been estimated that roughly 90% of the UK market will adopt SONIA compounded in arrears, certain sectors may choose to implement other forms of SONIA instead. In particular, term SONIA has already been developed as a published, usable reference rate that functions more similarly to LIBOR. As a forward-looking rate, term SONIA may offer borrowers with greater certainty as to what their interest payment will be. But the Working Group has steered market participants away from term SONIA, in part because it could potentially introduce manipulation risk implicit in forward-looking methodologies like LIBOR. Using the daily overnight SONIA rate endorsed by the Working Group would also conform to the risk-free reference rates being promulgated by administrators of other currencies. That may make it simpler to include in multicurrency credit facilities.

SONIA in the U.S.

While the UK market is anticipated to predominately utilize SONIA compounded in arrears, that is not the case for those in the United States. While a small percentage of U.S.-based fund finance transactions permit loans solely in sterling, it is far more common on this side of the pond to see sterling in multicurrency facilities that are primarily based on dollars. With SOFR replacing Dollar LIBOR, many U.S. lenders are establishing internal systems founded on the SOFR conventions. As such, they are also looking to track the replacement benchmarks for the other LIBOR-quoted currencies, like SONIA, using the same approach.

Per the recommendations of the Alternative Reference Rates Committee (the "ARRC"), most fund finance practitioners in the United States have accepted term SOFR as the initial fallback to Dollar LIBOR and daily simple SOFR as the next alternative in the replacement rate waterfall. As evidenced by the ARRC's announcement on April 20 setting forth key principles for a forward-looking SOFR term rate, it is still undetermined whether a term SOFR will ever be available. Either way, it is expected that many in the United States will conform SONIA and the other risk-free reference rates that will displace LIBOR to mirror SOFR. As such, the leading U.S. approach for SONIA is predicted to have term SONIA as the initial replacement benchmark, if it is available, and the secondary fallback as daily simple SONIA.

The market convention in the United States also differs from that in the United Kingdom for the spread adjustment. Rather than use a credit adjustment spread based on the delta between Sterling LIBOR and SONIA, it is forecast that most in America will devise a revised margin to make SONIA more economically similar to LIBOR. As SONIA is just now starting to be included in loan documentation in the United States, we have yet to see what overall approaches to SONIA will take hold.

Conclusion

The culmination of the LIBOR transition seems closer and closer with each passing day. As with Kurzweil's "Law of Accelerating Returns," the pace of the LIBOR phase-out seems to be increasing exponentially. The end of 2021 and Sterling LIBOR will be here before we know it. Now is the time to embrace SONIA.

Summary of Key Terms

The following is a list of key terms and a brief description of how they are to be used in loan documents. You can reference this list as you begin to include SONIA and the other risk-free alternative reference rates in your transactions.

"Backstop Rate Switch Date": For inclusion of a backstop date by when the rate switch from LIBOR to SONIA will occur.

"Benchmark" and related definitions: The primary terms for actualizing the change from LIBOR to the replacement reference rates.

"Central Bank Rate": For use in multicurrency facilities to distinguish between the primary fallback rates if any risk-free rate like SONIA is or becomes unavailable.

"Compounded Rate Terms": This sets out the specific terms and methodology for calculating interest at a compounded rate in any given currency.

"Compounded Reference Rate": For compounding SONIA in arrears.

"Daily Non-Cumulative Compounded RFR Rate": For non-cumulative compounding of SONIA.

"Daily Rate": If an interest rate floor is used, the parties may need to use this definition to compute the floor for each daily interest rate before SONIA is compounded.

"Daily Simple RFR": This provides the convention for calculating daily simple interest for the risk-free reference rates like SONIA and SOFR.

"Eurocurrency Rate" and related definitions: For maintaining "IBOR" rates for euros (EURIBOR) and yen (TIBOR).

"Interpolated Rate": A lender may need to use an interpolated rate to determine a eurocurrency rate if the eurocurrency rate is not available on the applicable screen page at the time of determination.

"Lookback Period": Generally used for calculating SONIA without observation shift.

"Observation Period" and related definitions: Generally used for calculating SONIA with observation shift.

"Rate Switch Trigger Event": This is meant to list objective triggers that lead to a rate switch on the applicable rate switch date, such as a public announcement from the appropriate regulatory authority.

"Rate Switch Currency": This typically is used to indicate the currencies for which a compounded reference rate would be permitted in the loan transaction.

"Rate Switch Date": This provides the mechanism for fixing a set date on which the change of benchmark rate would occur.

"RFR" and related definitions: For adopting risk-free reference rates as the fallback to LIBOR.

"Term RFR": This provides the convention for calculating term interest for the risk-free reference rates.

WFF Global: What Is Going On In the SPAC Market?

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This week, Women in Fund Finance Global hosted a two-day virtual event covering all aspects of SPACs.

Day One covered "What Is Going On in the SPAC Market?*"* The panelists included Nichole Burnap, a portfolio manager in charge of the SPAC portfolio at Teachers Retirement System of Texas; Amit Chandra, a managing director and head of Natural Resources & Sustainable Impact Equity Capital Markets at Barclays; Carol Lowe, an independent director at TCW Special Purpose Acquisition Corp.; Brett Northart, a member of the management team at Kernel Group Holdings, Inc.; and Thomas Amburgey, a director at First Reserve and CFO of a recent SPAC. The panel was moderated by Marshall Shaffer, a partner at Kirkland & Ellis.

The panel began with a discussion of why SPACs are so very hot right now. Amit explained that the upside is incredible and, with a typical buy-in of $10 a share as your floor, there is a minimum yield of 2% and the upside is "limitless." He called it a "best-in-class" investment in terms of risk-reward. And investors have lots to choose from, he noted, adding that there are 430 SPACs in the market right now looking for investment opportunities.

Nichole spoke from her perspective as an investor in the space. She explained how investors differentiate between investment opportunities given the volume in the market. She stressed the importance of a strong management team consisting of known operators with expertise in the relevant industry. She predicted a divergence in the market, which the panel echoed on Day Two, composed of "one-hit wonders" vs. those that have success and will be around for the long term.

Carol also emphasized the importance of quality and having a team that has the same values, the right network and the right plan to be successful. She said that while it is great that things can move so quickly with a SPAC IPO, the governance structure also needs to be right and the board needs to balance its obligations with the fast and furious pace of a SPAC IPO.

Day Two covered "The Nuts and Bolts of SPACs." The panelists were Edward Best, a partner at Mayer Brown; Gus Garcia, the president and director of G | SPACs; Beth Michelson, who is on the management team at Cartesian Growth Corporation SPAC; Lauren Rosa Sangaline, tax managing director at KPMG; and Andrew Stull, a managing director in the Board Advisory Services and Opinion practice at Houlihan Lokey. This panel was moderated by Alex Lebenthal, senior advisor in the Financial Sponsors Group at Houlihan Lokey.

Alex opened the discussion by assuring audience members that if they feel like they waited too long to get up to speed on SPACs and that it's too late, that is not the case. What followed was an incredibly comprehensive and educational discussion that touched on so many aspects of SPACs – from legal to management to accounting to banking, and the panelists even broke down the latest guidance from the SEC and its impact on the market.

First, the panelists discussed the current state of the market, which goes back about 15 years. Edward explained that SPAC IPOs started to take off in 2016 and 2017 before exploding with a record 247 SPAC IPOs in 2020. 2021 has remained hot with 298 IPOS in the first quarter, putting the pace at about 100 IPOs each month with $80 billion of value. To give a sense of the size of this market, there are presently over 400 SPACs holding approximately $140 billion in cash that are looking for targets. There are another 100 to 150 SPACs waiting to come out into the market. Given the quantity of SPACs and the two-year time horizon each one has to do a deal, Edward said this made for a "seller's market" among attractive target companies.

While the market has been hot, the panelists did describe some shifts they are seeing. With the latest SEC guidance on how warrants should be treated, the IPO market has slowed a bit, with only 10 SPAC IPOs taking place in the month of April so far, which looks slow compared to the last few months. The panelists discussed that news, along with other shifts in the market and a return to certain fundamentals.

While the panelists unanimously agreed that deals will start coming out again, they also said that investors are getting more discerning. Gus noted the quantity of SPACs that have come to market and said it is a question of whether M&A activity will absorb them. He noted that sellers are more discerning, and some SPACs may not find the deal they are looking for. He also predicted that the buzzword will be "experience." Simply put, management teams that can navigate both good times and bad will get capital allocated to them, and there will be a divergence in the market on that basis. Andrew also noted that he is seeing a shift in focus this quarter that differs from the fourth quarter of 2020 and the first quarter of this year: Now there is a shift towards companies that provide more stable growth and higher profitability. Beth also noted that sponsors are looking for clean, strong companies that are ready to go public, will make their numbers and are ready to report. There also needs to be the right match between the target and the investor for a successful partnership. Lauren also discussed seller readiness and the financial and tax preparation that is required when a target is going to go public and the steps it needs to take to perform as a public company on a go-forward basis.

Despite any shifts we may see, the market is predicted to stay hot, and one reason for it is that the economics are so compelling both for sponsors and for targets. Beth noted that a target gets more certainty of valuation, execution and liquidity. While the IPO process takes 1-2 years, a time during which the market can shift, a SPAC merger can be accomplished in as little as 3-4 months. There are also benefits in the way that valuation is approached. Gus agreed that that speed means more certainty and that is possible in the SPAC process.

The conversation turned to the latest SEC guidance on treating warrants as a liability that is causing a pause in the market while SPACs determine what they need to do to properly address the guidance. Edward explained the situation from a legal perspective and how the shift from treatment as equity to a liability impacts financial statements and the associated risks. Lauren explained that all of the Big Four accounting firms are working with the SEC, having daily meetings to try to get the guidance right.

The panel ended with “rapid-fire” predictions for the next 18-24 months. The panelists predicted changes in reporting. They also predicted a continued shift in the type of target that is attractive to investors. Companies that have near-term and actual profitability will continue to get attention, showing that investors are putting more value on more stable and proven businesses. The days of “light diligence” are over. And, finally, given the quantity of SPACs in the market, it is predicted that more SPACs will not find a deSPACing partner and actually liquidate in the next year or two.

The Fund Finance Association’s Mentorship Program: Video Interview

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FFA Vice Chairman Tina Meigh is joined on video by Robert Riley-Gledhill of MUFG Investor Services to discuss Robert’s experience in the Mentorship Program. Matthias Jahnke of Wells Fargo is Robert’s FFA Mentor. The program is designed to help develop current and future leaders in the Fund Finance space through a safe and supportive network of individuals who are committed to exploring, growing and developing with each other. **Watch here**.

WFF Event Announced

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The FFA’s Women in Fund Finance group this week announced an event titled “WFF Global: The Status of Equality,” featuring Savannah Maziya, the Chairperson of Bunengi Investment Group. The event will take place on May 6 at 11 a.m. NY time. For more information or to register, click **here**.

Fore! Q2 is here!

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The Fund Fanatics interview Mitch Melfi from Drake Real Estate Partners, discussing thoughtful fund raising with an eye towards financing, a recap of the market in Q1, and what to look forward to in Q2. The guys also recap the dramatic end to the NCAA men's basketball tournament and reminisce about Tiger Woods' victory at the Masters a year ago. Check it out **here**.

Private Funds CFO: Insurance Companies Step into Fund Finance

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A recent guest article by Khizer Ahmed in *Private Funds CFO* describes the entry of insurance companies into the fund finance market. Khizer highlights why insurance companies find fund finance lending attractive and summarizes several transactions insurance companies are participating in. The article is available **here**.