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LIBOR Update

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LIBOR has been a key interest rate benchmark for many decades, used as the principal reference rate to several hundred trillions of dollars in derivatives, bonds, loans and securitizations. However, when the LIBOR manipulation scandal unraveled itself in 2012, widespread problems with regard to the reliability of LIBOR were identified.

As a result of this, the global regulatory community introduced reform efforts with the aim to help rebuild the public's trust in the reliability and robustness of reference rates, including LIBOR. Since then, the Financial Conduct Authority had announced that after 2021 it will no longer compel participating banks to submit their LIBOR data. What this largely means is that from the end of this year LIBOR may disappear and floating rate loans that currently reference LIBOR would be expected to transition to a floating rate based on so-called "risk-free reference rates" (or RFRs). In the case of Sterling-denominated commercial loans, the relevant risk-free reference rate being strongly promoted by the Sterling Working Group (which was set up by the Bank of England to help develop alternative referencing rates) is the Sterling Overnight Index Average (or SONIA).

This article looks at the key differences between LIBOR and SONIA and how these rates may impact legacy loans and new loans going forward.

Key differences between LIBOR and SONIA

There are three key differences between LIBOR and SONIA that will impact how the rates are used in order to calculate interest under commercial loan facilities:

> **1. 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 for the specific forward-looking tenors (for instance, one week, one month, three months, etc.). In short, LIBOR is based on a projection, whereas SONIA is based on historical data.

2. Calculation: Broadly, LIBOR is determined by calculating the average rate at which a group of specified leading banks can borrow funds from each other in the wholesale London lending markets. However, with SONIA, it is determined by a compounded average in order 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.

3. 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 submitting 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).

As visible from these key differences, the transition away from LIBOR into SONIA does ultimately represent an important shift in the debt finance landscape, and will alter the way in which interest on commercial loans is calculated, as well as requiring a change of approach by the finance and treasury functions of borrowers.

What does this all mean for calculation of interest?

Currently, the LIBOR element of interest calculated on a loan for any period under a loan facility (being an Interest Period) is largely 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 in theory no longer be possible with SONIA, as it is a backward-looking overnight rate rather than a published forward-looking rate. Instead, with SONIA, 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 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 would not be practical or administratively workable for either lenders or borrowers.

In order to address this issue, the market at present is moving towards a “lag approach” whereby the compounded average of SONIA for an Interest Period is calculated over a lagged period (often called the 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 net 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, being 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.

What happens with existing loans and legacy loans?

It would be advisable to review existing facility agreements as soon as possible in order to determine two key points:

1. Transition mechanics: This looks at 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). For borrowers, particular caution needs to be given to any transition provisions that provide their lenders with a wide degree of discretion to unilaterally impose a LIBOR replacement methodology; and

2. Fallback provisions: What are the relevant fallback provisions which will apply if LIBOR ceases to be available and no alternative rate is adopted? Absent of any 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.

Considerations for new facility agreements

When negotiating new facility agreements, there are a few points worth considering:

1. Adjustment spread: As compounded SONIA does not incorporate any liquidity or credit risk premium, it is likely to result in a lower floating rate than LIBOR. However, this means that Lenders may seek to increase the margin or add a “credit adjustment spread” to cover the difference between SONIA and LIBOR in order to maintain their interest rate return.

2. Operational and treasury functions: Borrowers and their internal corporate treasury teams will need to ensure that the new methods of interest calculations are recognised and to regularise their systems in order to accommodate any new methodologies for the calculation and payment of interest. In particular, even with the inclusion of observation periods, this transition may require more active and stricter management of cash towards the end of Interest Periods to ensure that there are sufficient funds to meet interest payments. Borrowers should also be wary of the differences in methodology for interest calculation between different currencies depending on the relevant RFR involved, and whether existing reference rates are continually being used (for instance, for Euro denominated loans, EURIBOR will continue to be published).

3. Break costs: Currently, break costs are charged when borrowers repay an amount during an Interest Period, but with SONIA, in theory, it will no longer be relevant as loans will no longer be priced against a forward-looking term interest rate benchmark. As such, lenders may require additional or increased prepayment fees.

Conclusion

LIBOR discontinuation was first announced in 2017, yet the “market” approach to transitioning out to a new RFR such as SONIA is still a complex and developing area. Even in a series of announcements and guidance made as recent as March 5 by the FCA, the ICE Benchmark Administration (IBA) and the International Swaps and Derivatives Association (ISDA) did not provide definitive guidance regarding how all loans and derivatives will fall back. For instance, some of the most notable announcements included that one- and three-month USD LIBOR will be published through June 30, 2023, while all GBP LIBOR settings will be published through December 31, 2021. However, it was left open as to the possibility that the most common USD LIBOR and GBP LIBOR may nonetheless continue to be published under a “synthetic” methodology beyond those dates.

That said, whilst the desire to wait for market conventions to crystalise is understandable, time is ultimately running short. As such, to avoid any unpredictable pitfalls and exposure to unnecessary risks, we continue to advise our clients to remain proactive in their considerations towards a transition away from LIBOR. This would include reviewing existing loan agreements as well as opening engagement with lenders and borrower clients to agree on best ways forward.