Considerations in respect of the use of forward-looking term SONIA reference rates

1. Important notice

This note is intended as an overview and is not intended to be comprehensive. Whilst every care has been taken in its preparation no representation or warranty is given by the LMA or Clifford Chance LLP as to the accuracy or completeness of the contents of this note. Most importantly, this note is not designed to provide legal or other advice on any matter whatsoever.

2. Introduction

(a) From the end of Q1 2021, the Working Group on Sterling Risk-Free Reference Rates ("£RFR Working Group") has recommended that all new or refinanced GBP lending that expires after end-2021 be based on SONIA or other non-LIBOR alternatives from the outset.

(b) Forward-looking term SONIA reference rates ("TSRRs") have been available in beta form since July 2020, and have been available for use since 11 January 2021. Whilst the £RFR Working Group has indicated limited use cases for such TSRRs, they may provide an option for LIBOR transition for some parts of the loan market.

(c) The LMA's risk-free rate ("RFR") based documentation does not envisage the transition to TSRRs given the limited use cases for TSRRs. The LMA is not at this stage working on producing facility agreements based on TSRRs, but will look to do so for appropriate use cases in due course. In order to produce such documentation, sufficient market feedback will be needed on some key considerations for such documentation (for example, appropriate fallbacks). In this respect, the LMA has reached out to its relevant working parties, but welcomes wider member feedback.

(d) In the meantime, and noting the end-Q1 2021 milestone, the purpose of this note is to highlight considerations for LMA members when using TSRRs. TSRRs are forward-looking in nature and so similar in some respects to LIBOR, making a transition to TSRRs simpler from a documentation and operational perspective than a transition to compounded in arrear RFRs. However, TSRRs also have a number of important differences to LIBOR which need to be factored in to their use and documentation.

(e) The considerations outlined in this note focus on TSRRs, however, they may also be relevant when considering the use of forward-looking RFR term rates which become available in other currencies. As of the date of this note, such rates are not yet available for other LIBOR currencies, including notably US dollars and euro (where they are dependent on liquidity developing in the underlying derivatives market).
3. Is the loan within the specified use cases for TSRRs?

(a) The £RFR Working Group has stated that use of SONIA compounded in arrear is appropriate and likely to be operationally achievable for approximately 90% by value of the GBP LIBOR loan market. The remaining 10% by total loan value would likely require alternative rates. The £RFR Working Group identified use cases for some loan product areas including export finance and emerging markets, as well as trade and working capital finance. The FICC Market Standards Board ("FMSB") is also in the process of developing a proposed market standard for limiting use of TSRRs, which has recently been published for consultation (closing 28 May 2021).

(b) Parties will need to consider whether their transaction fits within these use cases and FMSB market standards. There may, of course, be some instances where transactions within specified use cases will instead use SONIA compounded in arrear. This may be the case where, for example, a corporate borrower has other financings which use SONIA compounded in arrear.

(c) Note that in respect of EURIBOR based euro facilities, the Working Group on Euro Risk-Free Rates consulted last year on term rate use cases in the context of fallbacks to EURIBOR (the "EURIBOR Fallbacks Consultation"). This included export finance and emerging markets, as well as trade finance, as use cases. Although a summary of the EURIBOR Fallbacks Consultation results has been released, the final recommendations are still awaited. In relation to US dollars, whilst forward-looking RFR term rates may be used for hardwired fallbacks, use cases for new SOFR loans have not yet been established but are expected to be limited in line with other currency working groups.

4. Which TSRR should be used?

(a) Since July 2020, three benchmark administrators (ICE Benchmark Administration Limited ("IBA"), Refinitiv and FTSE Russell) have made available beta versions of TSRRs for one, three, six and twelve month tenors. The £RFR Working Group has published a summary of the key attributes of the TSRRs (including their methodologies and publication times). After six months of initial beta period, the administrators were able to remove the beta tags from their rates. Since 11 January 2021, IBA and Refinitiv have published their TSRRs for use. Note that FTSE Russell has decided to discontinue the production of its beta TSRR.¹

(b) Readers should refer to the Refinitiv and IBA websites for more information on the available TSRRs, including terms of use.

¹ The FTSE TSRRs were developed by FTSE Russell, which is part of London Stock Exchange Group ("LSEG"). As part of the integration of LSEG and Refinitiv, Refinitiv Term SONIA will continue to be published.
(c) The £RFR Working Group has not made a recommendation as to which TSRR market participants should use and it is left for market participants to decide. Therefore parties will need to make a choice as to which TSRR to reference in their documentation.

(d) It should be noted that when referencing a TSRR in loan documentation, it is understood that screen pages are no longer expected to be used. As with references to daily RFRs in documentation, definitions are expected to refer to the benchmark itself and/or administrator. Note that the TSRRs are available through RICs (Reuters Instrument Codes) and other redistributor codes.²

(e) In addition, when referencing TSRRs in loan documentation, parties should consider the re-fixing policies of the administrators:

(i) In respect of Refinitiv Term SONIA if, following publication, a material error (0.1 bps of the published TSRR) is identified before 12:50 p.m. London time, the rate will be republished on the same day.

(ii) In respect of the ICE TSRR if, following publication, a material error (0.5 bps of the published TSRR) is identified before 3:00 p.m. London time, the rate will be republished by 4:00 p.m. London time on the same day.

(f) Illustrative definitions in respect of the available TSRRs are set out in Appendix 1 and 2 to this note. The definitions are in illustrative form only, have been prepared on a generic basis and are not designed to fit within the framework of any particular LMA document. Such illustrative definitions would need to be tailored to accord with the framework (and defined terms) used in the relevant document.

5. What should be the fallbacks to a TSRR?

(a) Another key consideration in respect of using a TSRR is what the fallbacks to the TSRR should be. Such fallbacks need to be considered in the context of both: (i) temporary unavailability (i.e. the TSRR is not published on a given day); and (ii) permanent cessation.

(b) For temporary unavailability, it could be that a similar structure to that used in the existing LMA Primary Documents could be adapted. For example, interpolated TSRRs and historic TSRR rates could be used. Parties may also wish to consider the use of the Bank of England Bank Rate at the end of the temporary unavailability waterfall as per the LMA RFR documentation.

(c) For permanent cessation fallbacks, careful thought will need to be given as to the appropriate fallback. There are various options which parties may want to consider, which include those outlined in the table below. In particular, where parties expect to use longer tenors (i.e. longer than three month tenors), careful consideration will need

² Refinitiv Term SONIA is available through <GBPTRR=RFTB> and the ICE TSRR through ICE Data Services: X:TSGBP1M; X:TSGBP3M; X:TSGBP6M; X:TSGBP12M.

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to be given as to the appropriate options as some of those listed below will be more appropriate for tenors of three months and below.\(^3\)

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<th>Options</th>
<th>Considerations</th>
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<td>Bank of England Bank Rate</td>
<td>The use of a central bank rate would align with the fallbacks in the LMA RFR documentation and would also provide a fallback to a well understood rate. Bank Rate is also the fallback specified by the Bank of England to SONIA. Consideration would need to be given as to how it would be used (for example, whether compounding would be appropriate).</td>
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<tr>
<td>SONIA compounded in advance(^4)</td>
<td>Whilst this provides certainty because the exact interest rate is known at the start of the interest period, it references rates observed in the market from the previous period. This may not be appropriate for interest periods longer than three months as the mismatch between the interest period and the observation period would be too great to provide an accurate enough reflection of the current interest rate environment. There may also be accounting and hedging costs and complexities with this option. Further considerations in respect of this option are set out in the EURIBOR Fallbacks Consultation.</td>
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<tr>
<td>SONIA compounded over the week prior to the interest period to determine the interest to be applied on a forward basis(^5)</td>
<td>This would provide certainty because the interest rate is known at the start of the interest period. It also gives a more recent rate than compounding over the entire previous period (i.e. compounded in advance). This method is explained further in a BIS paper on term rates (although only in the context of three month interest periods). However, this option may not be appropriate for interest periods longer than three months and there may also be accounting and hedging costs and complexities with this option. Depending on the period chosen for observation of</td>
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\(^3\) These options should also be considered in the context of other currencies where forward-looking term rates are not expected to be available in time for new non-LIBOR business. For example, the ARRC [recently announced](https://www.arcc-uk.org/media/advice-reports-and-guidance/term-rate-consultation) that it cannot guarantee that it will be in a position to recommend an administrator that can produce a robust forward-looking term rate by the end of 2021. Accordingly, the ARRC has urged market participants not to wait for a forward-looking term rate for new contracts.

\(^4\) This is also known as the "last reset" method.

\(^5\) This is also known as the "last recent" method.
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<td>the rate, it may be exposed to potentially extreme values of a short period of overnight fixings applied for the full interest period.</td>
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<td>Bond index yields</td>
<td>This would need to reference the closest maturity bond yield to the interest rate tenor and so it would need to be considered whether there are, for example, gilts maturing in the necessary tenor at the relevant time. Where the maturity of the gilts do not align with the relevant tenor, interpolation could be taken between the two closest outstanding gilts, although this can add complexity. The bond yields would also need to be adjusted for the coupon and the appropriate bond yield would need to be considered (for example, parties may wish to use local sovereign debt instruments). It should be noted that bond yields may be higher or lower than TSRRs given that bond yields also reflect, for example, risk premiums. It would also need to be considered which rate to take (for example, bid, ask or market close).</td>
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<tr>
<td>Fixed rate</td>
<td>Whilst this would provide certainty, there would need to be a transparent method of setting this fixed rate. Using a fixed rate could also result in an inefficient allocation of capital, given that it could lock the borrower into accepting an interest rate risk which they may not be best placed to take on.</td>
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<tr>
<td>Alternative TSRR(^6)</td>
<td>As there is more than one provider of a TSRR, it is understood that some parties have considered referencing one of the TSRRs as a fallback to the other TSRR. However, parties would need to consider the methodologies of the TSRRs. To the extent that these are similar, then the circumstances leading to the cessation of the publication of one TSRR may also lead to the cessation of the other TSRR.</td>
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\(^6\) In certain jurisdictions there may only be one term rate provider, for example the ARRC has conducted a request for proposals process to select a single administrator.
The options stated above are examples only and are not exhaustive of the options that are or may be available. This is an area which requires careful and further thought (especially where interest periods of six months or longer are used).

Note that the above options did not cover SONIA compounded in arrear. This is on the basis that if a loan falls within the use cases for a TSRR, it is unlikely that a compounded in arrear rate would be suitable as a fallback (for example, because it does not allow discounting for trade finance purposes or it does not allow sufficient time to make payments for certain export finance / emerging market borrowers).

6. Approach to market disruption and break costs

The market disruption provisions in the LMA Primary Documents provide that if a specified proportion of lenders report that the interest rate benchmark understates the cost to them of funding their participation in a loan, the pricing of the loan for the relevant interest period changes from being the interest rate benchmark plus the margin to being the lenders' reported cost of funds plus the margin. Break costs are intended to compensate a lender for the broken funding costs it may incur on any 'matched funding' arrangements it may have in place. Underpinning those provisions is the fundamental premise that the facilities are structured so as to be priced on the basis of a benchmark that is intended to represent an identifiable approximation of the lenders' likely cost of funds plus a margin.

Given the nature of SONIA, parties to transactions will need to determine whether these underlying funding considerations remain relevant to loans which are based on TSRRs and therefore whether the concepts of market disruption and break costs are appropriate in relation to those loans. See the commentaries to the LMA RFR documentation for further discussion.

7. Credit adjustment spreads

When amending loan agreements to actively transition from GBP LIBOR to SONIA or other alternative rates – whether directly, by way of pre-agreed conversion terms or through an agreed process for renegotiation – the possibility of value transfer needs to be carefully considered. This is because of the economic differences between GBP LIBOR and SONIA, which result from, amongst other factors, the term credit risk premium that is built into GBP LIBOR, but not into SONIA (or therefore into TSRRs). The concept of a credit adjustment spread ("CAS") has been used in the market as a way to mitigate, as far as possible, any value transfer.

In September 2020, following market consultation, the £RFR Working Group recommended the use of a five-year historical median for the CAS applicable to a SONIA rate (being either SONIA compounded in arrear or a TSRR) in fallback or replacement of screen rate provisions applying in cash market products (including loans) following a cessation trigger or pre-cessation trigger in relation to GBP LIBOR. This
is in line with the ISDA approach for derivatives fallbacks (which apply upon a cessation or pre-cessation trigger).

(c) In relation to active transition (i.e. transition before cessation or pre-cessation), readers should refer to the £RFR Working Group paper which sets out the methodologies available for active transition CAS and considerations relating to timing and other factors.

(d) For new transactions using TSRRs from the outset, it is less likely that a CAS will be separately specified. This is because the economics of the transaction can be determined at the outset without having to take account of any potential difference between reference rates before and after any rate switch. However, as the market develops practice in relation to the pricing metric for transactions which are priced by reference to a TSRR from the outset, it is possible that a CAS might be used as part of that metric if that would be helpful to demonstrate how the costs of the transaction are calculated.

8. Interaction with hedging

(a) Although not all loans are hedged, hedging may be a relevant consideration for some loans.

(b) The ISDA IBOR Fallbacks Supplement and IBOR Fallbacks Protocol provide for fallbacks to SONIA compounded in arrear. Whilst ISDA is working on new 'rate options' to facilitate use of RFRs and hedges with the conventions being seen in the loan and other cash markets, this is not planned to cover TSRRs. Moving to TSRRs could therefore result in basis risk and will need to be carefully considered.
Appendix 1

Illustrative definition for Refinitiv Term SONIA

*Illustrative definition to be adapted for use in conjunction with the interest rate framework used in the relevant facility agreement*

The Term SONIA reference rate administered by Refinitiv Benchmark Services (UK) Limited (or any other person which takes over the administration of that rate) for a period equal in length to the Interest Period of the relevant Loan [(before any correction, recalculation or republication by the administrator)] published by Refinitiv Benchmark Services (UK) Limited (or any other person which takes over the publication of that rate) as of the Quotation Day.

*Associated definition to be adapted for use in conjunction with the interest rate framework used in the relevant facility agreement*

"Quotation Day" The first day of the relevant Interest Period (unless market practice differs in the Relevant Market, in which case the Quotation Day will be determined by the Agent in accordance with market practice in the sterling wholesale market (and if quotations would normally be given on more than one day, the Quotation Day will be the last of those days)).

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7 Whilst “Refinitiv Term SONIA” is the formal name for this TSRR, “Term SONIA” has been used in case the administrator changes.

8 This formulation is used on the basis that the documentary framework within which the definition will be used cannot be assumed, and it cannot be assumed that the Term SONIA reference rate will be a "Screen Rate" or a "Term Reference Rate" within the meaning of LMA documentation.

9 This formulation assumes that the relevant facility agreement contains a construction provision in similar terms to that used in paragraph (b) of Clause 1.2 (Construction) of the recommended forms of LMA investment grade facility documentation.

10 The potential for subsequent intra-day correction, recalculation or republication of an originally published Term SONIA reference rate can raise difficult issues that should be considered carefully to ensure that the parties achieve the desired commercial outcome. Readers should carefully consider the extent to which excluding the effects of any such correction, recalculation or republication is suitable for the transaction in question.

11 This is often defined as the “Relevant Market” in LMA documentation.
Appendix 2

Illustrative definition for ICE Term SONIA Reference Rate

Illustrative definition to be adapted for use in conjunction with the interest rate framework used in the relevant facility agreement

The Term SONIA Reference Rate (TSRR)\textsuperscript{12} administered by ICE Benchmark Administration Limited (or any other person which takes over the administration of that rate) for a period equal in length to the Interest Period of the relevant Loan\textsuperscript{13} \textsuperscript{14} [(before any correction, recalculation or republication by the administrator)]\textsuperscript{15} published by ICE Benchmark Administration Limited (or any other person which takes over the publication of that rate) as of the Quotation Day.

Associated definition to be adapted for use in conjunction with the interest rate framework used in the relevant facility agreement

"Quotation Day" The first day of the relevant Interest Period (unless market practice differs in the Relevant Market, in which case the Quotation Day will be determined by the Agent in accordance with market practice in the sterling wholesale market\textsuperscript{16} (and if quotations would normally be given on more than one day, the Quotation Day will be the last of those days)).

\textsuperscript{12} Whilst "ICE Term SONIA Reference Rate" is the formal name for this TSRR, "Term SONIA Reference Rate" has been used in case the administrator changes.

\textsuperscript{13} This formulation is used on the basis that the documentary framework within which the definition will be used cannot be assumed and it cannot be assumed that the Term SONIA Reference Rate will be a "Screen Rate" or a "Term Reference Rate" within the meaning of LMA documentation.

\textsuperscript{14} This formulation assumes that the relevant facility agreement contains a construction provision in similar terms to that used in paragraph (b) of Clause 1.2 (Construction) of the recommended forms of LMA investment grade facility documentation.

\textsuperscript{15} The potential for subsequent intra-day correction, recalculation or republication of an originally published Term SONIA Reference Rate can raise difficult issues that should be considered carefully to ensure that the parties achieve the desired commercial outcome. Readers should carefully consider the extent to which excluding the effects of any such correction, recalculation or republication is suitable for the transaction in question.

\textsuperscript{16} This is often defined as the "Relevant Market" in LMA documentation.