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| **For the avoidance of doubt, this Commentary and the Rate Switch Agreements are in a non-binding form. Their intention is to be used to facilitate awareness of some of the issues involved in structuring syndicated loans referencing IBOR or similar term rates initially with a switch to compounded daily rates and to** **provide a documentary reflection of the recommendations for SONIA Loan Market Conventions issued by the Working Group on Sterling Risk-Free Reference Rates. Neither this Commentary nor the Rate Switch Agreements constitute a recommended form of the LMA. Individual parties are free to depart from their terms and should always satisfy themselves of the regulatory implications of their use. In particular nothing in this Commentary or any Rate Switch Agreement is intended to, or should be construed as, a recommendation of, or support for, any particular pricing methodology by the LMA.****Readers choosing to use the Rate Switch Agreements as the basis for preparing loan documentation for transactions should note that in the absence of established market or operational practice in relation to the SONIA Loan Market Conventions, the Rate Switch Agreements seek only to reflect those conventions and do not purport to offer any standardised position in relation to a number of issues associated with the use of compounded risk-free reference rates or the operation of those conventions. Those issues are outlined in this Commentary but will require consideration and resolution by the relevant parties in the context of the relevant transaction.** |
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| COMMENTARYTOTHE EXPOSURE DRAFTS OF THE MULTICURRENCY TERM AND REVOLVING FACILITIES AGREEMENTS INCORPORATING RATE SWITCH PROVISIONS NOVEMBER 2020 |
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1. Introduction

The purpose of this Commentary is to assist readers of the Exposure Draft Multicurrency Term and Revolving Facilities Agreement incorporating Rate Switch Provisions (Lookback without Observation Shift) published on 23 November 2020 (the "**Rate Switch Agreement (Lookback without Observation Shift)**") and the Exposure Draft Multicurrency Term and Revolving Facilities Agreement incorporating Rate Switch Provisions (Lookback with Observation Switch) published on 23 November 2020 (the "**Rate Switch Agreement (Lookback with Observation Shift)**") (together, the "**Rate Switch Agreements**") to:

* facilitate awareness of the issues involved in structuring syndicated loans referencing IBOR or similar term rates initially with a switch to compounded risk-free reference rates and the development of an approach to these issues by market participants; and
* provide a documentary reflection of the recommendations for SONIA Loan Market £RFR Working Group Conventions (the "**£RFR Working Group Conventions**")[[1]](#footnote-2) issued by the Working Group on Sterling Risk-Free Reference Rates (the "**£RFR Working Group**") in September 2020.  This is intended to facilitate market participants in their assessment of the extent to which the £RFR Working Group £RFR Working Group Conventions are appropriate for use (whether for sterling amounts or on a multicurrency basis) in the European syndicated lending market when documenting facilities which switch to compounded risk-free reference rates.

The Rate Switch Agreements continue not to constitute recommended forms of the LMA. It is for individual market participants to form their own view of the extent to which the Rate Switch Agreements (and each £RFR Working Group Convention) are suitable for use as the basis for preparing loan documentation for transactions. Individual parties are free to depart from their terms and should always satisfy themselves of the regulatory implications of their use.

Readers choosing to use the Rate Switch Agreements as the basis for preparing loan documentation for transactions should note that in the absence of established market or operational practice in relation to the £RFR Working Group Conventions the documents seek only to reflect the £RFR Working Group Conventions and do not purport to offer any standardised position in relation to a number of issues associated with the use of compounded risk-free reference rates or the operation of the £RFR Working Group Conventions. Those issues are outlined in this Commentary but will require consideration and resolution by the relevant parties in the context of the relevant transaction.

Nothing in this document is intended to, or should be construed as, a recommendation of, or support for, any particular pricing methodology by the LMA.

**Context for the development of the Rate Switch Agreements**

*Rate Switch Provisions*

Since the announcement in July 2017 that market participants should not rely on ICE LIBOR being available after 2021 the LMA has been playing a key role in the transition to the use of RFRs in syndicated loans in each of the ICE LIBOR currencies. The LMA remains in active discussions with the relevant regulators and national working groups to ensure that the interests of the loan market in ICE LIBOR transition are represented. The LMA is committed to assisting the syndicated loan market in transitioning away from the use of LIBOR.

Given the operational constraints which prevent some market participants from moving to transactions referencing compounded RFRs at present, the Rate Switch Agreements have been drafted to allow such market participants to enter into transactions based on existing reference rates but allowing a change in due course to compounded RFRs on either an agreed date or upon cessation of the existing reference rate(s). Market participants may therefore agree the terms relating to the RFRs at the point at which the transaction is entered into[[2]](#footnote-3) rather than having to enter an extensive negotiation and amendment process when cessation of LIBOR becomes imminent.

In April 2020, the Working Group on Sterling Risk Free Rates (the **"£RFR WG**") published a [statement](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfrwg-further-statement-on-the-impact-of-coronavirus-on-timeline-for-firms-libor-transition-plans.pdf) (the "**Statement**") on the impact of Coronavirus on the timeline for firms' LIBOR transition plans. The Statement recognised that, due to the challenges for the operating environment created by Coronavirus, for many firms it would not be feasible to meet a previously recommended target of transition away from LIBOR across all new sterling linked loans by the end of Q3 2020. Therefore, the Statement included a revised target recommendation that "after the end of Q3 2020 lenders, working with their borrowers should include clear contractual arrangements, in all new and re-financed LIBOR-referencing loan products to facilitate conversion ahead of end-2021, through pre-agreed conversion terms or an agreed process for renegotiation, to SONIA or other alternatives."

In order to clarify the interpretation of this recommendation and other elements relating to the Statement, in July 2020, the £RFR WG published a set of [questions and answers](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfr-working-group-q-and-a.pdf?la=en&hash=D7030E282C4E7579A1CD6ADFFE56D2CACF005A0F) (the "**Q&A**") prepared by the Loan Enabler Task Force, a sub-group of the £RFR WG, relating to the Statement. The Q&A states that "*It is recommended that after the end of Q3 2020, lenders and borrowers that are engaging in new sterling LIBOR referencing loan products, or are re-financing existing products of this type, should agree upfront to ensure that there will be no continuing reliance on sterling LIBOR in these products after the end of 2021, by including a contractual mechanism to facilitate conversion of the contract to a suitable SONIA-based, or other alternative, rate by 31 December 2021*." The Q&A also makes it clear that "*in either case, the conversion should take effect before the end of 2021*."

Although the LMA has published a suggested revision to its Revised Replacement of Screen Rate Clause[[3]](#footnote-4) which facilitates an "agreed process for negotiation" in transaction documentation to follow the recommendation set out in the Statement, the Statement makes it clear that the preferred course of action is for parties to agree terms for conversion of the benchmark rate in advance (or if that is not achievable to come as close to this as possible).

The Q&A further acknowledges the market precedents[[4]](#footnote-5) in the syndicated loan market which include an "inbuilt switch from sterling LIBOR to the replacement reference rate upon specified triggers. In those cases, the loan documentation includes the mechanics and provisions necessary for transition to the use of that replacement reference rate, mitigating the risk of a further amendment process being required."

*Compounded Rate Provisions*

The Rate Switch Agreements facilitate a change in reference rates from an initial term rate such as LIBOR directly to a compounded RFR. The drafting does not contemplate a switch to a term rate based on an RFR. This is because, at the time of drafting, alternative term rates are not yet available. Further, the £RFR WG has [indicated](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/use-cases-of-benchmark-rates-compounded-in-arrears-term-rate-and-further-alternatives.pdf) that there is a limited use case for term rates to be used for most sterling corporate loans. However, the £RFR WG has indicated that for some product areas, there may be a use case for RFR derived term rates and therefore readers may wish to consider adapting the Rate Switch Agreements to include a switch to such term rates in the particular context of their transactions.[[5]](#footnote-6) The potential use case for loans in other currencies remains to be seen. It is worth noting that (in relation to EURIBOR based euro facilities), EURIBOR is currently expected to continue and there may, accordingly, not be a commercial intention to move from the use of EURIBOR to the use of a risk free reference rate for euro Loans in the immediate future.

In 2019, the LMA released the exposure draft of the compounded SOFR based US dollar term and revolving facilities agreement (the "**Exposure Draft of Compounded SOFR Document**") and the exposure draft of the compounded SONIA based sterling term and revolving facilities agreement (the "**Exposure Draft of the Compounded SONIA Document**")(the "**2019 Exposure Drafts**"). The intention was that the 2019 Exposure Drafts should be used to facilitate awareness of the issues involved in structuring syndicated loans referencing SONIA, SOFR or other RFRs and the development of an approach to these issues by market participants.

The provisions of the Rate Switch Agreements relating to RFRs are based on the provisions set out in the 2019 Exposure Drafts with updates to reflect input from market participants, the multicurrency nature of the agreement and the recommendations of the £RFR WG.[[6]](#footnote-7) The £RFR WG issued a [statement](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/statement-on-behalf-of-rfrwg-recommendations-for-sonia-loan-market-conventions.pdf?la=en&hash=074583D7080993CE84B6A381B554BEFD6594C076) on its recommendations for SONIA Loan Market Conventions (the "**£RFR Working Group Conventions**") in early September 2020. The £RFR WG recommends that:

* use of SONIA as the recommended alternative to Sterling LIBOR is implemented via a compounded in arrears methodology;
* use of a five banking days lookback without observation shift is implemented;
* where an interest rate floor is proposed, it may be necessary to apply the floor to each daily interest rate before compounding; and
* accrued interest should be paid at the time of principal repayment.

Readers should note that the £RFR Working Group Conventions are recommendations and parties should determine whether these are the most appropriate for their transactions. The £RFR WG acknowledges and notes that, for example, use of a lookback *with* an observation shift is a viable and robust alternative to a lookback without such observation shift. As a result, the LMA has produced both the Rate Switch Agreement (Lookback without Observation Shift) and the Rate Switch Agreement (Lookback with Observation Shift) in order to facilitate choice by market participants.

Although the Rate Switch Agreements comprise multicurrency term and revolving facilities agreements and the £RFR Working Group Conventions apply to the SONIA loan market, the £RFR Working Group Conventions have been applied throughout, including to other currencies for which terms are set out. This has been done for reasons of simplicity and potential operational ease but does not constitute a recommendation of the LMA. It is for each market participant to determine their own view as to whether the £RFR Working Group Conventions are suitable for use on transactions and in respect of reference rates other than SONIA.

Readers should note that:

* in relation to US dollars and SOFR transactions, the US Alternative Reference Rates Committee ("**ARRC**") [released](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_SOFR_Synd_Loan_Conventions.pdf), in July 2020, a set of recommended SOFR "In Arrears" Conventions for Syndicated Business Loans (the "**ARRC Conventions**"); and
* in relation to Swiss francs and SARON transactions, the National Working Group on Swiss Franc Reference Rates has made a [recommendation](https://www.snb.ch/n/mmr/reference/minutes_20200929/source/minutes_20200929.n.pdf) for the use of SARON for syndicated loans (the "**NWG Recommendation**").

Whilst there are certain similarities between the £RFR Working Group Conventions, the ARRC Conventions and the NWG Recommendation, there are also, in each case, a number of differences. For the avoidance of doubt, the Rate Switch Agreements do not seek to reflect the ARRC Conventions in relation to the Compounded Rate Terms applicable to US dollars or the NWG Recommendation in relation to Swiss francs. Readers should consider, in the context of their transaction, whether this is the correct approach.

Readers may also want to consider (and take their own legal advice on) the applicability of the rate switch mechanics and the £RFR Working Group Conventions to provisions of the Rate Switch Agreements which relate to euro denominated Loans. It is anticipated at present that EURIBOR will continue but the [Working Group on Euro Risk Free Rates](https://www.ecb.europa.eu/paym/interest_rate_benchmarks/WG_euro_risk-free_rates/html/fallbacks_euribor.en.html) is considering potential fallback rates to EURIBOR based on €STR and, in November 2020, published two consultation papers: a [consultation on €STR based EURIBOR fallback rates](https://www.ecb.europa.eu/pub/pdf/other/ecb.pubcon_ESTRbasedEURIBORfallbackrates.202011~d7b62f129e.en.pdf) and a [consultation on EURIBOR fallback trigger events](https://www.ecb.europa.eu/pub/pdf/other/ecb.pubcon_EURIBORfallbacktriggerevents.202011~e3e84e2b02.en.pdf). Recommendations following these consultations are expected to be published in the first quarter of 2020. Therefore, inclusion of Compounded Rate Terms (and, therefore, rate switch mechanics) in relation to euro denominated Loans in the Rate Switch Agreements is optional.

**Development of the Rate Switch Agreements**

The initial version of the Rate Switch Agreement (Lookback without Observation Shift) was published on 11 September 2020 (the "**Initial Exposure Draft**"). That document was published without input and views provided by a working party of market participants. This departure from the LMA's usual practice was a function of the urgency with which it was felt that provision of a documentary reflection of the £RFR Working Group Conventions was required to facilitate market participants in the assessments described above.

The LMA sought initial market feedback on the Initial Exposure Draft. That market feedback has resulted in the publication of the Rate Switch Agreements. The Rate Switch Agreement (Lookback without Observation Shift) is a revised form of the Initial Exposure Draft. The Rate Switch Agreement (Lookback with Observation Shift) is based on this revised form: the key differences between the Rate Switch Agreements are in the provisions of Schedule 16 (*Daily Non-Cumulative Compounded RFR Rate*) and Schedule 17 (*Cumulative Compounded RFR Rate*) of each Rate Switch Agreement.

1. Commentary on the Rate Switch AgreementS

Section 7 of the LMA Users Guide to the Primary Documents sets out a Section by Section guide to the provisions of the LMA's recommended form of multicurrency term and revolving facilities agreement ("**MTR**") on which the Rate Switch Agreements are based. In addition, the LMA Commentary to the Exposure Drafts of Compounded RFR Facilities Agreement published in September 2019 (the "**2019 Exposure Drafts Commentary**") sets out an explanation of provisions of the Exposure Drafts and facilitates awareness of some of the issues associated with structuring syndicated loans referencing compounded SOFR, SONIA or other RFRs. We assume that readers are broadly familiar with both of these documents and so the intention of this Commentary is not to repeat the explanations contained within either of them. The purpose of this Commentary is to indicate how the benchmark rate change provisions of the Rate Switch Agreements work and to highlight the key features of the provisions relating to RFRs.

* + 1. The Rate Switch Agreements - summary of principal features

The Rate Switch Agreements are identical save for the calculation provisions set out in Schedule 16 (*Daily Non-Cumulative Compounded RFR Rate*) and Schedule 17 (*Cumulative Compounded RFR Rate*) of each Rate Switch Agreement. These reflect the differences in calculation formulae for a lookback without an observation shift and a lookback with an observation shift.

The key features of each Rate Switch Agreement are set out below.

* + A multicurrency term and revolving facilities agreement based on MTR.
	+ Initially, interest for any given Interest Period for a Loan in any currency determined by reference to an existing forward looking term rate applicable to that currency (for example, LIBOR for sterling).
	+ On the occurrence of a pre-agreed date (this is assumed to be prior to 31 December 2021 in the case of a LIBOR-referencing currency) for a currency or on the occurrence of a specified trigger event for a currency, the interest rate for any given Interest Period for a Loan in that currency will switch to the agreed alternative rate calculated on a compounded basis (for example, compounded SONIA for sterling).
	+ Provisions relating to the compounded average of the alternative rate are set out in the Rate Switch Agreements. These provisions are based on the format set out in the 2019 Exposure Drafts with updates to reflect comments from market participants, the multicurrency nature of the Rate Switch Agreements and the £RFR Working Group Conventions recommended by the £RFR WG (see above).

The following Commentary is divided into two sections: firstly, an explanation of the rate switch provisions and, secondly, the key features of the RFR terms.

* + 1. Rate Switch Agreements based on MTR

As the Rate Switch Agreements are based on MTR, provisions relating to Term Rate Loans remain largely the same as set out in MTR (including the fallback provisions). The differences to MTR are generally consequential to the inclusion of the rate switch concept and drafting for Compounded Rate Loans save in relation to the definition of "cost of funds" set out in paragraph (a)(iii) of Clause 1.2 (*Construction*). This formulation of "cost of funds" has been adapted to reflect wording first published in the 2019 Exposure Drafts which is intended to facilitate the making of a cost of funds quotation in the context of complex funding operations carried out on an aggregated non-granular basis. Its inclusion is not an inherent feature of either the rate switch provisions or the RFR terms.

* + 1. Rate Switch provisions
			1. Overview

The Rate Switch Agreements differ from the LMA Primary Documents in the ways listed below.

* + A "Rate Switch Currency" is a currency for which terms for the relevant risk free rate ("**RFR**") are specified in the document or otherwise later agreed and specified in a "*Compounded Rate Supplement*" (see below).
	+ The reference rate for a currency specified as a Rate Switch Currency may change over time to a compounded RFR.
	+ The change will be triggered by certain events.
	+ The change may occur for a currency on a certain date but there will be provisions relating to existing loans.
		- 1. The reference rate for a currency may change over time. The change will be triggered by certain events

Clause 9.1 (*Calculation of interest – Term Rate Loans*) and Clause 9.2 (*Calculation of interest – Compounded Rate Loans*) set out the provisions for the calculation of interest on Loans.

The Rate Switch Agreements contain a new Clause 9A[[7]](#footnote-8) (*Rate Switch*).

Clause 9A.1 (*Switch to Compounded Reference Rate*) provides that the Compounded Reference Rate for a Rate Switch Currency will replace the applicable Term Reference Rate. This change will occur on the Rate Switch Date, which will either be a pre-agreed backstop date or a date following a Rate Switch Trigger Event. On and from the Rate Switch Date (subject to Clause 9A.2 (*Delayed Switch for existing Term Rate Loans*)), Loans in the applicable currency will become Compounded Rate Loans and interest on those loans will be calculated by reference to the applicable Compounded Reference Rate.

In accordance with Clause 9A.4 (*Notifications by Agent*), the Agent shall notify the Company and the Lenders of the occurrence of a Rate Switch Trigger Event and the date of the corresponding Rate Switch Trigger Event Date as well as the occurrence of the Rate Switch Date. It is possible that a Rate Switch Trigger Event may occur a period of time before the actual Rate Switch Trigger Event Date and therefore the parties may wish to be notified when the Rate Switch Date has actually occurred. For example, in the context of the pre-cessation non-representativeness trigger (paragraph (b) of Rate Switch Trigger Event), a regulatory authority may make an announcement that a rate should be treated as being non-representative at a later date and confirmation that the Rate Switch Date had occurred would be made at that later date.

The relevant provisions are further examined below.

* + "*Rate Switch Trigger Event*"

This definition sets out the triggers to a rate switch that would then occur on the applicable Rate Switch Date. These triggers are intended to be events which are able to be objectively determined (for example, via a public announcement from a regulatory authority) and would lead to either the cessation of a benchmark rate or that rate being unsuitable for use. The triggers are based on those set out in Clause 35.4 (*Changes to reference rates*) although events set out in that Clause and which require more subjective determination are not included.

The Rate Switch Early Trigger Events apply in relation to "a Screen Rate" which, as the definition of "Screen Rate" refers to the "relevant currency and period" means that an event applying to one tenor of a Screen Rate would have the effect of triggering the rate switch. In order to assist users in making this distinction, a Screen Rate is referred to as being "for any Quoted Tenor" where appropriate. Therefore, the effect will be that if a Rate Switch Early Trigger Event applies to one tenor of the rate, the benchmark rate for all tenors of the rate for that currency will change. Appropriate amendments should be made if this does not reflect the commercial intention. It is worth noting that this approach contrasts with that of the US ARRC which provides in its [hardwired fallback language](https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/Updated-Final-Recommended-Language-June-30-2020.pdf) for syndicated loans that if any tenor of a benchmark rate ceases to be available or becomes unrepresentative, the administrative agent may modify the relevant agreement such that that tenor becomes unavailable. This would leave other available tenors for use under the terms of the agreement until such time as no tenors for a particular rate become available and a change of rate would occur. Readers may wish to consider whether this would be an appropriate option for their transactions.

Although the Rate Switch Early Trigger Events set out in the Rate Switch Agreements are intended to address the same events as the analogous provisions in documentation for other products, readers should ensure that where there are inter-linked products on transactions, such trigger events match appropriately as it is likely to be important to ensure that transition of linked products occurs simultaneously.

In particular, the Rate Switch Early Trigger Events set out in paragraphs (a) and (b) of the definition thereof are intended to address the same events that will constitute "Index Cessation Events"[[8]](#footnote-9) under the 2006 ISDA Definitions i.e. the administrator of a Screen Rate for any Quoted Tenor announcing that it will cease to provide that Screen Rate, the insolvency of the administrator of a Screen Rate and non-representativeness of the rate. Whilst the non-representativeness "pre-cessation trigger event" set out in paragraph (b) is similar to the ISDA formulation[[9]](#footnote-10) for the pre-cessation trigger event, it should be noted that the ISDA formulation will apply to LIBOR only and therefore readers should consider whether this paragraph (b) should similarly apply just to LIBOR or more widely.

The definition of Rate Switch Early Trigger Event includes the option, at paragraph (c) for the inclusion of other events as may be agreed on transactions. Readers may wish to consider the following:

* + - Clause 9A.4 (*Notifications by Agent*) provides that the Agent will give notification of a Rate Switch Early Trigger Event. To the extent that bespoke events are agreed by the parties which are less easy to objectively determine, consideration should be given to how such notice may be given (and by whom if the Agent might not be aware of the event).
		- Although the EU's Benchmark Regulation does not generally apply to syndicated loan transactions, readers may wish to consider whether any of the circumstances which would lead to supervised entities ceasing to be able to use a benchmark rate in accordance with the Benchmark Regulation would be appropriate for inclusion as a Rate Switch Early Trigger Event. To this end, readers may wish to follow the proposed amendments to the Benchmark Regulation which are anticipated to pass through the EU's legislative process in Autumn 2020[[10]](#footnote-11). The proposed amendments would enable the European Commission to designate, upon the occurrence of certain trigger events, a replacement benchmark that covers all references to a widely used reference rate that is phased out
	+ "*Rate Switch Date*"

This definition sets out the mechanism for determining the actual date on which the change of reference rate would occur on or following the occurrence of an agreed backstop date or the occurrence of a trigger event.

Paragraph (a)(i) allows, through the definition of Backstop Rate Switch Date, for the insertion of backstop date(s) on which the rate switch will occur and provides the ability for that date to be moved if agreed by the requisite parties. Readers should consider, in the context of their transaction and the currencies involved, whether there should be one single date for all currencies or whether different dates should apply for each currency (which would be specified in the Compounded Rate Terms for each currency). It may be appropriate for there to be a different Backstop Rate Switch Date for each currency to the extent that transition is not to occur simultaneously. Alternatively, it may be appropriate for the switch to occur simultaneously for all currencies for which LIBOR is the reference rate. In particular, consideration should be given to whether specification of a Backstop Rate Switch Date would be appropriate for the euro given that it is expected that EURIBOR will continue beyond the end of 2021.

In the context of LIBOR, although the period for which LIBOR's panel banks have voluntarily agreed to support LIBOR is scheduled to end at the end of 2021, readers should consider inserting date(s) in advance of this in order to facilitate active transition away from LIBOR as soon as they are able. In any event, the Q&A make it clear that to the extent that documentation is to contain "clear contractual arrangements…to facilitate conversion ahead of end-2021", the greatest certainty for borrowers and lenders would be achieved by "setting out in advance the terms for conversion at a future date". Therefore, date(s) falling prior to 31 December 2021 should be included in the definition of Backstop Rate Switch Date (or any applicable Compounded Rate Terms) for any currency for which interest is to be determined by reference to LIBOR. In the case of any currency for which interest is to be determined by reference to LIBOR, that specified date should fall prior to 31 December 2021 (since market participants should not rely on LIBOR being available after the end of 2021). The Financial Conduct Authority has published [Q&A on conduct risk during LIBOR transition](https://www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition) which include discussion on the variance of the spread between LIBOR and SONIA and factors that parties may want to take into account when determining the appropriate Backstop Rate Switch Date(s).

Paragraph (a)(ii) provides that the Rate Switch Date could also occur on a Rate Switch Trigger Event Date (i.e. the appropriate date on or following a Rate Switch Early Trigger Event). Noting that Clause 9A.2 (*Delayed switch for existing Term Rate Loans*) contains provisions allowing current Loans to continue on their existing rate until the end of the interest period, readers may wish to consider whether a grace period prior to the occurrence of the Rate Switch Trigger Event Date would be appropriate in certain circumstances for operational or administrative reasons. When considering the inclusion of such a grace period (and the length of any such grace period) readers should note the £RFR Working Group's recommendation in its [April 2020 statement on the impact of Coronavirus on the timeline for firms' LIBOR transition plans](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfrwg-further-statement-on-the-impact-of-coronavirus-on-timeline-for-firms-libor-transition-plans.pdf) that: "*After the end of Q3 2020 lenders, working with their borrowers, should include clear contractual arrangements in all new and re-financed LIBOR-referencing loan products to facilitate conversion ahead of end-2021, through pre-agreed conversion terms or an agreed process for renegotiation, to SONIA or other alternatives.*"

Readers may also wish to consider whether there are any other considerations or conditions that may need to be taken into account when determining the Rate Switch Date. For example, operational readiness of the parties to participate in transactions based on the relevant RFR(s) may need to be taken into account in determining any Backstop Rate Switch Date. Some parties may require additional flexibility to the extent that their operational preparations are not able to be completed by any pre-agreed Backstop Rate Switch Date. This could take the form of operational readiness being a condition to the pre-agreed Backstop Rate Switch Date occurring (noting the provisions of the Q&A above) on the initially proposed date and/or allowing the parties (such as the Lenders or the Company) to defer the pre-agreed Backstop Rate Switch Date by a pre-agreed length and number of times.

* + *"Rate Switch Currency"*

Clause 9A (*Rate Switch*) applies only to a currency which is a Rate Switch Currency (meaning any currency for which there are Compounded Rate Terms). Therefore, there will not be a switch to use of a Compounded Reference Rate unless there are Compounded Rate Terms specified for the relevant currency. Readers will need to consider the currencies involved and consider including such terms in Schedule 15 (*Compounded Rate Terms*) for the Base Currency and any pre-agreed Optional Currency which are intended to be subject to an automatic switch in reference rate pursuant to Clause 9A (*Rate Switch*). It is likely to be a commercial imperative to specify such terms if a Rate Switch Agreement is used on transactions to facilitate active transition away from LIBOR.

Further consideration should be given as to whether the availability of any given currency should be, or become, contingent on the existence of specified Compounded Rate Terms for that currency so that such currency will be subject to an automatic switch to the use of a Compounded Reference Rate under Clause 9A (*Rate Switch*).

* + - 1. Provisions relating to existing loans

Clause 9A.2 (*Delayed switch for existing Term Rate Loans*) provides that where the Rate Switch Date for a currency falls before the end of an Interest Period for a Term Rate Loan, that Loan shall continue to reference the applicable Term Reference Rate until the end of that Interest Period and will become a Compounded Rate Loan on and from the first day of the next Interest Period.

Clause 9A.3 (*Early termination of Interest Periods for existing Term Rate Loans*) limits the extent of such Term Rate Loans. It contains optional provisions which may be appropriate for inclusion where parties wish to ensure that the "spirit" of active transition away from LIBOR is preserved. It provides that where an Interest Period is selected when the Backstop Rate Switch Date or a previously notified Rate Switch Trigger Event Date for a currency is known to be scheduled to fall within that period, that Interest Period ends on the Rate Switch Date. This means that any accrued interest would become payable on the Rate Switch Date. In the case of a revolving facility Loan, the Loan becomes repayable (although could be refinanced through a Rollover Loan in the usual way) and, in the case of a term facility Loan, a new Interest Period begins: in each case the Rollover Loan (or the term Loan with effect from its new Interest Period) would be a Compounded Rate Loan.

Readers should note that an alternative method of achieving a similar outcome would be to prevent the selection for a Loan referencing a term rate (e.g. LIBOR) of an Interest Period extending beyond a known Rate Switch Date which would be applicable to that Loan. Such a method is not provided for in the Rate Switch Agreements.

Readers should consider, in the context of the Rate Switch Early Trigger Events and the length of selectable Interest Periods, whether it would be theoretically possible for an Interest Period extending beyond the end of 2021 to be selected for a Loan referencing LIBOR. If selection of such an Interest Period would be possible, readers should consider whether it would be appropriate to include the optional wording at paragraph (i) of Clause 10.1 (*Selection of Interest Periods*) restricting selection of such an Interest Period.

* + 1. Compounded Rate provisions
			1. Term Rate Loans and Compounded Rate Loans

The Rate Switch Agreements are based on MTR with additional provisions to provide the terms for loans based on compounded RFRs:

* + "*Term Rate Loans*"

These are Loans which are denominated in a currency for which there has been no automatic switch to the use of a Compounded Reference Rate or which are denominated in a currency which is not a Rate Switch Currency. The calculation of interest on Term Rate Loans follows that of MTR. Clause 9.1 (*Calculation of interest – Term Rate Loans*) provides that calculation of interest is based on the applicable Margin and the Reference Rate (which could be LIBOR, EURIBOR or another Benchmark Rate) for an Interest Period.

* + "*Compounded Rate Loans*"

These are Loans which are denominated in a Rate Switch Currency for which there has been an automatic switch to the use of a Compounded Reference Rate in accordance with Clause 9A.1 (*Switch to Compounded Reference Rate*).

The calculation of interest for Compounded Rate Loans (in any currency) is based on the £RFR Working Group Conventions.

The reference rate for a Compounded Rate Loan is the Compounded Reference Rate (see below). Clause 9.2 (*Calculation of interest – Compounded Rate Loans*) provides that the calculation of interest for any *day[[11]](#footnote-12)* during an Interest Period is the percentage per annum based on the applicable Margin[[12]](#footnote-13) and the Compounded Reference Rate.

This reflects the adoption of a non-cumulative compounding methodology. It means both that the applicable rate of interest on a Compounded Rate Loan varies on a daily basis and that the use of a compounded average RFR or compounded index is not possible.

* + "*Compounded Rate Terms*"

The specific terms applicable to the calculation of interest for a Compounded Rate Loan in any given currency are those set out in Schedule 15 (*Compounded Rate Terms*) or as are specified later in any Compounded Rate Supplement. A Compounded Rate Supplement provides a mechanic for specifying or replacing Compounded Rate Terms subsequent to the entering into of a Rate Switch Agreement without requiring a formal amendment of that Rate Switch Agreement. This may be helpful in circumstances where, either a new Optional Currency is agreed pursuant to Clause 4.3 (*Conditions relating to Optional Currencies*) or where, for example, it is agreed to change the originally agreed Compounded Rate Terms for a currency. Paragraph (g) of Clause 1.2 (*Construction*) provides that a Compounded Rate Supplement for a currency supersedes any Compounded Rate Terms specified for that currency in Schedule 15 (*Compounded Rate Terms*) or in any earlier Compounded Rate Supplement. It is intended to operate alongside, and as an alternative to, an amendment process. It is intended as a facilitative mechanic and (unlike Clause 35.4 (*Changes to reference rates*)) is not subject to parameters on its use. Accordingly it may be that the parties may wish to consider having different Lender consent levels under the Compounded Rate Supplement mechanic than those relating to an amendment pursuant to Clause 35.4 (*Changes to reference rates*).

* + - 1. Compounded Reference Rate

The Compounded Reference Rate constitutes two elements, the formulation of the compounded rate and the adjustment spread.

* + *Formulation of the compounded rate*
		- This is based on the [£RFR Working Group Conventions](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/statement-on-behalf-of-rfrwg-recommendations-for-sonia-loan-market-conventions.pdf?la=en&hash=074583D7080993CE84B6A381B554BEFD6594C076) recommended by the £RFR WG. Alongside the £RFR Working Group Conventions, the following supporting documentation was published:
			* [Supporting Slides](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/uk-loan-conventions-supporting-slides.pdf?la=en&hash=9190F626C8B4E58A1FD6AA6BB48AFCA830CAF56C) which set out further detail and explanation of the £RFR Working Group Conventions (the "**£RFR Working Group Conventions Supporting Slides**");
			* [Worked examples](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/uk-loan-conventions-worked-examples.xlsx?la=en&hash=6F18B755963140DAA51A0487C1935206FBA0492C) showing a variety of different compounding £RFR Working Group Conventions, for illustrative purposes; and
			* [Survey results](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfr-compounding-conventions-for-the-sterling-loan-market-survey-results.pdf?la=en&hash=7BA14A319372CDCDED747D095C3F9FEBDBB7738D) summarising responses to the survey on RFR compounding conventions for the sterling loan market carried out by the £RFR WG in June 2020, which provides additional context for the development of the £RFR Working Group Conventions.

[Section 3](#Section3) to this Commentary contains a copy of the £RFR Working Group Conventions which have been annotated to give further detail on where each such convention is reflected in the Rate Switch Agreements.

This Commentary highlights the main features of the Compounded Reference Rate as they are documented in the Rate Switch Agreements. Readers who wish to understand further context or detail should refer to the supporting documentation listed above. Further, readers may wish to consult the 2019 Exposure Drafts Commentary for background explanation of the issues involved in determining £RFR Working Group Conventions for RFRs for the syndicated loan markets.

* + - Whilst the Rate Switch Agreements are based on the £RFR Working Group Conventions recommended by the £RFR WG, readers should be aware that these are just recommendations and parties should determine which £RFR Working Group Conventions would be most appropriate for their transactions. The documentation published by the £RFR WG sets out alternative approaches where appropriate (see in particular the worked examples paper), and notes that a lookback with an observation shift remains a viable and robust alternative to their recommendation of a lookback without an observation shift.
		- Since August 2020, the Bank of England has published a [SONIA Compounded Index](https://www.bankofengland.co.uk/markets/sonia-benchmark) and, similarly, the New York Fed publishes a compounded [SOFR Index](https://apps.newyorkfed.org/markets/autorates/sofr-avg-ind). These indices show daily data that represents the returns from a rolling unit of investment earning compounded interest at the RFR on each day. The compounded RFR for a particular period can then be calculated as the weighted ratio. Whilst these indices are calculated by a compounding methodology using an observation shift, reference to them has not been made in the Rate Switch Agreement (Lookback with Observation Shift). This is because whilst indices may be helpful for some transactions, they are unlikely to be of general application in the syndicated loan markets as they will not be consistent with certain conventions. For example, they will not be compatible with the use of daily interest rate floors as such floors are not currently built into the calculation methodology. Further, the adoption of a non-cumulative compounding methodology means that the use of a compounded index is not possible.
		- As at the date of the Rate Switch Agreements, it seems unlikely that a screen rate reflecting the Compounded Reference Rate and the £RFR Working Group Conventions will be developed. Therefore, it was not felt to be appropriate for the Rate Switch Agreements to reference potential screen rate(s) for the Compounded Reference Rate unless and until there is confirmation that such screen rates will be developed.
	+ "*Daily Non-Cumulative Compounded RFR Rate*"

The Rate Switch Agreements adopt the non-cumulative compounding methodology set out in the £RFR Working Group Conventions and provides that the percentage rate per annum applicable to any day in the Interest Period for a Compounded Rate Loan will be determined by the Agent (or by any other Finance Party which agrees to perform that role) in accordance with the methodology set out in Schedule 16 (*Daily Non-Cumulative Compounded RFR Rate*) or in any Compounded Methodology Supplement. Such methodology differs between the Rate Switch Agreement (Lookback without Observation Shift) and the Rate Switch Agreement (Lookback with Observation Shift).

* + - *the formula set out in Schedule 16 (Daily Non-Cumulative Compounded RFR Rate)*

This formula is intended to reflect the recommended non-cumulative compounding methodology described on pages 7 and 8 (*Lookback without Observation Shift*) and pages 11 and 12 (*Lookback with Observation Shift*) of the £RFR Working Group Conventions Supporting Slides.

This reflects the recommendations of:

* + - * *Compounding in arrears*
				+ This is reflected through the "Compounded Reference Rate" definition – in essence, the daily RFR is compounded through the Daily Non-Cumulative Compounded RFR Rate formulation.
			* *Lookback without/with observation shift*
				+ The £RFR Working Group Conventions Supporting Slides set out explanations of the "*Lookback with observation shift*" and "*Lookback without observation shift*" concepts. The 2019 Exposure Drafts reflect the concept of a lookback with an observation shift.
				+ *Lookback without observation shift*

This concept is used in the Rate Switch Agreement (Lookback without Observation Shift).

The £RFR WG comments that "*A Lookback period allows for payment certainty for borrowers when using an 'in arrears' rate…. Lookback without Observation Shift (also known as Lag) is recommended as the standard approach by the Working Group. Here, the SONIA rate is derived from the reference period but weighted according to the days in the interest period."*

The "*lookback without observation shift*" concept is reflected in the definitions of "DailyRatei-LP**"** set out in Schedule 16 (*Daily Non-Cumulative Compounded RFR Rate*) and "Lookback Period". Together these definitions provide that: (i) the rate for any RFR Banking Day (A) is based on the Daily Rate for the RFR Banking Day (B) on the agreed number of days before that RFR Banking Day (A); and (ii) the weighting given to the rate will be determined by reference to that RFR Banking Day (A).

* + - * + *Lookback with observation shift*

This concept is used in the Rate Switch Agreement (Lookback with Observation Shift).

Whilst the recommendation of the £RFR WG is to use a lookback without observation shift, it is noted that "*A viable and robust alternative approach is a Lookback with Business Day Observation Shift.*  *The Observation Shift approach is where each SONIA rate is weighted according to the observation period (rather than the interest period). Note the compounded rate needs to be annualised and adjusted for the actual calendar days in the interest period*".

The "*lookback with observation shift*" concept is reflected in the definitions of "DailyRatei", "OP Cumulation Period", "Corresponding OP Day" and "Observation Period" set out in Schedule 16 (*Daily Non-Cumulative Compounded RFR Rate*) and "Lookback Period". Together these definitions provide that: (i) the rate for any RFR Banking Day (A) is based on the Daily Rate for the RFR Banking Day (B) during the Observation Period which falls on the agreed number of days before that RFR Banking Day (A); and (ii) the weighting given to that rate will be determined by reference to that RFR Banking Day (B).

* + - * *Five banking days lookback*
				+ The concept of RFR Banking Day reflects the £RFR WG's recommendation that "*Interest is compounded on banking days only" and that "In multi-currency contracts, interest can be compounded on banking days for the drawn currency and ignore the banking/non-banking days of other currencies*."
				+ The "Lookback Period" in each part of Schedule 15 (*Compounded Rate Terms*) suggests a period of five RFR Banking Days to reflect the £RFR WG's recommendation of a five banking days lookback. The £RFR WG notes that "*while a standard Lookback period of 5 business days is recommended, the Lookback period can vary based on borrower/lender needs*."
			* *Four decimal points rounding for SONIA*
				+ The £RFR WG recommendation that SONIA is "*rounded (and not truncated) to four decimal points*" is set out in the definition of "Daily Rate" and specified in the applicable Compounded Rate Terms.
			* *Actual/365 day count*
				+ Clause 32.3 (*Day count convention and interest calculation*), together with the definitions of "Daily Non-Cumulative Compounded RFR Rate" and "Cumulative CompoundedRFR Rate" reflect that the £RFR Working Group's recommendation for day count "…*is ACT/365 (fixed*)". The market practice override to the general premise that ACT/360 applies (as would be the case for dollars, for example) operates to apply ACT/365 (fixed) for sterling.

Further the recommended approaches for implementing those £RFR Working Group Conventions are also reflected:

* + - * *Compound the rate*
				+ On the basis of market feedback, the £RFR WG has recommended that the relevant rate is compounded rather than the balance. "Compounding the rate" is generally where the rate itself is compounded and then applied to the principal at the end of the relevant period whereas "compounding the balance" would involve applying the compounding rate to the principal and accrued interest on a daily basis.
				+ This is reflected in the definition of "Daily Non-Cumulative Compounded RFR Rate".
			* *Non-Cumulative Rate Method*
				+ A "cumulative" compound rate calculates the compound rate at the end of the interest period and it is applied to the whole period. Therefore it allows calculation of interest for the whole period using a single compounded rate.
				+ A "non-cumulative" compound rate is derived from a cumulative compound rate. It is calculated as the cumulative rate as of the current day minus the cumulative rate as of the prior business day. This therefore generates a daily compounded rate which allows the calculation of a daily interest amount and enables an accurate calculation of accrued interest at any point in time.
				+ Use of the "non-cumulative" convention means that the rate of interest on a Compounded Rate Loan varies on a daily basis rather than being a static average rate determined by reference to the entire Interest Period. This will mean that accrued interest on prepaid amounts will be capable of calculation at the time of prepayment without the need to end the Interest Period at the time of prepayment as otherwise may be the case. Other intra-period payments such as through secondary loan trading activity will also be supported by this methodology.
				+ The length of selectable Interest Periods is a matter for commercial agreement. Readers should consider the impact of permitting the potential selection of longer Interest Periods for Compounded Rate Loans and the extent to which such Interest Periods may cause operational and other difficulties in the context of the potential for rate movements over such a period.
				+ Clause 9.2 (*Calculation of interest – Compounded Rate Loans*), Clause 32.3 (*Day count convention and interest calculation*) and the definitions of "Compounded Reference Rate", "Daily Non-Cumulative Compounded RFR Rate" and "Cumulative Compounded RFR Rate" reflect this method.
			* *Sterling amounts rounded to two decimal places and no rounding of the non-cumulative rate*
				+ The £RFR WG recommends that *"sterling amounts be rounded to two decimal points"* and thatto ensure that the total accrued interest amount calculated using the cumulative and non-cumulative compounded rate is always the same "*the sterling amount of accrued interest (i.e. compounded RFR component + margin + Credit Adjustment Spread (if applicable)), whether generated using the cumulative compounded rate or the sum of daily amounts using the non-cumulative compounded rate, to be rounded to two decimal places."* Step 4 of the recommended non-cumulative compounding methodology described in the sections entitled *"Recommended Convention Lookback without Observation Shift"* and *"Alternative convention Lookback with Observation Shift"* of the £RFR Working Group's Supporting Slides requires that the interest amount is *"rounded to 2 decimal point daily".*
				+ Further, the £RFR WG recommends that "*the non-cumulative compounded rate derived from the daily cumulative compounded rate [is] not to be rounded*."
				+ These recommendations are reflected in the definition of "Daily Non-Cumulative Compounded RFR Rate" and Clause 32.3 (*Day count convention and interest calculation*) which provides that the amount of interest, commission or fee which accrues in respect of any day during an Interest Period for a Compounded Rate Loan shall be rounded to two decimal places.
				+ A further recommendation is that "*the daily compounded RFR interest component calculated using the non-cumulative compounded rate not to be rounded (so that the total accrued interest calculated as the sum of these daily compounded RFR interest components does not carry forward rounded amounts)*".
				+ Clause 9.2 (*Calculation of interest – Compounded Rate Loans*) is consistent with this recommendation by requiring the components of the interest calculation (the Daily Non-Cumulative Compounded RFR Rate, the applicable Credit Adjustment Spread and the Margin) to be applied to the principal as a single aggregated rate. aggregated rate.
				+ To the extent that interest is calculated for a period which includes any days which are not RFR Banking Days (for example, over a weekend or a public holiday), paragraph (c) of Clause 32.3 (*Day count convention and interest calculation*) provides that the daily interest amount is calculated without rounding but that the aggregate amount of interest which accrues in respect of that period is rounded to two decimal places. This reflects that Step 4 of the recommended non-cumulative compounding methodology described in the sections entitled *"Recommended Convention Lookback without Observation Shift"* and *"Alternative convention Lookback with Observation Shift"* of the £RFR Working Group's Supporting Slides provides that the requirement for the interest to be "*rounded to 2 decimal point daily*" is applied collectively to any period of days consisting of an RFR Banking Day followed by a public holiday or weekend.
				+ Readers should note that whilst the principle of the approach to rounding is clear, it is recognised that systems may have differing capabilities which might result in very small differences. The requirement in the Rate Switch Agreements that the specified rounding be carried out "to the extent reasonably practicable for the Finance Party performing the calculation, taking into account the capabilities of any software used for that purpose" is intended to reflect the potential for any such differing system capabilities. This means that, at the time of any rate switch, any rounding related systems constraints of the Finance Party performing the calculation should not prevent them from doing so. The qualification is dynamic ("to the extent reasonably practicable") as it is anticipated that over time systems will be updated such that they will be able to implement the specified rounding.

The Annotated £RFR Working Group Conventions contain further details of the recommendations of the £RFR WG and where these recommendations are reflected in the Rate Switch Agreements.

* *Compounding Methodology Supplement*

The definition of "Daily Non-Cumulative Compounded RFR Rate" also refers to the rate calculation methodology being set out in a Compounded Methodology Supplement. Given that market practice for the use of RFRs continues to evolve in the syndicated loan markets, it is possible that parties to transactions may wish to amend documentation to allow for subsequent amendments to the calculation methodology to reflect developing market practice or operational procedure in due course. The Compounding Methodology Supplement performs a similar function for the calculation methodologies as the Compounded Rate Supplement does for the RFR terms for a currency.

Paragraph (i) of Clause 1.2 (*Construction*) provides that a Compounding Methodology Supplement for a currency supersedes anything relating to the Daily Non-Cumulative Compounded Rate or the Cumulative Compounded Rate in Schedules 16 or 17 and any earlier Compounding Methodology Supplement specified for that currency in Schedule 15 (*Compounded Rate Terms*). It is intended to operate alongside, and as an alternative to, an amendment process. It is intended as a facilitative mechanic and (unlike Clause 35.4 (*Changes to reference rates*) and, in particular, paragraph (b) thereof – see below) is not subject to parameters on its use. Accordingly it may be that the parties may wish to consider having different Lender consent levels under the Compounded Rate Supplement mechanic than those relating to an amendment pursuant to Clause 35.4 (*Changes to reference rates*). However, given that the mechanic for a Compounding Methodology Supplement is similar to that of a Compounded Rate Supplement. and that such supplements are likely to be used in similar circumstances, the same Lender consent levels may be appropriate for both such supplements.

* *Credit Adjustment Spread*

The second element of the Compounded Reference Rate is the credit adjustment spread. Given the Rate Switch Agreements are intended to be used in order for transactions to transition away from term rates such as LIBOR to rates based on RFRs, it is assumed that a specified credit adjustment spread will be used as the means of addressing the issue of potential transfer of economic value from one party to another as a result of the switch from use of the Term Reference Rate to the Compounded Reference Rate for a Rate Switch Currency pursuant to Clause 9A (*Rate Switch*). Therefore, the Credit Adjustment Spread has been structured as a separate component of the interest rate calculation for Compounded Rate Loans. Consequently, the document assumes that there will be no change in Margin associated with the switch from a Term Reference Rate to the Compounded Reference Rate for a Rate Switch Currency and does not provide the mechanics to effect such a change in Margin as part of such switch.

The Credit Adjustment Spread for a particular currency and rate is to be specified in the Compounded Rate Terms. No rate or methodology is included as it is recognised that this will be a function of the commercial agreement. The Rate Switch Agreements allow the specification of the Credit Adjustment Spread as either (a) a methodology/formula which will produce a percentage rate per annum or (b) as a percentage rate per annum.

Readers should note that it is possible that a methodology specified for a Credit Adjustment Spread may be capable of producing a negative result depending upon the movement and relative positions of the relevant rates and metrics referenced in any such methodology. Readers may wish to consider the extent to which it may be appropriate to provide that the Credit Adjustment Spread may never be less than zero to address this possibility. The Financial Conduct Authority has published [Q&A on conduct risk during LIBOR transition](https://www.fca.org.uk/markets/libor/conduct-risk-during-libor-transition) which include discussion on the variance of the spread between LIBOR and SONIA.

When considering the Credit Adjustment Spread methodology on transactions, Readers may wish to consider the following:

* + *The time at which the Credit Adjustment Spread is determined*

For example, a percentage rate could be agreed at signing or a methodology for calculating that percentage rate upon the Rate Switch Date may be preferred.

* + *Determination of the Credit Adjustment Spread by a static or dynamic calculation*

This will depend on whether the parties agree that the Credit Adjustment Spread should be a one-time calculation or calculated at the beginning of each Interest Period.

* + *Relationship of the Credit Adjustment Spread to the length of an Interest Period*

Parties may determine whether or not the Credit Adjustment Spread should vary depending on the length of the Interest Period. If there is to be some variance, parties should consider the operational implications of this, particularly where there are Interest Periods which are not of a standard duration.

* + *Methodology for calculation of the Credit Adjustment Spread*

Although the £RFR WG has [recommended](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/recommendation-of-credit-adjustment-spread.pdf?la=en&hash=3F7198EBBE9866DC362B6F6BAF6BEE91F7C2AA58) "*use of the historical five-year median spread adjustment methodology when calculating the credit adjustment spread which should then be applied to any [SONIA] rate chosen or recommended to replace GBP LIBOR pursuant to contractual fallback and replacement of screen rate provisions following a permanent cessation or pre-cessation trigger in relation to GBP LIBOR*", Readers should consider whether this methodology is appropriate for an active transition away from LIBOR where cessation or pre-cessation fallbacks are not triggered and the Backstop Rate Switch Date occurs.

Further parameters of the Credit Adjustment Spread could be considered, such as whether any rounding convention should be specified.

* + 1. Other terms

Whilst this Commentary does not and cannot detail every feature of the Rate Switch Agreements or every issue that parties will need to consider when structuring a transaction featuring RFRs, the following are some of the most important to consider.

* + *Break Costs*

In relation to Compounded Rate Loans, the applicability (or otherwise) of Break Costs is addressed in Schedule 15 (*Compounded Rate Terms*). This allows for the use of a currency specific approach to the extent to which Break Costs are applicable to Compounded Rate Loans. In relation to Term Rate Loans, the concept applies to such loans in accordance with the existing provisions of MTR which are replicated in the Rate Switch Agreements.

The Primary Documents include a concept of Break Costs in order to protect the commercial interest of the Lenders on the assumption that the Lenders have funded a Loan by "match-funding" arrangements (borrowing an amount equal to the amount of the Loan for a period equal to the Interest Period). A Lender is protected against any potential loss where, on prepayment of a Loan prior to the last day of its Interest Period, the Lender continues to be required to pay interest on such match funding until the end of the Interest Period. The Borrower would be required to recompense the Lender to the extent of the amount of interest that it would have received had the prepayment not taken place (minus the amount it would be able to recoup by redepositing that sum).

Given that the concept of Break Costs was predicated on term funding arrangements, it may be argued that the use of a RFR as the basis for calculation of the rate of interest for Compounded Rate Loans in the Rate Switch Agreements suggests that Lenders are likely to be obtaining funding on a rolling overnight basis, undermining that predication, and therefore the commercial rationale for the Break Costs concept. It might, however, be possible to quantify Break Costs in an alternative manner, for example by reference to breakage costs that would arise on an appropriate fixed/floating interest rate swap broken at the date of repayment/prepayment. This would require the development of a recognised and established methodology as well as a sufficiently liquid market in the relevant swap contracts.

However, there is no immutable principle that the chosen interest rate benchmark is required to reflect the Lenders' funding practices - or that Lenders' funding practices will be tailored to the characteristics of the chosen interest rate benchmark. In addition, although the Break Costs concept in the Primary Documents primarily protects the commercial interest described above, it could be argued that Break Costs have the *de facto* effect of protecting other interests.

In the context of a syndicated loan referencing a RFR where basing Break Costs on the loss that a Lender may suffer on its term-funding arrangements might cause difficulties, it might be considered that the Break Costs concept should be retained but adapted to protect those other commercial interests and structured as a fee.

Examples might include the compensation of Lenders for unexpected administration costs associated with a payment made prior to the last day of an Interest Period or acting as an optional pricing supplement in return for which the borrower group gains the flexibility to make a repayment/prepayment prior to the last day of an Interest Period.

Limits on voluntary prepayments or provisions relating to the length of Interest Periods[[13]](#footnote-14) could be potential alternatives to Break Costs as these could minimise any costs associated with prepayments made prior to the last day of an Interest Period.

Therefore, the extent to which Break Costs are relevant for Compounded Rate Loans will depend on the structuring of the relevant transaction, the funding arrangements in place and the level of protection required against costs associated with prepayments.

* + *Zero floors*

If optional zero floor wording for a Term Reference Rate is applicable to a currency, it is envisaged that a corresponding zero floor is included in respect of Compounded Rate Loans in that currency. This is reflected in the definitions of "Daily Rate" and "Compounded Rate Terms" and takes account of the Credit Adjustment Spread.

This reflects the £RFR WG's recommendations that:

(a) "*If an interest rate floor is included in a facility agreement, it is recommended that the floor be calculated daily (rather than at the end of an interest period) because loans accrue interest daily. The floor can then be applied to the applicable daily SONIA for the relevant interest period*."; and

(b) "*where the aggregate of SONIA plus the credit adjustment spread is less than the legacy floor value, the Working Group’s recommendation is for the credit adjustment spread to remain unchanged, with SONIA adjusted to ensure that the aggregate of SONIA plus the credit adjustment spread is equal to the legacy floor value. However, the Working Group recognises that an alternative* *method, where the credit spread is adjusted, may be preferred by some market participants*."

* + *Voluntary Prepayments*

In relation to voluntary prepayments of Compounded Rate Loans, readers should consider whether the length of the notice period for voluntary prepayments of Compounded Rate Loans should be structured so as to take into account the amount of notice needed by all parties of the amount of accrued interest payable on that prepayment and the processes involved in calculating that amount of accrued interest. In order to achieve a similar length of notice that the lookback mechanic provides for the amounts of scheduled payments of interest, the amount of notice required for such a voluntary prepayment should be no less than the applicable Lookback Period.

Also, the extent to which the consent of the Agent should be required for a short notice of prepayment of a Compounded Rate Loan given its role in calculating the amount of accrued interest due should be considered.

* + *Notification of rates of interest*

In the absence of established market and operational practice, paragraph (b) of Clause 9.5 (*Notifications*) reflects a current expectation that facility agents will be unable to notify the parties of each daily rate of interest applicable to a Compounded Rate Loan on a daily basis given the significant operational burden that would involve. It reflects a current expectation that facility agents will, instead, notify the parties of: (a) amounts of accrued interest that become payable; (b) at the same time, provide an accompanying breakdown of each individual daily rate of interest applicable to that Compounded Rate Loan used in the calculation of that amount of accrued interest to allow borrowers and lenders to reconcile their own daily accrual records (if any); and (c) at the same time provide details of any Market Disruption Rate (to the extent relevant) applicable to that Compounded Rate Loan. The effect is that the facility agent would, assuming no intra-Interest Period events, make one single notification per Interest Period. Changes should be made to this paragraph if this arrangement does not reflect the commercial agreement between the facility agent and the other parties.

Paragraph (e) of Clause 9.5 (*Notifications*) has been included to reflect that the first day on which accrued interest on a Compounded Rate Loan becomes ascertainable may not be a Business Day[[14]](#footnote-15) and that, as a consequence, the Agent may not be open for business.

* + *Duration of Interest Periods*

The Rate Switch Agreements are consistent with the LMA's Primary Documents in the way that interest periods are framed. The documents are drafted throughout on the basis of the established practice that the length of Interest Periods (and the extent to which days are "in" or "during" an Interest Period) is determined on an overnight basis and that, accordingly, an Interest Period beginning on 27 May and ending on 27 June will take account of 27 May but not 27 June. By way of example, paragraph (f) of Clause 10.1 (*Selection of Interest Periods*) states that "Each Interest Period for a [term loan] shall start on the Utilisation Date or (if already made) on the last day of its preceding Interest Period." Clause 32.3 (*Day count convention and interest calculation*) further adds that "Any interest, commission or fee accruing under a Finance Document will accrue from day to day….".

This is also the basis on which the references in Schedule 16 (*Daily Non-Cumulative Compounded RFR Rate*) and Schedule 17 (*Cumulative Compounded RFR Rate*) to the number of days during an Interest Period and the extent to which a day is during an Interest Period would be construed.

* + *Cost of funds as a fallback*

The suitability or otherwise of the use of a Lender's costs of funds as an ultimate fallback has generated much debate since the 2013 discontinuance of LIBOR for various currencies and tenors made evident the practical issues associated with its use and particularly:

* + - the difficulty that some institutions experience in assessing their "cost of funds" associated with funding their participation in a Loan – this can be particularly acute when institutions assess the cost of their funding requirements on an aggregated non-granular basis
		- the administrative burden placed on the facility agent when the interest rate for any particular Loan falls to be determined on a cost of funds basis
		- the perception among some borrowers of a lack of transparency.

The use of cost of funds as an ultimate fallback (after central bank rates) has been included as an optional fallback for Compounded Rate Loans.[[15]](#footnote-16) Inclusion or otherwise will be dependent on the structuring of transactions and commercial agreement. If it is not to apply as a fallback in the event of the unavailability of a risk-free reference rate and a central bank rate, readers should consider whether any other fallback could be specified for such a scenario.

In the Rate Switch Agreements, applicability (or otherwise) of the use of cost of funds as a fallback for Compounded Rate Loans is addressed in Schedule 15 (*Compounded Rate Terms*). This allows for the use of a currency specific approach to the extent to which cost of funds is to apply as a fallback for Compounded Rate Loans. If it is the case in the context of a particular transaction that the commercial agreement is that cost of funds is not to apply as a fallback to any Compounded Rate Loan in any currency then Clause 11.3 (*Interest calculation if no RFR or Central Bank Rate*) and the corresponding section in each part of Schedule 15 (*Compounded Rate Terms*) may be deleted.

* + *Market Disruption*

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. 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 credit margin.

Given the nature of RFRs (as discussed above in relation to "*Break Costs*" and "*Cost of funds as a fallback*"), parties to transactions will need to determine whether these underlying funding considerations remain relevant to loans which switch to be based on RFRs and therefore whether the concept of Market Disruption is appropriate in relation to those loans.

Therefore, in relation to Compounded Rate Loans, the applicability (or otherwise) of Market Disruption is addressed in Schedule 15 (*Compounded Rate Terms*). This allows for the use of a currency specific approach to the extent to which Market Disruption is applicable to Compounded Rate Loans. The Market Disruption Rate is expressed to be the Cumulative Compounded RFR Rate for the relevant Interest Period plus the relevant Credit Adjustment Spread. This reflects that market disruption remains to be assessed by reference to the Interest Period as a whole. The Cumulative Compounded RFR Rate for an Interest Period is intended to be economically identical to the combined effect of the application of each individual Daily Non-Cumulative Compounded RFR Rate. For more detail, see the £RFR Working Group Conventions Supporting Slides.

* + *Changes to reference rates*

The optional Clause 35.4 (*Changes to reference rates*) has been expanded to extend to RFRs as well as Screen Rates. Readers should note that the clause provides that a Published Rate Replacement Event that applies to only one tenor of a Screen Rate will lead to the facilitation of the replacement of the Screen Rate for that tenor only and not the replacement of that Screen Rate for all tenors. Readers should also note that this position contrasts with that under Clause 9A (*Rate Switch*) – see the note on "Rate Switch Early Trigger Event" above.

This clause is an evolution of the "Replacement of Screen Rate" clause included in the LMA's Primary Documents. A pre-cessation trigger has also been added to the definition of "Published Rate Replacement Event" in this clause in order to ensure consistency between these events and the Rate Switch Early Trigger Events.

Readers should also consider the extent to which this clause should be supplemented to allow changes to be made to the methodology, formula or other means of determining the calculation of interest for a Compounded Rate Loan and whether any such changes should be specific to any particular currency. Paragraph (b) of the clause contains an optional provision which would allow amendments or waivers aligning the interest rate calculation to any recommendation of a Relevant Nominating Body (for the use of a compounded RFR in the international or relevant domestic syndicated loan markets) with a lower consent threshold than may otherwise be required. This may be relevant in circumstances where documentation is executed prior to any such recommendations for a particular currency being made or where parties may want to take into account any changes to any existing recommendations.

The "Compounding Methodology Supplement" referred to above is intended to allow for changes to the calculation of the Daily Non-Cumulative Compounded RFR Rate or the Cumulative Compounded Rate to be made without a formal amendment process and subject to fewer parameters than set out in this clause.

* + *Pro rata interest settlement*

The optional Clause 24.10 (*Pro-rata interest settlement*) facilitates (and is consistent with) the £RFR Working Group's recommendation that "*the 'pro-rata' method of distributing interest across syndicated lenders is used. This means interest paid by a borrower for a given day (business or otherwise) would be earned by a lender based on its pro-rata share of the principal amount of the loan owned for that day. If a lender sells out of a loan completely, they are owed interest based on the time they held part of the loan but do not earn further interest after they leave, regardless of the fact that they will not be paid until the end of the interest period. If a new lender buys into a loan during the interest period, their interest is calculated using the compounded rate as of that day in the interest period (and will not start to compound separately from the date they buy) i.e. non-cumulative compounded rate for that day can be used*."

* + *Central Bank Rate and Central Bank Rate Adjustment*

The primary fallbacks suggested for use in the event of unavailability of RFRs are Central Bank Rates. If the Central Bank Rate for the relevant RFR Banking Day is not available, a historic Central Bank Rate may be used. This is set out in the definition of "Daily Rate" and Schedule 15 (*Compounded Rate Terms*). The definition of "Daily Rate" also provides an optional framework (through the definition of "Central Bank Rate Adjustment") for the addition of a spread to the Central Bank Rate when it is used as a fallback to the relevant RFR for the purposes of calculating the Compounded Reference Rate. Whether any such spread is required to take any account of the potential difference between the RFR and the specified central bank rate, and if so, its formulation, would be a matter for the structuring of the transaction in light of each currency.

The specified Central Bank Rate (and associated issues) vary across each of the currencies described below.

*Dollars*

By way of illustration only, the Rate Switch Agreements envisage that the central bank rate to be substituted for an unavailable SOFR when calculating the Compounded Reference Rate might be the short-term interest rate target (or the mid-point of any target range) set by the US Federal Open Market Committee published by the Federal Reserve Bank of New York for the relevant day.[[16]](#footnote-17) The Federal Reserve Bank of New York publishes the rate on a daily basis on its website and the definition of "*Central Bank Rate*" reflects this. The use of square brackets in this definition reflects the fact that the Federal Reserve Bank of New York also publishes a number of reference rates based upon transactions in the money markets[[17]](#footnote-18) and that one of those rates may be preferred for use instead of, or as well as, the short-term interest rate target set by the US Federal Open Market Committee.

*Sterling*

The Rate Switch Agreements provide that the specified central bank rate to be substituted for an unavailable SONIA when calculating the Compounded Reference Rate is the Bank of England's Bank Rate prevailing at the close of business on the relevant day. Readers should refer to the website of the Bank of England for more information on the Bank of England's Bank Rate.

Reflective of those sterling denominated transactions based on SONIA which have been in the public domain, it is anticipated that a Central Bank Rate Adjustment will be specified. Readers may wish to consider the Bank of England's published methodology for its short-term contingency arrangements for the calculation of SONIA. This methodology calculates a spread based on the mean of the spread of SONIA to the Bank of England Bank Rate over the previous five days on which SONIA was available, excluding the days with the highest and lowest spread to the Bank of England Base Rate.

*Swiss Francs*

The Rate Switch Agreements provide that the specified central bank rate to be substituted for unavailable SARON when calculating the Compounded Reference Rate is the policy rate of the Swiss National Bank as published by the Swiss National Bank from time to time.

*Euro*

The Rate Switch Agreements present three options for the applicable Central Bank Rate given that the European Central Bank ("**ECB**") produces three [official interest rates](https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html) for euro which could fulfil this function. Parties should choose the appropriate rate in the context of their transaction.

Firstly, the fixed rate for the main refinancing operations of the ECB or, if that rate is not published, the minimum bid rate for the main refinancing operations of the ECB, each as published by the ECB from time to time. This is the interest rate which banks pay when they borrow money from the ECB for one week on a secured basis and provides the bulk of liquidity to the banking system. The fixed rate and bid rate are distinguished here as, over its history, the rate for the ECB's main refinancing operations has either been (a) a single rate or (b) a floor for bids, depending on how the ECB structure the facility at any point in time. One or other of these rates is used and published and, to date, never both at the same time. The ECB distinguishes between these rates in its published rate information.

Secondly, the rate for the marginal lending facility of the ECB as published by the ECB from time to time. This is the interest rate that banks pay when they borrower from the ECB overnight on a secured basis.

Thirdly, the rate for the deposit facility of the central banking system of the Participating Member States as published by the European Central Bank from time to time. This rate defines the interest banks receive for depositing money with the central bank overnight. Since June 2014, this rate has been negative.

1. Annotated £RFR Working Group Conventions

# **Statement on behalf of the Working Group on Sterling Risk-Free Reference Rates – Recommendations for SONIA Loan Market Conventions[[18]](#footnote-19)**

# Annotations in blue highlight indicate the provisions of the LMA's Rate Switch Agreements which reflect the relevant recommendations

# **Objectives**

Further to its [statement](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/rfrwg-further-statement-on-the-impact-of-coronavirus-on-timeline-for-firms-libor-transition-plans.pdf) of 29 April 2020, the Working Group on Sterling Risk-Free Reference Rates (the "**Working Group**") today issues recommendations on conventions to support the use of SONIA in loan markets for Sterling Bilateral and Syndicated Facilities, including Multicurrency Syndicated Facilities where there is a sterling currency option.

In recognition of the urgent need for loan market participants to commence transition away from the use of LIBOR, the Working Group, through its sub-groups including the Loan Enablers Task Force

(“**LETF**”) has undertaken an evaluation of the available market conventions, taking into consideration the overall needs of the Sterling market, a variety of operational and implementation considerations and the need for the

maximum possible degree of consistency across currencies, products and markets. The Working Group also recognises the desire from many market participants for a close alignment of cash and derivatives markets, the need to minimise basis risk in any hedging arrangements and for international consistency wherever practicable.

Additionally, there is recognition that in cash markets there is a need for a product feature that affords parties sufficient time for notice and collection of payment. The LETF has reviewed available methodologies for doing so, including those which utilise an ‘observational shift’. With multiple robust approaches available and no clear preference in sterling markets to date, identification of a standard approach in this respect was a key objective of the LETF to support rapid availability of consistent products across the loan market.

In arriving at the conclusions set out below, the Working Group was mindful and conscious of the need to effect an orderly transformation of this critical market structure change. The recommendations are based on careful consideration of potential options that are feasible or available and based on the review and challenge of Working Group members together with feedback from a survey involving its members and the members of its associated sub-groups and task forces.

Overall, the aim is clear – as previously highlighted, market participants should be ready to offer non- LIBOR loans products by end Q3 2020. SONIA compounded in arrears remains the Working Group’s recommended alternative to Sterling LIBOR and the intent of these recommendations is to enable and expedite the transition away from the use of LIBOR based products for the loan market.

# **Summary of Recommendations**

1. SONIA remains the Working Group’s recommended alternative to Sterling LIBOR, implemented via a **compounded in arrears methodology**, and loan markets should now move consistently towards this.

The LMA's Rate Switch Agreements reflect this recommendation in the definitions of "**Compounded Reference Rate**" and "**Daily Non-Cumulative Compounded RFR Rate**"

1. Use of a **Five Banking Days Lookback without Observation Shift[[19]](#footnote-20)** is recommended as the standard approach by the Working Group. This aligns with the approach recommended by the Alternative Reference Rate Committee for US dollar loan markets and in the Working Group’s view is most likely to be made rapidly available. Whilst this approach is the recommendation, where lenders are also able to offer lookback with an observation shift this remains a viable and robust alternative (see the Annex below for the comparison between these two approaches).

The LMA's Rate Switch Agreements reflect this recommendation in the definitions of "**Lookback Period**" and "**Daily Non-Cumulative Compounded Rate**".

1. Where an interest rate floor is used, the Working Group recognises that it may be necessary to apply the **floor to each daily interest rate before compounding**.

 The LMA's Rate Switch Agreements reflect this recommendation in the definitions of "**Daily Rate**".

1. **Prepayments**. The Working Group recommends that accrued interest should be paid at the time of principal prepayment.

The LMA's Rate Switch Agreements reflect this recommendation in paragraph (b) of Clause 8.7 (*Restrictions*).

These recommendations are published in order to assist market participants who have been awaiting direction on the preferred methodology prior to commencing implementation and developing their standard product offerings. These recommendations are not binding and it is recognised that in certain transaction or client-specific circumstances an alternative methodology or rate may be more appropriate or convenient, and that market conventions may continue to evolve over time. Please see the Annex below for details of the recommendations.

# **Explanatory background**

In August 2019, the Working Group issued a [statement](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/statement-and-summary-of-responses-to-sonia-conventions-discussion-paper.pdf) and summary of responses to its consultation on the use of SONIA in new contracts which set out a framework for how SONIA could be implemented in loans contracts, through the use of a compounding in arrears methodology.

The Working Group, including its various sub-groups, have carefully examined how to implement compounding in arrears in loan markets, recognising the value of providing clear direction to market participants to assist in developing market practice, whilst, at the same time being mindful of alternative options or methodologies should parties deem them to be more appropriate in the circumstances. It also recognises that standards and conventions may evolve as market participants become more familiar with the pros and cons of particular conventions and product features.

A significant part of the Working Group’s considerations centred around the requirement to build in product features that afford sufficient time to calculate, notify and collect interest payments based on compounded in arrears rates. Market participants will be aware that there are two primary methods by which this can be implemented in calculations; *lookback without observation shift* or *lookback with observation shift*. The Working Group carried out a survey seeking the views of its members and the members of its associated sub-groups and task forces on conventions in the loan markets in June 2020 which attracted responses from a range of market participants, including banks, corporates, trade associations, and other financial firms. Please refer to the summary of survey responses and supporting papers (found on the Working Group’s webpage [here](https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor)) for further background on the lookback methodology outcomes and other key conventions.

**September 2020**

**Annex: RFR Compounding Conventions for the Sterling Loan Market**

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| **SONIA** | Sterling Overnight Index Average - the chosen risk-free rate for sterling markets administered by the Bank of England. |
| **SONIA Compounded in Arrears** | Calculated by compounding SONIA daily during the interest period.Whilst the market has shown a preference for compounding the rate rather than compounding the balance, several methods exist to calculate SONIA Compounded in arrears and implementation choice is left to individual market participants. To the extent compounding the rate is selected, the method for calculating the cumulative compounded rate should be based on ISDA's formula for Compound RFR.The LMA's Rate Switch Agreements reflect this recommendation in the definitions of "**Cumulative Compounded RFR Rate**" and "**Daily Non-Cumulative Compounded RFR Rate**"Given the need for the calculation of daily interest accruals to support distribution of interest impacted by intra-period activity such as prepayments and secondary trading, daily non-cumulative compounded rate ('NCCR') derived from the cumulative compounded rate may be an option.NCCR for a given day is the cumulative compounded rate for the prior day subtracted from the cumulative compounded rate for that given day.*Please see associated spreadsheets with calculation methodologies to reconcile cumulative and non-cumulative compounded rates.*The LMA's Rate Switch Agreements reflect this recommendation in the definitions of "**Compounded Reference Rate**" and "**Daily Non-Cumulative Compounded RFR Rate**"; Clause 9.2 (*Calculation of interest – Compounded Rate Loans*) and Clause 32.3 (*Day count convention and interest calculation*). |
| **Holiday and weekend convention** | Interest is compounded on banking days only; for each calendar day which is a weekend or holiday, the immediately preceding banking day's rate is applied, weighted by the number of calendar days until the next banking day.Holiday convention for SONIA follows London Bank Holidays. In multi- currency contracts, interest can be compounded on banking days for the drawn currency and ignore the banking/ non-banking days of other currencies.The LMA's Rate Switch Agreements reflect this recommendation in the definitions of "**Cumulative Compounded RFR Rate**" and "**Daily Non-Cumulative Compounded RFR Rate**" |
| **Lookback** | A Lookback period allows for payment certainty for borrowers when using an 'in arrears' rate. While a standard Lookback period of 5 Business Days is recommended, the Lookback period can vary based on borrower/lender needs.Lookback without Observation Shift (also known as Lag) is recommended as the standard approach by the Working Group. Here, the SONIA rate is derived from the observation period but weighted according to the days in the interest period.The LMA's Rate Switch Agreement (Lookback without Observation Shift) reflects this recommendation in the definitions of "**Lookback Period**"; "**Daily Non-Cumulative Compounded RFR Rate**" and "**Cumulative Compounded RFR Rate**".A viable and robust alternative approach is a Lookback with Business Day Observation Shift. The Observation Shift approach is where each SONIA rate is weighted according to the days in the observation period (rather than the interest period). Note the compounded rate needs to be annualised and adjusted for the actual calendar days in the interest period.The LMA's Rate Switch Agreement (Lookback with Observation Shift) reflects this recommendation in the definitions of "**Lookback Period**"; "**Daily Non-Cumulative Compounded RFR Rate**" and "**Cumulative Compounded RFR Rate**".*Please see associated materials for explanation of Lookback without Observation Shift or Lookback with Observation Shift.* |
| **Rounding** | The Working Group’s recommendation is for SONIA to be rounded (and not truncated) to 4 decimal pointsThe LMA's Rate Switch Agreements reflect this recommendation in the definition of "**Daily Rate**". and sterling amounts be rounded to two decimal points.The LMA's Rate Switch Agreements reflect this recommendation in Clause 32.3 (*Day count convention and interest calculation*).To ensure the total accrued interest amount calculated using the cumulative and non-cumulative compounded rate is always the same, the Working Group’s recommendation is for: |

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|  | * the cumulative compounded rate to be rounded on a daily basis (based on the number of decimal points stated in the credit agreement);

The LMA's Rate Switch Agreements reflect this recommendation in the definitions of "**Cumulative Compounded RFR Rate**" and "**Daily Non-Cumulative Compounded RFR Rate**"* the non-cumulative compounded rate derived from the daily cumulative compounded rate not to be rounded;

The LMA's Rate Switch Agreements reflect this recommendation in the definition of "**Daily Non-Cumulative Compounded RFR Rate**".* the daily compounded RFR interest component calculated using the non-cumulative compounded rate not to be rounded (so that the total accrued interest calculated as the sum of these daily compounded RFR interest components does not carry forward rounded amounts); and

Clause 9.2 (*Calculation of interest- Compounded Rate Loans*) of the LMA's Rate Switch Agreements is consistent with this recommendation.* the sterling amount of total accrued interest (i.e. compounded RFR component + margin + Credit Adjustment Spread (if applicable)), whether generated using the cumulative compounded rate or the sum of daily amounts calculated using the non-cumulative compounded rate, to be rounded to two decimal places*.*

The LMA's Rate Switch Agreements reflect this recommendation in Clause 32.3 (*Day count convention and interest calculation*). |
| **Day count** | The Working Group’s recommendation is ACT/365 (fixed)The LMA's Rate Switch Agreements reflect this recommendation in the definitions of "**Cumulative Compounded RFR Rate**" and "**Daily Non-Cumulative Compounded RFR Rate**", and in Clause 32.3 (*Day count convention and interest calculation*). |
| **Business day convention for payments** | The Working Group’s recommendation is “Modified Following Business Day Convention.”This means payments of interest that would fall to be made on a day that is a non-Business Day are adjusted to the next succeeding Business Day, unless that Business Day falls in the next calendar month, in which case the interest payment date is the preceding Business Day.The LMA's Rate Switch Agreements reflect this recommendation in Clause 10.3 (*Non-Business Days*), Clause 29.7 (*Business Days*) and in the business day conventions sections in each part of Schedule 15 (*Compounded Rate Terms*). |
| **Timing** | SONIA for each London business day is published at 9.00 am the following London business day.While the rate is subject to correction, the Lookback permits users to select the corrected rate were a correction to occur. The Working Group recommends that if a corrected rate is published, it is used in place of the original, uncorrected, rate.The LMA's Rate Switch Agreements reflect this recommendation in the definitions of "**Daily Rate**" and "**RFR**". |
| **Margin Treatment** | The Working Group’s recommendation is that margin should be added after rate compounding (i.e. margin is not compounded).The LMA's Rate Switch Agreements reflect this recommendation in Clause 9.2 (*Calculation of interest – Compounded Rate Loans*) |
| **Prepayments** | The Working Group’s recommendation is for proportional accrued interest to be paid at the time of prepayment on any amounts of principal prepaid.The LMA's Rate Switch Agreements reflect this recommendation in paragraph (b) of Clause 8.7 (*Restrictions*).If principal is paid down without any accompanying interest being paid down at the same time, this can affect the accuracy of compounded calculations and be operationally complex. |
| **Floors** | Market participants are free to decide whether a floor is applied and at which level.If an interest rate floor is included in a facility agreement, it is recommended that the floor be calculated daily (rather than at the end of an interest period) because loans accrue interest daily. The floor can then be applied to the applicable daily SONIA for the relevant interest period.The LMA's Rate Switch Agreements reflect this recommendation in the definition of "**Daily Rate**".For legacy contracts containing a floor, where the aggregate of SONIA plus the credit adjustment spread is less than the legacy floor value, the Working Group’s recommendation is for the credit adjustment spread to remain unchanged, with SONIA adjusted to ensure that the aggregate of SONIA plus the credit adjustment spread is equal to the legacy floor value. The LMA's Rate Switch Agreements reflect this recommendation in the definition of "**Daily Rate**".However, the Working Group recognises that an alternative method,where the credit spread is adjusted, may be preferred by some market participants. |

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| **Distribution of interest** | The Working Group’s recommendation is that the 'pro-rata' method of distributing interest across syndicated lenders is used.This means interest paid by a borrower for a given day (business or otherwise) would be earned by a lender based on its pro-rata share of the principal amount of the loan owned for that day.If a lender sells out of a loan completely, they are owed interest based on the time they held part of the loan but do not earn further interest after they leave, regardless of the fact that they will not be paid until the end of the interest period.If a new lender buys into a loan during the interest period, their interest is calculated using the compounded rate as of that day in the interest period (and will not start to compound separately from the date they buy) i.e. noncumulative compounded rate for that day can be used.Clause 24.10 (*Pro rata interest settlement*) of the LMA's Rate Switch Agreements allow for this recommendation. |

**Secondary Market Conventions**

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| **Delayed Compensation** | The Working Group’s recommendation is for the Seller to pay the Buyer the all-in rate i.e. SONIA Compounded in arrears plus Margin.For facilities where the all-in rate may also include a credit adjustment spread (whether by reason of transition or otherwise), the all-in rate would be SONIA Compounded in arrears plus credit adjustment spread plus Margin. |
| **Cost of Carry** | The Working Group’s recommendation on the cost of carry is for the Buyer to pay the Seller SONIA Compounded in arrears plus any credit adjustment spread, if applicable. |

1. The package of documents constituting the £RFR Working Group £RFR Working Group Conventions is available through the [website of the £RFR Working Group.](https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor)  Unless otherwise indicated, a reference in the footnotes to this document to a recommendation or statement of the £RFR Working Group is a reference to a recommendation or statement contained in the [£RFR Working Group Conventions](https://www.bankofengland.co.uk/-/media/boe/files/markets/benchmarks/rfr/statement-on-behalf-of-rfrwg-recommendations-for-sonia-loan-market-conventions.pdf?la=en&hash=074583D7080993CE84B6A381B554BEFD6594C076) [↑](#footnote-ref-2)
2. There have been a few transactions in the market which have followed this approach. The LMA has published, based on publicly available information, a list of loans referencing risk-free reference rates which includes these transactions ([www.lma.eu.com/libor](http://www.lma.eu.com/libor)). [↑](#footnote-ref-3)
3. See the "Note on the Revised Replacement of Screen Rate Clause and documentary recommendations published by the Working Group on Sterling Risk-Free Reference Rates" published on 24 August 2020 and available on the [LMA website](https://www.lma.eu.com/documents-guidelines/documents). [↑](#footnote-ref-4)
4. See footnote 2. [↑](#footnote-ref-5)
5. The £RFR WG indicated that there may be a use case for term rates in, for example, trade and working capital facilities, export finance/emerging markets transactions and Islamic facilities. The Rate Switch Agreements are based on the LMA's form of investment grade multicurrency term and revolving facilities agreement and therefore necessarily address that market. The LMA is mindful that its suite of documentation addresses other loan product areas and jurisdictions and will be considering the needs of such markets in due course. [↑](#footnote-ref-6)
6. The LMA intends to update the 2019 Exposure Drafts to reflect the provisions of the Rate Switch Agreements which reflect developments in structuring and drafting syndicated loan documentation referencing SONIA and SOFR in due course. [↑](#footnote-ref-7)
7. The numbering has been added in this way to avoid extensive re-numbering of the following clauses because this clause is a new addition which is not intended to be a permanent change to LMA documentation. Once more market participants are able to enter into RFR based documentation, the necessity of initially using a rate such as LIBOR may no longer exist and for other forward looking term rates, fallbacks to alternative rates rather than a switch mechanism may suffice. [↑](#footnote-ref-8)
8. The Amendments to the 2006 ISDA Definitions to include new IBOR fallbacks (Supplement number 70) (the "[ISDA Fallbacks Supplement](http://assets.isda.org/media/3062e7b4/23aa1658-pdf/)") will insert a new Section 7.3 (i) "Index Cessation Event" into the 2006 ISDA Definitions. The ISDA Fallbacks Supplement was finalised on 23 October 2020 and will be published by ISDA and become effective on 25 January 2021. [↑](#footnote-ref-9)
9. Paragraph (iii) of "Index Cessation Event" which will be set out in Section 7.3(i) of the 2006 ISDA Definitions once the IBOR Fallbacks Supplement becomes effective on 25 January 2021. [↑](#footnote-ref-10)
10. See the [European Commission proposal](https://ec.europa.eu/info/publications/200722-proposal-benchmarks_en) and subsequent [European Council position](https://data.consilium.europa.eu/doc/document/ST-11049-2020-ADD-1-REV-1/en/pdf). [↑](#footnote-ref-11)
11. This is based on the £RFR WG's recommendation "*to adopt a Non-Cumulative Compounded Rate Method*". [↑](#footnote-ref-12)
12. This reflects the £RFR WG's recommendation that *"….margin should be added after rate compounding (i.e. the margin is not compounded)*." [↑](#footnote-ref-13)
13. A shorter Interest Period may lead to fewer costs being associated with any prepayment during that Interest Period. [↑](#footnote-ref-14)
14. This is because the use of a Lookback Period is determined by reference to RFR Banking Days instead of Business Days. [↑](#footnote-ref-15)
15. Cost of funds has been included on an optional basis following differing market feedback as to whether cost of funds should be included. [↑](#footnote-ref-16)
16. Readers should refer to the website of the Federal Reserve Bank of New York for more information on the short-term interest rate target set by the US Federal Open Market Committee. [↑](#footnote-ref-17)
17. These rates include:

	* the Effective Federal Funds Rate; and
	* the Overnight Bank Funding Rate.Readers should refer to the website of the Federal Reserve Bank of New York for more information on these reference rates. [↑](#footnote-ref-18)
18. The overall objective of the Working Group on Sterling Risk-Free Reference Rates (the "**Working Group**") is to enable a broad-based transition to SONIA by the end of 2021 across the sterling bond, loan and derivative markets. This will reduce the financial stability risks arising from widespread reliance on GBP LIBOR.

The Bank of England and the Financial Conduct Authority ("**FCA**") are each ex-officio members of the Working Group. The views and outputs set out herein do not constitute guidance or legal advice from the Bank of England (including the Prudential Regulation Authority ("**PRA**")) or the FCA and are not necessarily endorsed by the Bank of England (including the PRA) or the FCA. [↑](#footnote-ref-19)
19. Lookback without Observation Shift is also known as the Observation Lag convention [↑](#footnote-ref-20)