Transition from Libor to risk-free rates: Where are we now in the loan market?

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It was July 2017 when Andrew Bailey, then chief executive of the UK Financial Conduct Authority (FCA), warned market participants that they should not rely on the London inter-bank offered rate (Libor) being available after 2021. After this point, the FCA will no longer encourage or compel panel banks to submit to Libor.

This deadline has been reiterated by authorities around the world and in some jurisdictions even shorter deadlines have been set. This is most notably the case in the sterling market, where the Working Group on Sterling Risk-Free Reference Rates (Sterling Working Group) has set a target of ceasing issuance of cash products linked to sterling Libor by end-Q3 2020. It is important to note that even in this challenging time for the market with coronavirus concerns, the FCA has stated that the end of 2021 timeline for transition has not changed. The FCA has however stated that the coronavirus "is likely to affect some of the interim transition milestones" particularly in the loan market (although no further information has been provided).

With these impending deadlines, where are we now in terms of transition in the loan market?

A reminder of the RFRs in the Libor currencies and their use in cash markets

The table below sets out the alternative near risk-free rates (RFRs) identified by the various currency working groups in the Libor currency jurisdictions:

Currency	Chosen Risk-Free Rate	Secured / Unsecured	Administrator	Working Group
Sterling	SONIA (Sterling Overnight Index Average)	Unsecured	Bank of England	Working Group on Sterling Risk-Free Reference Rates
U.S. Dollar	SOFR (Secured Overnight Financing Rate)	Secured	Federal Reserve Bank of New York	Alternative Reference Rates Committee
Euro	€STR (Euro Short-Term Rate)	Unsecured	European Central Bank	Working Group on Euro Risk-Free Rates
Swiss Franc	SARON (Swiss Averaged Rate Overnight)	Secured	SIX Swiss Exchange	Swiss National Working Group
Japanese Yen	TONA (Tokyo Overnight Average Rate)	Unsecured	Bank of Japan	Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks

The RFRs selected are all overnight rates which are published daily. To be suitable for use in cash markets, term versions of these overnight rates are required.

While forward-looking term rates based on overnight index swap or futures markets referencing the RFRs are under development in each currency jurisdiction (aside from Switzerland), none are available as yet. In addition, the authorities have been clear that the use of any such forward-looking term rates is to be limited. For example, the Sterling Working Group has stated that sterling overnight index average (SONIA) compounded in arrears is appropriate and operationally achievable for 90% of new loans by value. The other 10% of loans by value would need a forward-looking term rate, or could look to use a fixed rate or Bank of England base rate. While a forward-looking term rate is expected to be available in sterling by the end of 2020, in some jurisdictions such a rate may not even be available until after the end of 2021.

The focus in the majority of the loan market has therefore been on compounded in arrears structures.

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Use of RFRs in the loan market

We have over the last eight months seen transactions in the loan market using RFRs. In the sterling market, we have seen SONIA-based bilateral loans to National Express, SSE, Kennedy Wilson Europe Real Estate II, ABP and the amendment of a Libor loan to SONIA by South West Water. All of these transactions opted for the compounded in arrears methodology using a five business day lag.

In terms of activity in SARON (the Swiss RFR), last year there were 2 bilateral real estate loans based on SARON compounded and calculated on the last day of the interest period for Halter AG and SenioResidenz AG. In terms of SOFR (the U.S. dollar RFR), JPMorgan completed a bilateral SOFR loan and Bank of China provided a 90-day bilateral trade finance loan using a 30 day simple historical average of SOFR applied on a forward basis (given the tenor but also the nature of trade finance deals).

In the syndicated space, Shell signed a USD Libor based syndicated loan with an in-built switch to compounded SOFR in arrears as early as the first anniversary of the signing date of the revolving credit facility, once the bank market is fully prepared for SOFR as an underlying rate. BAT recently signed a multicurrency syndicated facility using the same mechanism as Shell whereby Libor interest rates for sterling and U.S. dollar will be replaced by SONIA and SOFR respectively.

While there has been some activity in the loan market, there are still some issues to be worked through before wider transition is likely to be seen.

What is required for further adoption in the loan market?

What has become clear from work on transition in the loan market is that the formulae for compounding being used in the derivatives and floating rate note markets do not seem to work well for the loan market given the need to manage events taking place intra-interest period (such as prepayments or secondary trading).

Consensus is still needed across currencies on key conventions in the loan market re compounding. For example, there have been discussions taking place around the use or not of an observation shift (which impacts the weighting of days in the interest rate reference period), and the impact on secondary trading (e.g. how to deal with accrued interest). Clarity on these points and certain other conventions (for example, the application of floors and rounding) is needed for wider adoption.

In respect of conventions, there have been positive developments such as the publication by central banks of daily compounded RFR indices which will help borrowers reconcile interest calculations. For example, the Federal Reserve Bank of New York has published a SOFR Index since March 2, 2020 and the Bank of England will begin publishing a SONIA compounded index from end of July 2020. Work is continuing in terms of how such indices can be utilised in the loan market.

Linked to agreement on conventions is the need for loan and treasury management systems which facilitate loan transactions based on compounding in arrears. The first part of this is having the relevant updates from systems providers, however the second part is the implementation and testing of such systems within institutions. All of this requires significant time and cost and such systems are needed to drive further adoption.

Where are we with loan documentation?

There have been some key developments in respect of documentation for new RFR loans, legacy loans and also fallbacks.

New agreements based on RFRs

In September 2019, the Loan Market Association (LMA) published two exposure draft facility agreements based on compounded in arrears – a SONIA-based sterling facility and a SOFR-based U.S. dollar facility. These documents are exposure drafts given the lack of market practice in relation to RFR based loans and the need for agreement on the key compounding conventions. In the United States, the LSTA has produced a concept document based on SOFR compounded in arrears.

Documenting loans based on RFRs entails a change to the current structure of documentation and, in particular, raises a number of structuring issues which are commercial in nature (for example, the application or not of break costs). The exposure drafts help to facilitate consideration of these issues.

The legacy book

In October 2019, the LMA published an exposure draft reference rate selection agreement to assist with the transition of legacy syndicated agreements based on Libor to RFRs.

With loans, there is no protocol style system for amendments (such as that operated by ISDA) given the more bespoke nature of loans and the multilateral nature of syndicated loans. Therefore each individual loan agreement referencing Libor would need to be amended to refer to a replacement rate. The reference rate selection agreement tries to streamline this process by using the same form of agreement on different transactions. In addition, the parties would agree the basic commercial terms for the selection of the applicable RFR and then authorise the agent and the obligors to determine the necessary amendments to the facility agreement. While this is a two-stage process, it is expected to make the process of agreement to amendments easier to manage for the agent and also the lenders (who would not need to approve all of the changes to the relevant facility agreement).

Fallbacks and switch mechanisms

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What about documents still being entered into which reference Libor? There has to date been a focus on the "amendment approach" to fallbacks which provides flexibility to make amendments to agreements with a lower consent level than would otherwise be required to introduce a replacement rate. It does require agreement to those changes, albeit at a reduced level rather than hard-wiring in any particular fallbacks. We are now however starting to see calls in the loan market for a more hard-wired approach and indeed have seen the use of in-built switch mechanisms in the Shell and BAT deals which cater for systems developments. The LMA is looking at wording for such switch mechanisms.

Looking ahead

Given the recent message from the FCA that, despite current market developments, transition away from Libor still needs to happen by the end of 2021, it is important for loan market participants to remain focused on the task ahead. Decisions therefore need to start being made as to what rates to move to, the applicable conventions and work carried out with system providers to ensure the necessary systems are in place.

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Complaints Procedure

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