The Impact of the Demise of LIBOR and the Rise of Risk Free Rates on the LMA Developing Markets Documentation

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December, 2021
Financial Services

The Demise of LIBOR

LIBOR has been used as a benchmark for determining floating rates of interest in the syndicated loan markets for many decades but is now due to come to an end for most currencies (other than USD)[1] from 31 December 2021 due to the structural issues identified by the UK's Financial Conduct Authority (FCA) in 2017.[2]

As from 31 December 2021, financial institutions and borrowers that would traditionally have used LIBOR will be required to use other benchmarks or fallback rates to determine floating rates of interest for various currencies as the rate for those currencies ceases to be published or is otherwise prohibited. Notwithstanding the continued publication of key USD LIBOR beyond 31 December 2021, it is expected that use of USD LIBOR as a benchmark rate will decrease significantly.

Accordingly, new floating rate loans that would otherwise have used LIBOR must include a new benchmark rate that is acceptable to both financial institutions and borrowers and existing loans with a tenor that continues beyond that date must transition to such a new benchmark rate.

The financial markets have developed alternative benchmark rates (so called "**risk free rates**" or "**RFR**") in anticipation of this discontinuation of LIBOR and this note outlines the planned transition away from LIBOR to such alternative risk free rates under the various types of recommended form of Loan Market Association (**LMA**) documentation.

The Calculation of Interest by reference to LIBOR in LMA Documentation

The vast majority of syndicated loan agreements based on LMA documentation which currently exist in the market provide for floating rates of interest to be calculated by reference to a base rate of interest calculated by reference to an internationally accepted inter-bank benchmark rate such as LIBOR, EURIBOR and JIBAR (each an **IBOR**). A margin is then added on top of such IBOR to create the total interest calculation. We refer in this note to such LMA documentation which references LIBOR as **LMA LIBOR Based Documentation**.

This is documented under the LMA LIBOR Based Documentation as the percentage rate per annum which is the aggregate of the applicable:

(a) margin; and

[1] USD LIBOR overnight and 1, 3, 6 and 12 month rates will continue to be published until 30 June 2023 (albeit the publication of these USD LIBOR tenors until the end of June 2023 is primarily intended to support the rundown of legacy contracts only). It should be noted that some other commonly used inter-bank benchmark rates, such as EURIBOR (used for euro denominated loans) are currently not expected to be affected by these changes.

[2] The main structural issue identified by the FCA related to the sample size for calculating LIBOR, which had been declining since the financial crisis, with fewer and fewer banks on the panel reporting LIBOR transactions. The result of this change saw an increase in market and transaction data-based expert judgment rather than hard data that was objective.

(b) the relevant inter-bank benchmark rate,

with the relevant benchmark rate being determined by reference to screen rates published for specific periods of time - typically 1, 3, 6 or 12 months - establishing the length of an interest period.

In this context: (i) the "*margin*" is intended to represent the profit or credit risk element made by a lender on a loan calculated by reference to the particular borrower and/or loan structure during the relevant interest period;[3] and (ii) the "*inter-bank benchmark rate*" is intended to provide a benchmark to help determine a notional "*cost of funds*" for lenders to make a loan available for a given interest period, regardless of the borrower or any other aspect of the particular transaction.[4]

The Consequences of LIBOR becoming Unavailable

In light of the vast majority of LIBOR screen rates becoming unavailable at the end of 2021, lenders and borrowers are under pressure to:

(a) agree alternative benchmark rates for the relevant IBORs; or

(b) (in the case of LMA LIBOR Based Documentation that is currently in use) look to the relevant loan documentation to see what the contractual fallback position is for each party under those documents when LIBOR becomes unavailable.

The Fallback Position under LMA LIBOR Based Documentation

The main provision dealing with the unavailability of LIBOR in LMA LIBOR Based Documentation is the "*Changes to the Calculation of Interest*" clause, which should be read together with the definitions of "*LIBOR*" and "*Screen Rate*".[5] These provisions deal with LIBOR unavailability and provide a number of fallback options which arise in circumstances where the relevant screen rate for any LIBOR is not available.

For example, where a LIBOR screen rate for any interest period has become unavailable under existing LMA LIBOR based loan documentation, and no replacement page or information service is available, options may exist under the documentation to apply:

(a) an interpolated screen rate for LIBOR;

(b) a shortened interest period for LIBOR;

(c) a historic screen rate for LIBOR; or

(d) an interpolated historic screen rate for LIBOR.[6]

This first set of fallbacks are particularly useful in circumstances where LIBOR is unavailable for short periods of time and some kind of LIBOR rates have been published and can be interpolated or otherwise used to provide historic rates. If these rates are not available, or are not recent, then these fallbacks become unhelpful.

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[3] Some financial institutions operating within Developing Markets include certain other costs within the margin (e.g. capital costs).
[4] It is important to note that this is an industry benchmark attached to certain leading reference banks and does not reflect the actual cost of funds or capital costs incurred by all banks operating in the syndicated loan market concerned. For example, certain banks operating in Developing Markets would be expected to have a higher cost of funds for USD than leading international banks operating in the London inter-bank market. Because of this, certain banks may add a liquidity premium to the margin or possibly add a separate line item within the calculation of interest to accommodate this liquidity premium (or the cost of supporting hedging instruments).
[5] See clause 10 of the Single Currency Secured Term Facility Agreement for Developing Market c version ST03 for an example of this clause.
[6] See, for example, Clause 10.1 (*Unavailability of Screen Rate*) of the Single Currency Secured Term Facility Agreement for Developing Market Jurisdictions version ST03.

If the fallback rates mentioned above are not available to the parties, the facility agent (or the individual lender on a bilateral loan) is then given the right to substitute LIBOR rates with alternative rates provided by certain "reference banks".[7] These reference banks are typically agreed in advance by the borrower or appointed by the agent in consultation with the borrower.[8]

If the relevant reference bank is:

(a) **a contributor to LIBOR**, the rate will be the rate (for the relevant currency and period) which it is asked to submit to the relevant administrator of LIBOR; or[9]

(b) **not a contributor to LIBOR**, the rate at which the relevant reference bank could fund itself in the relevant currency for the relevant period with reference to the unsecured wholesale funding market.

As with the other fallback positions mentioned above, this fallback position is also designed to address short term disruptions to the availability of LIBOR (and, where relevant to the particular loan agreement, other IBOR benchmarks) rather than a long-term transition to a new rate. It is also subject to operational difficulties in the context of identifying reference banks that are still willing to provide these rates in considering possible compliance risk, exposure and pricing sensitivity.

In the absence of the fallback positions mentioned above providing a long term solution, and in the absence of an alternative rate being agreed among the obligors and the relevant lenders,[10] or imposed by law, the contractual position in the LMA LIBOR Based Documentation defaults to a "cost of funds" fallback position.

The "cost of funds" fallback position is included in the LMA LIBOR Based Documentation as a last resort and is designed to enable the lenders to recover their actual cost of funds from the borrower for the relevant interest period. This is typically documented under LMA LIBOR Based Documentation to be "that which expresses as a percentage rate per annum the cost to the relevant lender of funding its participation in any loan from whatever source that lender may reasonably select".

In the context of finding a long term solution to the cessation of LIBOR, the "cost of funds" fallback position however is also unsatisfactory and raises a number of important operational and structural issues. For example: (i) it is not easy for a lender to accurately calculate its "cost of funds"; (ii) the calculation process is not transparent; (iii) the lack of clarity introduces a risk of litigation or dispute, (iv) it is administratively burdensome for the agent and the individual lenders; (v) it creates pricing differentials across a syndicate of different lenders (with different costs of funds); and (vi) it requires commercially sensitive "pricing" information to be disclosed to third parties.

Because of this, the LMA LIBOR Based Documentation goes on to provide a specific contractual platform to agree a substitute basis for determining an alternative rate of interest, should a "cost of funds" scenario arise, by providing for a period of negotiation of not more than 30 days between the borrower and the facility agent (or the individual lender on a bilateral loan) to agree an alternative rate. See, for example, Clause 10.4(b) (*Cost of funds*) of the Single Currency Secured Term Facility Agreement for use in Developing Market Jurisdictions version ST03.

A number of the forms of LMA LIBOR Based Documentation also go on to set out additional steps that may be required in terms of any waiver or amendment of the rate. See, for example, Clause 35.4 (*Replacement of Screen Rate*) of the Single Currency Secured Term Facility Agreement for Developing Market Jurisdictions version ST03

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[7] See, for example, Clause 10.2 (*Calculation of Reference Bank Rate*) of the Single Currency Secured Term Facility Agreement for Developing Market Jurisdictions version ST03.

[8] The reference bank provisions are intended to provide a rate of interest that is equivalent to LIBOR and one would ordinarily expect to see international banks operating in the London inter-bank market being approached first to act as a reference bank.

[9] This limb of the fallback will fall away with the end of LIBOR for each currency where the Administrator no longer requires submissions.

[10] See clause 35.4 (*Changes to reference rates*) of the of the Single Currency Secured Term Facility Agreement for Developing Markets Jurisdictions version ST03 for an example of wording providing support for the obligors and relevant lenders to adopt a new rate. We expand on this below.

which provides for obligors and relevant lenders to agree, should a screen rate replacement event occur, for: (i) a replacement benchmark rate to apply in circumstances where a screen rate for a particular currency is not available; (ii) aligning provisions of the finance documents to align with that new rate; (iii) enabling a replacement benchmark to be used for the calculation of interest under the loan agreement; (iv) implementing market conventions applicable to that rate; (v) providing for appropriate fallback (and market disruption) provisions for that rate; and (vi) the adjustment of pricing to reduce or eliminate any economic imbalance among the parties as a result of the application of that rate (and if any adjustment or method for calculating any adjustment has been formally designated, nominated or recommended by the Relevant Nominating Body, the adjustment shall be determined on the basis of that designation, nomination or recommendation).

In the absence of such agreement between the borrower and the relevant lender(s) however, the borrower may have no choice but to prepay the loan and refinance its facility with another lender or syndicate. This may need to be done, with or without penalty or premium[11], under the voluntary prepayment provisions of the agreement.[12]

The Rise of Risk Free Rates in Response to the Proposed Discontinuation of LIBOR

In response to the proposed discontinuation of LIBOR, new benchmark rates have been developed (or are in the process of being developed) in the market to address this issue. This includes various new benchmark rates:

(a) **Overnight Rates**

(i) SONIA (the Sterling Overnight Index Average, administered by the Bank of England) for sterling denominated loans;[13] and

(ii) SOFR (the Secured Overnight Funding Rate for US$, calculated by reference to the USA's Treasury repurchase / repo market) for US$ denominated loans.

These new rates (known as overnight risk free rates) are backward-looking calculated by reference to current overnight rates during the term of the relevant loan, rather than "forward looking" screen rates.[14]

These new rates have been adopted by the LMA in its suite of overnight RFR based loan documentation (the **LMA Overnight RFR Based Loan Documentation**).

(b) **Term Rates** – term SOFR reference rates are derived from SOFR derivatives and are produced and published by CME Group Inc. (**Term SOFR**).

Unlike the Overnight Rates, this new Term SOFR looks to "forward looking" rates similar to LIBOR (and other IBOR benchmarks).

The LMA has adopted Term SOFR in the new developing markets single currency term and revolving facilities agreement incorporating Term SOFR (which was published by the LMA as an exposure draft on October 27, 2021) (the **LMA Term SOFR Developing Markets Document**, together with the LMA Overnight RFR Based Loan Documentation, the **LMA RFR Based Loan Documentation**).

The Approach of the LMA

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[11] Borrowers typically aim to exclude penalties, premiums or prepayment fees (as a commercial matter) in these circumstances.

[12] For an example of this, see clause 7.4 (Voluntary prepayment of Loans) of the Single Currency Secured Term Facility Agreement for Developing Markets Jurisdictions version ST03.

[13] To support the Risk-Free Rate transition in Sterling markets the Bank of England began publishing the SONIA Compounded Index from 3 August 2020. This simplifies the calculation of compounded interest rates and in doing so provides a standardised basis through its publication as an official source.

[14] SONIA is designed to be based on actual transactions and reflects the average of the interest rates that banks pay to borrow Sterling overnight from other financial institutions and institutional investors.

The LMA has been at the forefront of the LIBOR transition and has, among other things, published the LMA RFR Based Loan Documentation, together with supporting guidance notes to facilitate the transition from LIBOR to the risk free rates referred to above.[15]

This includes the following publications:

•	**RFR Drafting Guide**
-	Drafting Guide for Use in Relation to the Incorporation of Provisions Relating to the Use of Compounded Risk-Free Reference Rates into LMA Documentation.
•	**Rate Switch Documentation and Commentary:**
-	LMA recommended form of multicurrency term and revolving facilities agreement incorporating rate switch provisions (lookback without observation shift).
-	LMA recommended form of multicurrency term and revolving facilities agreement incorporating rate switch provisions (lookback with observation shift).
-	LMA term sheet for multicurrency term and revolving facilities agreements incorporating rate switch provisions (lookback [without]/[with] observation shift).
-	Commentary to the LMA recommended form of multicurrency term and revolving facilities agreements incorporating rate switch provisions (lookback without and with observation shift).
-	LIBOR transition considerations overview for wider LMA document suite.
•	**Replacement of Screen Rate Clause**
-	RFR Terms for Replacement of Screen Rate Clause.
-	Note on the Revised Replacement of Screen Rate Clause and pre-cessation trigger.
-	Note on the Revised Replacement of Screen Rate Clause and documentary recommendations published by the Working Group on Sterling Risk-Free Reference Rates.
-	LMA Recommended Revised Form of Replacement Screen Rate Clause and Users Guide (Please note that this clause was incorporated into the LMA facility agreements as of 28 February 2020).
•	**Issues & Guidance**
-	Transitioning to RFRs - Practical guidance for Amendments.
-	LIBOR transition considerations overview for wider LMA document suite.
-	Considerations in respect of the use of forward-looking term SONIA reference rates.
-	€STR publication and changes to EONIA.
-	LMA Revised Replacement of Screen Rate Clause and considerations in respect of credit adjustment spreads.
-	EONIA – planned change in methodology and discontinuation.
-	ICE LIBOR and EURIBOR refixing policies and LMA facility documentation.
-	LIBOR code of conduct and revised LMA facility documentation guidance note.
•	**Multicurrency Compounded Rate/Term Rate Documentation and Commentary:**
-	LMA recommended form of multicurrency term and revolving facilities agreement incorporating backward-looking compounded rates and forward-looking term rates with rate switch provisions (lookback without observation shift).
-	LMA recommended form of multicurrency term and revolving facilities agreement incorporating backward-looking compounded rates and forward-looking term rates with rate switch provisions (lookback with observation shift).
-	Commentary to the LMA recommended forms of compounded rate facilities agreements (lookback without and with observation shift).
-	LMA term sheet for recommended forms of single currency term and revolving facilities agreements incorporating backward-looking compounded rates (lookback [without]/[with] observation shift).
-	LMA recommended form of single currency term and revolving facilities agreement incorporating backward-looking compounded rates (lookback without observation shift).

[15] The initial drafts were published as "exposure" drafts and more recently as "recommended forms" of loan agreement.

-	LMA recommended form of single currency term and revolving facilities agreement incorporating backward-looking compounded rates (lookback with observation shift).
-	LMA term sheet for recommended forms of multicurrency term and revolving facilities agreements incorporating backward-looking compounded rates and forward-looking term rates with rate switch provisions (lookback [without[/[with] observation shift).
-	LIBOR transition considerations overview for wider LMA document suite.
•	**Reference Rate Selection Agreement**
-	LMA recommended form of reference rate selection agreement for use in relation to legacy transactions and the transition to alternative reference rates.
•	**Borrowing Base**
-	Revolving facility agreement incorporating backward-looking compounded rates (with option for lookback without or with observation shift) for use in borrowing base transactions.
•	**Investment Grade – RFR Facility Documentation**
-	Users Guide to LMA Finance Party Default Clauses in Conjunction with the LMA Recommended Form of Primary Document.
-	LMA Multicurrency Term and Revolving Facilities Agreement incorporating a Swingline Facility with/without Observation Shift.
-	LMA Multicurrency Revolving Facility Agreement with/without Observation Shift.
-	LMA Single Currency Revolving Facility Agreement with/without Observation Shift.
-	LMA Recommended form of Designated Entity Clause and User Guide.
-	LMA Multicurrency Term Facility Agreement with/without Observation Shift.
-	LMA Multicurrency Term and Revolving Facilities Agreement with Letter of Credit with/without Observation Shift.
-	LMA Single Currency Term Facility Agreement with/without Observation Shift.
•	**Leveraged / High Yield – RFR Documentation**
-	Super Senior Multicurrency Revolving Facility Agreement (Compounded Rate/Term Rate).
-	Super Senior Multicurrency Revolving Facility Agreement with HY Notes (Compounded Rate/Term Rate).
-	Super Senior Intercreditor Agreement (Compounded Rate/Term Rate)
-	Super Senior Intercreditor Agreement with HY Notes (Compounded Rate/Term Rate)
•	**Leveraged / High Yield – RFR Drafting Guide**
-	Drafting Guide for Use in Relation to the Incorporation of Provisions Relating to the Use of Compounded Risk-Free Reference Rates into LMA Documentation.
•	**Leveraged - Senior/Mezzanine – RFR Documentation**
-	Mezzanine Facility Agreement Drafting Guide for Leveraged Acquisition Finance Transactions (Senior/Mezzanine) (Compounded Rate/Term Rate)
-	LMA Leveraged Facilities Agreement (Compounded Rate/Term Rate)
-	Leveraged Term Sheet (RFR)
-	Financial Covenants Provisions
-	LMA Intercreditor Agreement (Senior/Mezzanine) (Compounded Rate/Term Rate)
•	**Leveraged - Senior/Mezzanine – RFR Drafting Guide**
-	Drafting Guide for Use in Relation to the Incorporation of Provisions Relating to the Use of Compounded Risk-Free Reference Rates into LMA Documentation.
•	**Leveraged - Super Senior/Senior – RFR Intercreditor Documentation**
-	Intercreditor Agreement for Leveraged Acquisition Finance Transactions (Super Senior/Senior) (Compounded Rate/Term Rate)
•	**Leveraged - Super Senior/Senior – RFR Drafting Guide**
-	Drafting Guide for Use in Relation to the Incorporation of Provisions Relating to the Use of Compounded Risk-Free Reference Rates into LMA Documentation.
•	**Real Estate Finance – RFR Facility Documentation**

-	Single Currency Term Facility Agreement for Real Estate Finance Multiproperty Investment Transactions with/without Observation Shift.
-	Mark-up: REF RFR facility agreement against REF LIBOR facility agreement.
•	**Private Placement – RFR Drafting Guide**
-	Drafting Guide for Use in Relation to the Incorporation of Provisions Relating to the Use of Compounded Risk-Free Reference Rates into LMA Documentation.
•	**Pre-Export Finance – RFR Drafting Guide**
-	Drafting Guide for Use in Relation to the Incorporation of Provisions Relating to the Use of Compounded Risk-Free Reference Rates into LMA Documentation.
•	**Export Finance – RFR Drafting Guide**
-	Drafting Guide for Use in Relation to the Incorporation of Provisions Relating to the Use of Compounded Risk-Free Reference Rates into LMA Documentation.
•	**Developing Markets**
-	LMA Secured Single Currency Term Facility Agreement for Developing Markets Transactions without or with Observation Shift.
-	LMA Exposure Draft Single Currency Term and Revolving Facilities Agreement Incorporating Term SOFR for use in Developing Market Jurisdictions
	Drafting Guide for Use in Relation to the Incorporation of Provisions Relating to the Use of Compounded Risk-Free Reference Rates into LMA Documentation.
•	**South African Law Investment Grade – RFR Drafting Guide**
	Drafting Guide for Use in Relation to the Incorporation of Provisions Relating to the Use of Compounded Risk-Free Reference Rates into LMA Documentation.
•	**Local African Law – RFR Drafting Guide**
	Drafting Guide for Use in Relation to the Incorporation of Provisions Relating to the Use of Compounded Risk-Free Reference Rates into LMA Documentation.
	Secondary Debt Trading – RFR Exposure Drafts
	LMA Exposure Draft Trade Confirmation (Risk Participation).
	LMA Exposure Draft Trade Confirmation (Claims).
	LMA Exposure Draft Standard Terms and Conditions for Par and Distressed Trade Transactions (Bank Debt/Claims).
	Explanatory Note to LMA Exposure Draft Standard Terms and Conditions for Par and Distressed Trade Transactions (Bank Debt/Claims).
	LMA Exposure Draft Trade Confirmation (Bank Debt)

In this note, we take a general look at the LMA RFR Based Loan Documentation as well as an in-depth look at:

(a) the new developing markets single currency secured single currency term facility agreement (incorporating backward-looking compounded rates with option for lookback without or with observation shift) (the **LMA Overnight RFR Developing Markets Document**); and

(b) the new LMA Term SOFR Developing Markets Document incorporating Term SOFR (which was published on as an exposure draft and does not constitute a recommended form of the LMA),

with a view to breaking these two agreements down into slightly easier to understand, bite sized, chunks.

General Observation with regard to the new LMA Overnight RFR Based Loan Documentation

As one might expect, the LMA LIBOR Based Documentation remains largely intact and only specific definitions and clauses dealing with LIBOR, and the transition from LIBOR, have been amended and replaced with RFR based definitions and mechanics. For most purposes, this means that the standard drawdown mechanics, tax and grossup indemnities, representations and warranties, undertakings, events of default and general boiler plate provisions mirror the LMA LIBOR Based Documentation which many parties will already be very familiar with.[16]

Structural Observations on the new LMA Overnight RFR Based Loan Documentation

Important points to note in relation to the new LMA Overnight RFR Based Loan Documentation are as follows:

(a) **Rate Switch Mechanism** – the new documentation draws a distinction between:

(i) a loan agreement that will make use of an IBOR on day one until such time as a trigger event has occurred (e.g. the screen rate for the relevant IBOR becoming unavailable), at which point the existing IBOR mechanics will switch to the new RFR mechanics (referred to as a **Rate Switch Mechanism**); and

(ii) a loan agreement that will adopt the new RFR mechanics from day one with no IBOR rate switch mechanics included in the document at all.[17]

Depending on what the borrower and lenders agree at the outset of the relevant documentation negotiation, the new LMA Overnight RFR Based Loan Documentation provides optional wording to accommodate each scenario.[18] This mechanism will invariably become less relevant from the start of next year but may be helpful for documents referencing other IBORs such as JIBAR and NIBOR, once replacement rates are identified.

(b) **RFR Schedules** – in order to simplify the new LMA Overnight RFR Based Loan Documentation from an optical perspective, the methodology for establishing a number of important commercial terms relating to the determination of RFRs is set out in schedules. These schedules provide a degree of optionality and are designed to include self-contained mechanics for regulating the use of RFRs. We expand on this in more detail below.

(c) **Overnight Rates** – RFRs are backward-looking overnight rates whereas LIBOR (and other IBOR benchmarks) are a forward-looking term rate quoted for a range of maturities (for example, 1, 3 or 6 months). The new LMA Overnight RFR Based Loan Documentation therefore refers to current "overnight" rates published by SONIA (for Sterling) and SOFR (for USD) throughout the term of the relevant loan.[19]

In this context, it should be noted that, unlike sterling and USD LIBOR, these new overnight rates for sterling and USD are calculated differently. SOFR is based on a secured rate and SONIA is based on an unsecured rate. As a result, SONIA builds a premium into the unsecured rate to accommodate the inherent credit risk that is associated with an unsecured loan.

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[16] Brexit: as this document is a new facility agreement published after 1 January 2021, the LMA does also include some changes required as a result of the end of the Brexit transition period on 31 December 2020 for English law facility documentation. In particular:

• an optional two-way exclusive jurisdiction clause has been included as per the LMA note on Documentary implications of the end of the Brexit transition period for LMA facility documentation - Consolidated and Updated Note (the **Documentary Implications Note**); and

• a contractual recognition of bail-in clause has been included as per the LMA Recommended Form of Bail-In Clause and Users Guide (the **Bail-In Users Guide**). Users of the LMA documentation should, consider adding in Contractual Recognition of Bail-In (CROB) and Stay in Resolution (Stays) Parts of the PRA Rulebook terms into existing loan documentation for a third-country law-governed liability or financial arrangement if any documentation is to be amended as part of the LIBOR transition. This is to avoid residual doubt about such amendments constitution a "**material amendment**" for CROB and Stays parts of the PRA Rulebook. It is particularly important if other amendments are also being made to that documentation at the same time.

[17] Rate Switch based documentation provides a temporary grand-fathering mechanism that is designed to fall away over time as LIBOR rates are no longer published or used for a particular currency, allowing LIBOR based interest rates until that change-over moment.

[18] The LMA Overnight RFR Developing Markets Document is an example of a loan agreement that assumes that the new RFR mechanics will apply from day one. The multicurrency term and revolving facilities agreement incorporating backward-looking compounded rates and forward-looking term rates with rate switch provisions (lookback without observation shift) (the **RFR Rate Switch Compounded Rate Document**) is an example of a loan agreement that includes a Rate Switch Mechanism.

[19] These rates are taken from deep and liquid underlying markets and are not based on panel bank submissions. For example, overnight SONIA is underpinned by circa. £60 billion worth of daily transactions which are reported to the Bank of England.

(d) **Compounded Rates (Forward Looking or in Arrears)** – as mentioned above, RFRs are backward-looking overnight rates. As a result, they do not include any inbuilt premium for term funding. On the other hand LIBOR (and other IBOR benchmark rates) include an element of "term risk" (or liquidity premium) on the part of the participating lenders, recognising that LIBOR (and other IBOR benchmark rates) assume funds are being committed to a borrower for a specific extended period (i.e. 1, 3 or 6 months) rather than simply overnight. Accordingly, if the use of RFR in lieu of LIBOR is to provide the lenders with a benchmark rate that is economically similar to LIBOR (or other IBOR benchmark rates), the lenders need to include an element of this term risk for a similar period of 1, 3 or 6 months within their pricing metric.

This pricing metric is achieved in part under the new LMA Overnight RFR Based Loan Documentation by aggregating RFR overnight rates and incorporating an element of term pricing into the RFR calculation metrics (which gets lenders some way towards compensating for time value of money but does not replace the term risk element) by "compounding" or "averaging" overnight rates over a specific period of time in order to achieve a rate that may be used for these longer periods of time (e.g. 1, 3 or 6 months as per LIBOR). [20]

In order to do this, the relevant compounding can be done to create a term rate for an interest period using one of the following two methods:

(a) "**forward looking**" method – where the agent uses the RFR daily overnight rates from before the relevant interest period and projecting them for the duration of the relevant interest period; or

(b) "**in arrears**" method – where the agent uses the RFR daily overnight rates obtained during the relevant interest period.

In this context, the LMA Overnight RFR Based Documentation makes use of the compounded "in arrears" methodology and provides for the facility agent to (i) compound the daily overnight RFR rate for each day falling during the relevant interest period (e.g. 1, 3 or 6 months); and (ii) calculate the amount of interest due by the borrower in respect of an interest period at the end of such interest period.[21]

For the purposes of the compounded in arrears methodology, the LMA Overnight RFR Based Loan Documentation also draws a distinction between the following two methods of compounding for daily RFR rates:

(i) Cumulative Compounded RFR Rates;[22] and

(ii) Daily Non-Cumulative Compounded RFR Rates.[23]

The main difference between "Cumulative Compounded RFR Rate" and "Daily Non-Cumulative Compounded RFR Rate" is that:

(i) with **Cumulative Compounded RFR Rates**, the compounded rate is calculated at the end of the relevant interest period (or related observation period) and is applied to the whole interest period. This allows interest to be calculated for the whole interest period using a single compounded RFR rate; and

[20] Note that RFRs are more flexible than LIBOR as they are derived from daily rates. Accordingly, interest periods are not technically limited to the 1, 3, 6 or 12 month interest periods published for LIBOR based loans.
[21] The new LMA Overnight RFR Developing Markets Document compounds the daily RFR rate, rather than the balance of the loan outstanding under the relevant loan agreement, to achieve a product as part of this calculation.
[22] This is calculated as a percentage rate per annum calculated in accordance with the methodology set out in Schedule 15 (Cumulative Compounded RFR Rate) of the LMA Overnight RFR Based Loan Documentation.
[23] This is calculated as a percentage rate per annum calculated in accordance with the methodology set out in Schedule 14 (Daily Non-Cumulative Compounded RFR Rate) of the LMA Overnight RFR Based Loan Documentation.

(ii) with **Daily Non-Cumulative Compounded RFR Rates**, the compounded rate is calculated day by day during the interest period as the cumulative rate as of the current day, minus the cumulative rate as of the prior business day.

We note that the Sterling Working Group[24] recommends the Daily Non-Cumulative Compounded RFR Rates methodology for syndicated loans due to the need to calculate daily interest accruals for intra-period activity, such as prepayments and secondary trading activity during an interest period. [25]

(e) **Timing Issues with Daily Compounding**

Because compounding in arrears looks backwards, the amount of interest payable by the borrower to the lenders will not be known until (i) the RFR daily rate has been published for each day of an interest period; and (ii) the relevant compounding calculation is completed by the facility agent at the end of that period.

If a facility agent were to use the rates published during each actual interest period, the interest rate for the relevant period would only become known at the end of that period when all the RFR rates for the period are known. A short period is therefore required before the end of the interest period to allow the facility agent (from an administrative perspective) to set the applicable interest rate and calculate payments due by the borrower on the last day of that interest period.

To solve the issue around the short time period available to a borrower to make an interest payment, a lookback period has been included in the LMA Overnight RFR Based Loan Documentation to enable the facility agent to calculate the amount of interest payable before the end of the relevant interest period. This is done by using RFR rates from a slightly earlier period rather than using the RFR rates corresponding to each day during the actual interest period (with the observation period being the same length as the relevant interest period).

This lookback period can vary based on borrower and lender needs but the Sterling Working Group recommends a period commencing (and ending) 5 business days in advance of the actual commencement (and end) date for each interest period.[26]

In this context, borrowers will always need to ensure that the length of the lookback period provides enough notice to arrange for interest payments to be made on the relevant interest payment date.

This is very different from LIBOR (and other IBOR benchmark rates), where the borrower is aware of the relevant rate of interest at the start of each interest period. Note that while not specifically relevant to LMA documentation, this can have an impact for Islamic finance documentation, given the lack of certainty (*gharar*) in respect of the amount payable by a debtor in respect of the equivalent of an interest period at the beginning of such period. We mention this, given the increased use of Islamic finance documentation (sometimes based on mechanics included in LMA recommended forms of documentation) in the developing markets.

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[24] The Sterling Working Group is a working group of market participants and trade associations formed to catalyse the transition from the interest rate benchmark LIBOR towards SONIA in sterling markets The Bank of England and the Financial Conduct Authority (FCA) participate as ex-officio members and provide administrative support to the group (https://www.bankofengland.co.uk/markets/transition-to-sterling-risk-free-rates-from-libor/working-group-on-sterling-risk-free-reference-rates).

[25] By way of example, LMA LIBOR based loan documentation includes "break costs" (and, in certain documents, "break gains") that are payable if a prepayment is made during an interest period. Break costs are payable by the borrower to the lender if break losses arise and are intended to notionally compensate a lender for any break funding costs it may incur in terms of its back to back funding. The position is slightly more complex with RFRs as break costs are not technically meant to represent the lender's cost of funds so there is arguably less reason to charge break costs. That said, if break cost language is required, it will not be possible to calculate the cost during an interest period from a practical perspective if the RFR rates can't be identified for specific dates during that interest period.

[26] The LMA note that a 5 day period may not be appropriate in certain circumstances – e.g. where an interest period is very short or where back to back hedging / swaps transactions dictate a different period from a treasury perspective.

(f) **Lookback With or Without Observation Shift** - the new LMA Overnight RFR Based Loan Documentation also refers to "Lookback With or Without Observation Shift".

The main difference between "**Lookback Without Observation Shift**" (sometimes referred to as the "**Lag Approach**") and "**Lookback With Observation Shift**" (sometimes referred to as the "**Observation Shift Approach**") relates to the weighting of daily overnight RFR in the compounding formula to address the non-business days for which the relevant RFR is not published.

Lookback without Observation Shift applies a weighting to the interest calculation according to the actual number of days in the interest period whilst the Lookback With Observation Shift applies a weighting according to the days of the week in the observation period (rather than the interest period).

As with the Rate Switch Mechanism, borrowers and lenders are given an option as to whether to include the "Observational Shift" wording in the relevant loan documentation. Both approaches have been used in the loan market and the LMA notes that it is unlikely that the two approaches will result in significantly different results.

For further information on observation shifts, the Sterling Working Group has published an overview of the "Lag Approach" and "Observation Shift Approach", together with a worked example of each approach (see Sterling Working Group on Sterling Risk-Free Rates Detailed Loans Conventions (September 2020-Updated in March 2021)).

(g) **Baseline Credit Adjustment Spread** – the LMA RFR Based Loan Documentation also refers to "credit adjustment spreads". In short, credit adjustment spreads are adjustments added to the rate of interest to compensate lenders for an element of credit risk over and above their funding costs (being something that was indirectly captured in the cost of interbank lending and factored into LIBOR and other IBOR rates). They are designed to recognize that RFRs are not a direct economic equivalent of LIBOR (or other IBOR benchmark rates) and that additional pricing may need to be included in the interest rate clause as an optional line item to support the transition to RFRs, with a view to making an interest rate based on an RFR as economically equivalent as possible to an interest rate based on an IBOR.

As with the Rate Switch Mechanism, borrowers and lenders are given optional wording in the new LMA Overnight RFR Based Loan Documentation to determine whether a credit adjustment spread will apply to the calculation of interest. In the absence of this adjustment, lenders may be required to increase their margin to better reflect the returns made by lenders under LIBOR rates and to achieve an equivalent economic effect on the interest rate, when take as a whole, to imposing a credit adjustment spread.

It is less likely that credit adjustment spreads will be required for new loan agreements, as opposed to a legacy loan agreements, but lenders may decide to include these spreads as a pricing element.

A Deep Dive into the LMA Overnight RFR Developing Markets Document

The new LMA Overnight RFR Developing Markets Document assumes that the RFR rate and related mechanics will apply from day one and, accordingly, does not include a Rate Switch Mechanism or any IBOR mechanics.

Aside from this, the main differences between the original LMA LIBOR based Developing Markets document and the new LMA Overnight RFR Developing Markets Document are as follows:

<u>Definitions</u>

(a) the retention of USD and Sterling as optional currencies, but the removal of Euros from the agreement;

(b) the removal of all Euro related definitions – e.g. the "Euribor", "Participating Member State", "Target2" and "Target Day" definitions;

(c) the removal of the "Fixed Rate" definition and supporting mechanics;

(e) the removal of "LIBOR" and other LIBOR related definitions such as "Reference Bank", "Reference Bank Quotation", "Reference Bank Rate", "Benchmark Rate", "Fallback Interest Period", "Historic Screen Rates", "Interpolated Historic Screen Rates", "Interpolated Screen Rates", "Quotation Day" and "Screen Rates", which are all definitions that previously formed part of the primary mechanics to determine "LIBOR" (or fallback mechanics to determine LIBOR in circumstances where normal LIBOR rates were not available, before triggering "cost of funds" type language);

(f) the incorporation of various RFR related definitions, e.g.:

(i) the introduction of the new "**SOFR**" definition as "the secured overnight financing rate (SOFR) administered by the Federal Reserve Bank of New York (or any other person which takes over the administration of that rate) published by the Federal Reserve Bank of New York (or any other person which takes over the publication of that rate)". This definition provides the primary benchmark rate for determining daily RFR rates for USD;

(ii) the introduction of the new "**SONIA**" definition as the "Sterling overnight index average (SONIA) reference rate displayed on the relevant screen of any authorised distributor". This definition provides the primary benchmark rate for determining daily RFR rates for Sterling;

(iii) the introduction of new "**Central Bank Rate**" and "**Central Bank Rate Adjustment**" definitions to provide for an "overnight" fallback rate of interest in circumstances where SONIA or SOFR screen rates become unavailable; [27]

(iv) the introduction of new "**Compounded Reference Rate**" and "**Compounding Methodology Supplement**" definitions which are used in the agreement to determine a rate of interest by aggregating the percentage rate per annum which is the aggregate of (A) the Daily Non-Cumulative Compounded RFR Rate for a RFR banking day; and (B) (if applicable) the applicable baseline credit adjustment spread mentioned above;[28]

(v) the introduction of a new "**Daily Rate**" definition to reflect the fact that the new RFR rate is calculated on a current daily basis by reference to SOFR and SONIA for each RFR Banking Day (or the relevant Central Bank Rate / Central Bank Rate Adjustment if the relevant SOFR or SONIA rates are not available), floored in each case at zero;

(vi) the introduction of a new "**Lookback Period**" definition to reflect the fact that the relevant rate on any day may be subject to a correction by the administrators of that rate. The "Lookback" period (which is typically 5 banking days)[29] permits users of the relevant

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[27] The Central Bank Rate is defined as (i) "The short-term interest rate target set by the US Federal Open Market Committee as published by the Federal Reserve Bank of New York from time to time" for US$ denominated loans or (ii) "The Bank of England's Bank Rate as published by the Bank of England from time to time" for Sterling denominated loans.

[28] As mentioned above, the Baseline CAS is the specified credit adjustment spread (if any) which is to be added to the Daily Non-Cumulative Compounded RFR Rate and used as part of the pricing metric under the LMA guidance. If the commercial agreement is that no such a credit adjustment spread will be employed this reference may be deleted.

[29] The LMA notes that whilst a standard Lookback Period of five banking days is recommended, this can vary based on borrower and lender needs, including in the context of developing market transactions. Users may wish to refer to the Developing Markets LIBOR Transition Note for further details of the relevant considerations in the context of the Lookback Period.

agreement to select the corrected rate should a correction occur. Accordingly, if a corrected rate is published, it is used in place of the original, uncorrected, rate;

(vii) the introduction of a new "**Market Disruption Rate**" definition which is calculated as the percentage rate per annum which is the aggregate of (A) the Cumulative Compounded RFR Rate for the interest period of the relevant loan; and (B) (if applicable) the applicable baseline credit adjustment spread mentioned above;

(viii) the introduction of a new "**Relevant Market**" definition as "the market for overnight cash borrowing collateralised by US Government securities" in relation to USD and "the Sterling wholesale market" in relation to Sterling; and

(ix) the introduction of a new "**Reference Rate Supplement**" definition to the allow supplementary terms to be agreed in writing between the relevant parties in relation to the RFR rates (which over-ride the original mechanics set out in the Schedules);

(g) the extension of the definition of "**Finance Documents**" to include any "**Reference Rate Supplement**" or "**Compounding Methodology Supplement**";

(h) the amendment to the definition of "Business Day" to recognize additional business day operational requirements for RFRs ("**RFR Banking Days**"); and

(i) the retention of the "**Break Costs**" definition (on an optional basis) but with no substitute or recommended wording in the actual agreement.

<u>Interpretation</u>

(i) the movement of certain "**cost of funds**" language (which was the final step of the market disruption clause) from the market disruption clause into the construction clause; and

(ii) the movement of the information service provider language (which was previously referred to in the definition of "**LIBOR**" and pre-supposed the replacement of Thomson Reuters Page) into the construction clause (where it would now apply to Central Bank Rates).

<u>Clause 8.1 (*Calculation of Interest*)</u>

The most important difference between the original LMA LIBOR based Developing Markets document and the new LMA Overnight RFR Developing Markets Document is in Clause 8.1 (which should be read together with Schedule 13 (*Reference Rate Terms*), Schedule 14 (*Daily Non-Cumulative Compounded RFR Rate*) and Schedule 15 (*Cumulative Compounded RFR Rate*) of the LMA Overnight RFR Based Loan Documentation.

Instead of interest being calculated on each loan for each interest period, as the percentage rate per annum which is the aggregate of the applicable Margin and IBOR (or Fixed Rate), it is calculated under the new agreement by reference to the aggregate of the **Margin** and the applicable **Compounded Reference Rate** for the relevant day, calculated on a daily basis.

This clause can be broken down as follows:

"The rate of interest on each loan for any day during an interest period is the percentage rate per annum which is the aggregate of the applicable:

(i) the margin;[30]

[30] Note that the margin is not subject to compounding.

(ii) the credit adjustment spread (if any); and

(iii) the Daily Non-Cumulative Compounded RFR Rate for the relevant day".

In this context, the new RFR rate obviously looks to SONIA and SOFR compounded rates rather than LIBOR screen rates. The inclusion of the baseline credit adjustment spread is, as mentioned above, optional.

<u>Clause 8.4 (*Notifications*)</u>

In the original LMA LIBOR based Developing Markets document this clause provides for a simple notification of any rate of interest determined under the agreement and each funding rate relating to a loan (in a "cost of funds" scenario). The equivalent clause in the new LMA Overnight RFR Developing Markets Document is a little more sophisticated and requires the facility agent to promptly, upon an interest payment being determinable, notify:

1. the borrower of that interest payment (being the aggregate amount of interest that is, or is scheduled to become, payable under any finance document);
2. each lender of the proportion of that interest payment which relates to each lender's participation in the relevant loan; and
3. the lenders and the borrower of:
    a. each applicable rate of interest used for the purposes of the determination of that interest payment; and
    b. to the extent it is then determinable, the market disruption rate (if any) relating to the relevant loan,

    excluding a "cost of funds" scenario.

It then goes on to address "cost of funds" in a similar manner to the original LMA LIBOR based Developing Markets documentation.

<u>Clause 9.1 (*Interest Periods*)</u>

This clause in the new LMA Overnight RFR Developing Markets Document is similar to the equivalent in the LMA LIBOR based Developing Markets documentation but does include a statement to the effect that "No Interest Period shall be longer than six Months". This replaces the previous language in Clause 8.2 (*Payment of interest*) of the LMA LIBOR based Developing Markets documentation which states that if an Interest Period is longer than six Months, then interest would have to be paid on each six month period even if an interest period is longer under the relevant loan agreement.

<u>Clause 9.3 (*Non-Business Days*)</u>

Clause 9.3 (*Non-Business Days*), Clause 29.7 (*Business Days*) and the definitions of "Business Day conventions" in Schedule 13 (*Reference Rate Terms*) of the new LMA Overnight RFR Developing Markets Document reflect that the Sterling Working Group's recommendation for business day conventions for payments 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".

<u>Clause 10 (*Changes to the Calculation of Interest*)</u>

The structure of this clause in the new LMA Overnight RFR Developing Markets Document is similar to that in the LMA LIBOR based Developing Markets documentation but instead of applying the interpolated screen rate, shortened interest periods, historic screen rates or reference bank rates, in circumstances where there is no RFR or Central Bank Rate, it jumps directly to "cost of funds" type language (albeit on an optional basis, if agreed in advance between the parties).

Clause 10.2 (*Market Disruption*)

The market disruption clause in the new LMA Overnight RFR Developing Markets Document has been slightly amended, primarily to provide for some optionality within the LMA Overnight RFR Developing Markets Document as to whether it will apply in any given loan. The market disruption clause otherwise remains substantively the same as the LMA LIBOR based Developing Markets documentation, although it refers to the relevant percentage of lenders' cost of funds relating to its participation in a loan exceeding the "Market Disruption Rate" rather than exceeding LIBOR or another benchmark rate. In either case, it results in a "cost of funds" recovery by the relevant lenders under both documents.

Clause 10.3 (*Cost of funds*)

The wording in the new LMA Overnight RFR Developing Markets Document is slightly different from that in the LMA LIBOR based Developing Markets documentation and refers to the cost of funds of a lender being "that which expresses as a percentage rate per annum its cost of funds relating to its participation in the relevant loan" rather than "that which expresses as a percentage rate per annum the cost to the relevant lender of funding its participation in any loan from whatever source that lender may reasonably select". The language in the LMA Overnight RFR Developing Markets Document is clear and objective and requires the treasury team of the relevant lender to determine that lender's actual cost of funds in relation to a loan.

Clause 10.4 (*Break Costs*)

The break costs clause has been slightly amended, primarily to provide for some optionality as to whether it will apply in any given financing.

Clause 16.5 (*Reference Rate transition costs*)

A new clause 16.5 heading has been introduced in the new LMA Overnight RFR Developing Markets Document as an optional clause in relation to the potential recovery of RFR transition costs from the Borrower. However, the LMA does not provide any suggested wording in the body of the actual clause and the user is left to propose such wording. It is assumed that use of this clause will be limited in situations (such as is envisaged in new LMA Overnight RFR Developing Markets Document) where the RFR rate and related mechanics apply from day one and, accordingly, no Rate Switch Mechanism or IBOR mechanics apply to the facility.

Clause 25 (*Role of the Agent and the Arranger*)

Clause 25.18 (*Role of Reference Banks*), 25.19 (*Third party Reference Banks*) and Clause 35.3 (*Other exceptions*) from the the LMA LIBOR based Developing Markets documentation are not included in the new LMA Overnight RFR Developing Markets Document, as the RFRs do not fall back to reference banks (as they previously did under the IBOR based documentation).

Clause 32.3 (*Day count convention and interest calculation*)

The day count convention used in the LMA LIBOR based Developing Markets documentation has been amended in the new LMA Overnight RFR Developing Markets Document to refer to the actual number of days elapsed and a year of 360 days (or, in any case where the practice in the Relevant Market differs, in accordance with that market practice); and subject to rounding of up to two decimal places. The position for Sterling under the original IBOR based Developing Markets documentation was 365 days.[31]

35.4 (*Changes to reference rates*)

The wording in the LMA LIBOR based Developing Markets documentation and the new LMA Overnight RFR Developing Markets Document is broadly the same, except that the new LMA Overnight RFR Developing Markets Document refers to an "RFR Replacement Event" rather than a "Screen Rate Replacement Event", reflecting changes to the published rate for overnight SOFR rather than changes to the screen rate for LIBOR (or another benchmark rate).

The only material difference between the clause in the LMA LIBOR based Developing Markets documentation and the equivalent in the new LMA Overnight RFR Developing Markets Document is the introduction of a new optional sub-paragraph (b) which states that if an amendment or waiver relates to, or has the effect of, aligning the means of calculation of interest on a loan under a loan agreement to any recommendation of a Relevant Nominating Body which:

(i) relates to the use of an RFR on a compounded basis in the international or any relevant domestic syndicated loan markets; and

Iii) is issued on or after the date of the relevant loan agreement,

it may be made with the consent of the facility agent (acting on the instructions of the [majority lenders]) and the obligors. This paragraph is optional and is clearly designed to accommodate possible new RFR compounding formulations that may develop in the market.

In both cases, this wording, tries to provide majority lender rights to address situations, similar to the one being faced by the original IBOR based Developing Markets documentation, in agreement with the borrower and to provide language to help track market practice in the relevant syndicated loan markets.

The relevant definitions in the new LMA Overnight RFR Developing Markets Document are as follows:

"RFR Replacement Event" means:

(a) the methodology, formula or other means of determining the RFR has[, in the opinion of the [Majority Lenders], and the Obligors] materially changed;

(b)

(i)

(A) the administrator of the RFR or its supervisor publicly announces that such administrator is insolvent; or

(B) information is published in any order, decree, notice, petition or filing, however described, of or filed with a court, tribunal, exchange, regulatory authority or similar administrative, regulatory or judicial body which reasonably confirms that the administrator of the RFR is insolvent,

[31] Note: the LMA guidance note goes on to state that "Clause 32.3 (*Day count convention and interest calculation*), together with the definitions of "Daily Non-Cumulative Compounded RFR Rate" and "Cumulative Compounded RFR Rate", reflects that the £RFR Working Group's recommendation for day count "… is ACT/365 (fixed)". Careful consideration should therefore be taken by users as to whether a 360 or 365 day count should be referenced here in relation to a particular financing transaction.

provided that, in each case, at that time, there is no successor administrator to continue to provide the RFR;

(ii) the administrator of the RFR publicly announces that it has ceased or will cease, to provide the RFR permanently or indefinitely and, at that time, there is no successor administrator to continue to provide the RFR;

(iii) the supervisor of the administrator of the RFR publicly announces that the RFR has been or will be permanently or indefinitely discontinued; [or]

(iv) the administrator of the RFR or its supervisor announces that the RFR may no longer be used; [or]

(c) [the administrator of the RFR determines that the RFR should be calculated in accordance with its reduced submissions or other contingency or fallback policies or arrangements and either:

(i) the circumstance(s) or event(s) leading to such determination are not (in the opinion of the [Majority Lenders] and the Obligors) temporary; or

(ii) the RFR is calculated in accordance with any such policy or arrangement for a period no less than the period specified as the "RFR Contingency Period" in the Reference Rate Terms[; or]]

(d) [in the opinion of the [Majority Lenders] and the Obligors, the RFR is otherwise no longer appropriate for the purposes of calculating interest under this Agreement].]

"**Relevant Nominating Body**" means any applicable central bank, regulator or other supervisory authority or a group of them, or any working group or committee sponsored or chaired by, or constituted at the request of, any of them or the Financial Stability Board.

"**Replacement Reference Rate**" means [ ] / [a reference rate which is:

(a) formally designated, nominated or recommended as the replacement for the RFR by:

(i) the administrator of the RFR [(provided that the market or economic reality that such reference rate measures is the same as that measured by the RFR)]; or

(ii) any Relevant Nominating Body,

and if replacements have, at the relevant time, been formally designated, nominated or recommended under both paragraphs, the "Replacement Reference Rate" will be the replacement under paragraph (ii) above;

(b) in the opinion of the [Majority Lenders] and the Obligors, generally accepted in the international or any relevant domestic syndicated loan markets as the appropriate successor to the RFR; or

(c) in the opinion of the [Majority Lenders] and the Obligors, an appropriate successor to the RFR.]

Schedule 11 (*Timetables*)

The timelines in the LMA LIBOR based Developing Markets documentation have been amended in the new LMA Overnight RFR Developing Markets Document to reflect SOFR and SONIA reference rate requirements rather than IBOR screen rate requirements.

Schedule 13 (*Reference rate terms*)

Schedule 13 of the new LMA Overnight RFR Developing Markets Document sets out the main terms relating to the RFRs for both USD and Sterling. In this context it provides, among other things, for:

(i) election on whether "cost of funds" will apply as a fallback rate;

(ii) whether any baseline Credit Adjustment Spread will apply and how it is to be calculated;

(iii) whether any Break Costs will apply and how it will be calculated;

(iv) the Central Bank Rate to be used as a fallback rate (i.e. the short-term interest rate target set by the US Federal Open Market Committee for USD or The Bank of England's Bank Rate for Sterling);[32] and

(v) whether there will be any Central Bank Rate Adjustment in circumstances where it is used as a fallback rate.

It also includes a number of the new definitions intended to support the mechanics referred to above.

Schedule 14 (*Daily Non-Cumulative Compounded RFR Rate*)

This schedule contains two alternative options in circumstances where the RFR is to be calculated by a Daily Non-Cumulative Compounded RFR Rate. Option 1 provides the necessary wording for "Lookback without Observation Shift" and option 2 provides the necessary wording for "Lookback with Observation Shift".

Schedule 15 (*Cumulative Compounded RFR Rate*)

This schedule of the new LMA Overnight RFR Developing Markets Document contains two alternative options in circumstances where the Market Disruption Rate is to be calculated by a Daily Cumulative Compounded RFR Rate. Option 1 provides the necessary wording for "Lookback without Observation Shift" and option 2 provides the necessary wording for "Lookback with Observation Shift".

Structural Observations on the new LMA Term SOFR Based Developing Markets Loan Document

The new LMA Term SOFR Based Developing Markets Document assumes that Term SOFR will be used from the outset of the facilities[33] as the primary basis on which interest is calculated for US dollar amounts.[34] As noted above, these rates are derived from SOFR derivatives and are produced and published by CME Group Inc.

Aside from this, the LMA LIBOR based Developing Markets document and the new LMA Term SOFR Based Developing Markets Loan Document is quite similar, given that both documents use a "term" based benchmark rate rather than an "overnight" rate.

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[32] For USD and Sterling, this means that if the daily SOFR or SONIA rate is unavailable, the relevant US Federal Open Market Committee for USD and the Bank of England Bank Rate for Sterling (plus any spread adjustment, if applicable) will be used as the fallback.
[33] The new document does not include any Rate Switch Mechanism.
[34] The LMA expressly states that "the publication of this document is not intended to be, and should not be construed as, a determination or implication by the LMA that the use of Term SOFR is suitable for use in any given case or that any market participant is, or ought to be, capable of entering into, and managing, a facility based on Term SOFR. It is for individual market participants to form their own view of the extent to which it is suitable for use as the basis for preparing loan documentation for transactions".

The main differences between the LMA LIBOR based Developing Markets documentation and the new LMA Term SOFR Based Developing Markets Loan Document are as follows:

Parties

The LMA Term SOFR Based Developing Markets Loan Document is designed for unsecured developing markets loans only and no security agent or security trust language is provided for in the document. That said, it can be adapted to include the necessary security agent or security trust language as required.

Definitions

(a) the LMA Term SOFR Based Developing Markets Loan Document includes a revolving facility in addition to a term loan facility (with associated definition changes to "Available Commitment", "Available Facility", "Availability Period", "Facility A", "Facility B", "Facility A Loan", "Facility B Loan", "Rollover Loan", "Termination Date", "Total Commitments" etc. to accommodate both facilities);

(b) the currency of the loan in the new LMA Term SOFR Based Developing Markets Loan Document is assumed to be US Dollars; with all references to Sterling and Euro related definitions removed from the agreement – e.g. the "Euribor", "Participating Member State", "Target2" and "Target Day" definitions;

(c) the removal of "LIBOR" and certain LIBOR related definitions such as "Reference Bank Quotation", "Reference Bank Rate", "Benchmark Rate", and "Screen Rates", which are all definitions that previously formed part of the primary mechanics to determine "LIBOR" (or fallback mechanics to determine LIBOR in circumstances where normal LIBOR rates were not available (before triggering "cost of funds" type language);

(d) the retention of certain definitions or mechanics previously associated with LIBOR such as "**Fallback Interest Period**", "**Historic Term SOFR**" (previously "**Historic Screen Rate**"), "**Interpolated Historic Term SOFR**" (previously "**Interpolated Historic Screen Rate**"), "**Interpolated Term SOFR**" (previously "**Interpolated Screen Rate**") and "**Quotation Day**", but with reference to Term SOFR based fallback rates rather than IBOR based fallback rates.

(e) the incorporation of various Term SOFR related definitions, e.g.:

(i) the introduction of the new "**SOFR**" definition as "the secured overnight financing rate (SOFR) administered by the Federal Reserve Bank of New York (or any other person which takes over the administration of that rate) published [(before any correction, recalculation or republication by the administrator)] by the Federal Reserve Bank of New York (or any other person which takes over the publication of that rate)]";

(ii) the introduction of the new "**Term SOFR**" definition as "the term SOFR reference rate administered by CME Group Benchmark Administration Limited (or any other person which takes over the administration of that rate) for the relevant period published [(before any correction, recalculation or republication by the administrator)] by CME Group Benchmark Administration Limited (or any other person which takes over the publication of that rate)]", These two definitions provide the benchmark rate for determining term SOFR rates for USD;

(ii) the introduction of the new "**US Government Securities Business Day**" definition "as any day other than a Saturday or a Sunday" or "a day on which the Securities Industry and Financial Markets Association (or any successor organisation) recommends that the fixed income departments of its members be closed for the entire day for purposes of trading in US Government securities". This feeds into the new "**Business Day**" and "**Quotation Day**" definitions, which no longer refer to London (unless that facility agent's office is located in London);

(iii) the introduction of the new optional "**Credit Adjustment Spread**" definition; which can be added to Term SOFR (and the specified fallback(s)) and used as part of the pricing metric;

(iv) the introduction of a new "**Market Disruption Rate**" definition which is calculated as the percentage rate per annum which is the aggregate of (A) the Reference Rate and (B) (if applicable) the applicable Credit Adjustment Spread mentioned above;

(v) the introduction of a new "**Reference Rate**" definition in relation to a Loan as:

(A) the applicable Term SOFR as of the specified time and for a period equal in length to the Interest Period of that Loan; or

(B) as otherwise determined pursuant to Clause 10.1 (*Unavailability of Term SOFR*)[, and if, in either case, that rate is less than zero, the Reference Rate shall be deemed to be zero]".

(vi) the introduction of a new "**Relevant Market**" definition as "the market for overnight cash borrowing collateralised by US Government securities"; and

(f) the retention of the "**Break Costs**" definition (on an optional basis) but with no substitute or recommended wording in the actual agreement.[35]

Interpretation

In the new LMA Term SOFR Based Developing Markets Loan Document certain "**cost of funds**" language (which was the final step of the market disruption clause in the LMA LIBOR based Developing Markets documentation) is moved from the market disruption clause into the construction clause.

Clause 8.1 (*Calculation of Interest*)

The most important difference between the new LMA Term SOFR Based Developing Markets Loan Document and the LMA LIBOR based Developing Markets documentation is in Clause 8.1. Instead of interest being calculated on each loan for each interest period, as the percentage rate per annum which is the aggregate of the applicable margin and IBOR (or Fixed Rate), it is calculated under the new agreement by reference to the aggregate of the **margin**, applicable **reference rate** and **credit adjustment spread** (if any).

The new clause can be broken down as follows:

"The rate of interest on each loan for any day during an interest period is the percentage rate per annum which is the aggregate of the applicable:

(i) the margin;[36]

(ii) Reference Rate (or Fixed Rate); and

(iii) the credit adjustment spread (if any)".

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[35] The LMA notes that "if the interest rate is determined by reference to Term SOFR readers should refer to the Term SOFR Commentary in relation to this definition".

[36] Note that the margin is not subject to compounding.

In this context, the new Reference Rate obviously looks to SOFR term rates rather than LIBOR screen rates. The inclusion of the baseline Credit Adjustment Spread is, as mentioned above, optional.

Clause 10 (*Changes to the Calculation of Interest*)

The main difference between the new LMA Term SOFR Based Developing Markets Loan Document and the LMA LIBOR based Developing Markets documentation in this clause is the removal of "Reference Bank Rates" as a fallback option. The structure of this clause in the new LMA Term SOFR Based Developing Markets Loan Document is otherwise very similar to the LMA LIBOR based Developing Markets documentation and (unlike the LMA Overnight RFR Based Loan Documentation) it retains various definitions and mechanics previously associated with IBOR (including "Fallback Interest Period", "Historic Term SOFR" (previously "Historic Screen Rate"), "Interpolated Historic Term SOFR" (previously "Interpolated Historic Screen Rate"), "Interpolated Term SOFR" (previously "Interpolated Screen Rate") and "Quotation Day", but with reference to Term SOFR based fallback rates rather than IBOR based fallback rates. Importantly, the LMA notes that "In relation to fallback provisions, although there is currently a lack of established market practice and consensus as to the most appropriate fallbacks to Term SOFR, illustrative drafting has been included to address the short-term unavailability of Term SOFR. However, the Term SOFR exposure draft is left blank in respect of fallbacks for a permanent cessation of Term SOFR". Appropriate fallbacks in this event will need to be considered by the parties. The LMA commentary accompanying the new LMA Term SOFR Based Developing Markets Loan Document contains a discussion on various possibilities which users may want to consider.

Clause 10.2 (*Market Disruption*)

The market disruption clause remains substantively the same new LMA Term SOFR Based Developing Markets Loan Document as in the LMA LIBOR based Developing Markets documentation, although it refers to the relevant percentage of lenders' cost of funds relating to its participation in a loan exceeding the "Market Disruption Rate" rather than exceeding LIBOR or another benchmark rate. In either case, it results in a "cost of funds" recovery by the relevant lenders under both documents.

Clause 10.3 (*Cost of funds*)

The wording in the new LMA Term SOFR Based Developing Markets Loan Document is slightly different from the LMA LIBOR based Developing Markets documentation and refers to the cost of funds of a lender being "that which expresses as a percentage rate per annum its cost of funds relating to its participation in the relevant loan" rather than "that which expresses as a percentage rate per annum the cost to the relevant lender of funding its participation in any loan from whatever source that lender may reasonably select". The language in the LMA Term SOFR Based Developing Markets Loan Document is clear and objective and requires the treasury team of the relevant lender to determine that lender's actual cost of funds in relation to a loan.

Clause 10.4 (*Break Costs*)

The wording in the break costs clause in the new LMA Term SOFR Based Developing Markets Loan Document has been slightly amended to provide some additional certainty re timing, but is otherwise the same as the equivalent wording in the LMA LIBOR based Developing Markets documentation and reflects the fact that Term SOFR is a term based benchmark, rather than an overnight based benchmark.

Clause 25 (*Role of the Agent and the Arranger*)

Clause 25.18 (*Role of Reference Banks*), 25.19 (*Third party Reference Banks*) and Clause 34.3 (*Other exceptions*) from the the LMA LIBOR based Developing Markets documentation are not included in the new

LMA Term SOFR Based Developing Markets Loan Document, as the RFRs do not fall back to reference banks (as they previously did under the original Developing Markets IBOR based document).

Clause 34.4 (*Changes to reference rates*)

The wording in the LMA LIBOR based Developing Markets documentation and the new LMA Term SOFR Based Developing Markets Loan Document is broadly the same except that the new LMA Term SOFR Based Developing Markets Loan Document refers to (i) a "Published Rate Replacement Event" rather than a "Screen Rate Replacement Event" and (ii) a "Replacement Reference Rate" rather than "Replacement Benchmark", reflecting changes to the published rate for SOFR and Term SOFR for any quoted tenor rather than changes to the screen rate for LIBOR (or another benchmark rate).

Clause 41.1 (*Jurisdiction of English courts*) and 42.1 (*Jurisdiction*)

Although not related to IBOR replacement, new optional Clauses 41.1 (*Jurisdiction of English courts*) and 42.1 (*Jurisdiction*) have been added to the new LMA Term SOFR Based Developing Markets Loan Document. These provide for exclusive jurisdiction in favour of all the parties to the agreement, in order to meet the recognition of judgment requirements under the Hague Convention for use where parties consider such a jurisdiction clause to be appropriate for their transaction. See the "Documentary Implications Note" published by the LMA for further explanation on this and other Brexit related matters.

Schedule 11 (*Timetables*)

The original timelines have been amended to reflect Term SOFR reference rate requirements rather than IBOR screen rate requirements.

Ongoing Development of the LMA RFR Based Loan Documentation

It must be remembered that the LMA's RFR Based Loan Documentation is still under development and remains a work in progress. That said, the new LMA RFR Based Loan Documentation is extremely helpful and is designed to guide market participants generally and the evolution of market accepted drafting specifically, as the transition towards RFRs continues.

In this context, the LMA notes (i) the importance for lenders to make an assessment of their operational capability to enter into, and manage, an arrangement which envisages the immediate use of a compounded risk-free reference rate or Term SOFR; (ii) the suitability from a commercial, regulatory and any other relevant perspective of the use of Term SOFR and other RFRs; and (iii) the need for suitable software systems by loan system providers and treasury management systems vendors, as a crucial element in the adoption of RFR rates.

Users should also carefully consider the use of RFRs in the context of the developing markets and should refer to the latest developing markets LIBOR transition note published by the LMA for additional guidance on this. In this context, some countries in Developing Markets will face difficulties in respect of some of the concepts included in the new LMA RFR Based Loan Documentation. This includes calculating interest on a compounded in arrears basis (as for example, knowing the amount of interest due in advance can be a required to obtain regulatory approval to pay money offshore – e.g. SARB approval in South Africa or RBZ approval in Zimbabwe). We have noted already the issues that some of the proposed RFR mechanics in the new LMA RFR Based Loan Documentation may have for Islamic finance structures which use concepts taken from LMA documentation.

For these reasons, and the reasons highlighted elsewhere in this article, we would expect the loan market to transition towards term SOFR and other derivative based term benchmarks (rather than overnight rates) in a number of Developing Markets as market participants try to find a more familiar substitute to LIBOR and other IBORs that are certain and more easy to manage from the perspective of both financial institutions and borrowers.

The new exposure draft LMA Term SOFR Based Developing Markets Loan Document is a great step in this direction and we look forward to seeing how the market in Africa and other developing responds to this development.

Members of the LMA may access the latest information on LIBOR developments on https://www.lma.eu.com/news-publications.

Conclusion

LIBOR is now being replaced across international finance markets and it is strongly recommended that both lenders and borrowers who have not taken action to address the cessation of LIBOR carry out a due diligence of their existing loans and identify finance documents which use interbank rates such as LIBOR and to assess (where possible) whether it is prudent to make anticipatory changes to any financing arrangements at this point in time. Banks and financial institutions should also take steps (if they have not done so already) to establish systems and procedures necessary to enable their transition to new RFRs for future floating rate loans. If any clients would like help amending their suite of documentation, Covington would be delighted to assist.

This article is not intended to be exhaustive, but it hopefully provides readers with useful guidance on the approach being taken to RFRs and the direction of new clauses to deal with the discontinuation of LIBOR. If readers have specific queries on any of the developments or documentation mentioned above, or wish to discuss the availability of tools to mitigate this risk, we would be delighted to discuss these with you.

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