LIBOR TRANSITION: ARE YOU READY?

LIBOR transition is here – Law firms at the ready

The 'final countdown' for LIBOR is here. Now that we are in the third month of 2021, LIBOR transition deadlines are fast becoming a stark reality. The regulatory message remains clear: LIBOR transition is happening, the focus must be on active transition and this is the year when loan market participants must be ready to lend and borrow based on risk-free rates ("**RFRs**"). The continued publication of key USD LIBOR tenors until June 2023 does not change this.

The transition from LIBOR to RFRs affects everyone in the syndicated loan market. We previously conducted interviews on the agency and borrower approaches to LIBOR transition. In this interview, we shine a spotlight on the approach of law firms to the transition, including advising on the transition of the legacy book and the documentation of legacy transition and also new RFR facilities.

Kam Mahil, Senior Director – Legal at the LMA spoke to Dora Mace-Kokota, Finance Partner at Stephenson Harwood LLP about her views on the law firm approach to LIBOR transition.

Dora, thank you very much for agreeing to share your views on this important topic.

Thank you very much, Kam. It is a great pleasure for Stephenson Harwood and me to be invited to provide our views on this topic. As you say, it is important not only because it affects so many markets, but also because it is truly international. It is also going to bring on certain fundamental changes in finance documents, not to mention the operational side of the RFRs. These are changes that particularly lenders, borrowers and their legal counsel will need to explore and understand in detail.

What have been your experiences in terms of client engagement on LIBOR transition? Have you noticed a difference in approaches between clients, and in particular between lenders and borrowers?

In the ship finance and the aviation finance market, the majority of the loans we advise on are either USD loans or euro loans. Clients with euro loans continue using the traditional EURIBOR provisions and do not wish to discuss EURIBOR discontinuation yet. Clients with USD loans (especially lenders and facility agents) do wish to discuss the topic either during a transaction or as a general matter. The difficulty with USD loans is that most market participants are waiting for clear guidelines from the regulators and are still undecided whether to follow the Working Group on Sterling Risk-Free Reference Rates ("**£RFR WG**") recommendations or the ARRC recommendations for USD loans based on the LMA forms. They are waiting to see what others in the market are doing and therefore, decisions are postponed. The recent announcement about delaying LIBOR non-representativeness for most tenors to the end of June 2023 also makes them feel that they have more time to make these decisions, even if such postponement is likely to be relevant to legacy loans only. As a result, most of them still prefer to use the replacement of screen rate clause. We have worked on a few transactions with the LMA rate switch provisions, but these are still the exception at the moment.

By contrast, in the real estate finance market, where loans are commonly denominated in sterling, we have seen clients opting to use the LMA rate switch provisions. Since January 2021, there has also been a noticeable increase in the number of our lender clients opting to use "Day 1" SONIA-referencing documentation for new facilities. This is in line with our expectations, given the £RFR WG milestone recommendation that by end-Q1 2021 lenders should cease initiation of new sterling LIBOR-linked loans that expire after the end of 2021.

As well as differences between clients, are you seeing a difference in engagement between sectors?

Especially since the beginning of January 2021, we are seeing a difference between sectors. The ship finance sector is still at a preliminary stage on adopting rate switch provisions or even day-1 RFR loans, whereas (as noted above) other markets like the real estate finance market, whose loans are mainly denominated in sterling seem to be moving towards day-1 SONIA-referencing loans.

On the private equity side, until recently PE houses and borrowers were opting to use the LMA's recommended form of replacement of screen rate language. They were reluctant to "hardwire" LIBOR transition language into documents when there was not an accepted market approach and they were also reluctant to pay the associated costs for the work involved. However, more recently (not surprisingly, given the fast-approaching end-Q1 2021 £RFR WG milestone) we have started to see more requests to include rate switch language in new transactions.

LIBOR transition requires significant time and resources, including legal expertise. Given the number of legacy LIBOR referencing loans that need to be transitioned, in addition to servicing new liquidity needs, legal expertise may become more limited as we progress through this year. How do you see resources being impacted this year, what with impending transition deadlines, and what would you say to lenders and borrowers who may not be as far ahead with transition at the moment?

We agree that lenders and borrowers need to review their loans as early as possible and we have been encouraging them to do so. We have discussed with some clients how to approach such review and which information they need to collect to be in position to transition these loans efficiently and in a cost-efficient manner. In ship finance, we have also taken preliminary advice from various ship registries and foreign counsels as to the impact of a switch to an RFR loan for existing vessel mortgages.

To lenders and borrowers who may not be as far ahead with the transition, we would say that they need to start reviewing their loans in a methodical way. There are various ways to collect this information using tools as simple as Microsoft Excel. Once they have clarity on their legacy loans and which of these they should prioritise (for example, if the deadlines are different between currencies or in the light of the maturity date of those loans), they should contact the relevant parties to start the discussions. We would also advise lenders to develop a template form of the LMA rate switch schedules for their LMA-based legacy loan agreements (for each relevant currency) to ensure consistency between their loans. They can then send these templates to their borrowers at the negotiation stage and to their legal advisers at the drafting stage. The same advice applies for new Day 1-RFR loans.

How have you approached LIBOR transition internally? Do you have a dedicated LIBOR transition team given the number of practice areas impacted by this and are you proactively reaching out to clients?

We set up a "LIBOR Taskforce" some months ago, with representatives from our different offices, to discuss market trends and developments.

We have also set up a dedicated LIBOR discontinuation page on our internal site where fee-earners can find internal and external templates, guidance and training materials. Our PSLs have developed some templates based on the LMA exposure drafts but tailored to different markets (e.g. the ship finance and the real estate finance markets). We have also provided detailed training to our different teams.

We have been proactively reaching out to our clients to ask them about their LIBOR transition strategy and offer our help. We have also provided some general or bespoke training to lenders and borrowers to explain the latest position and their options for new loans and legacy loans.

Finally, while LIBOR transition is an issue with which lenders, borrowers and their lawyers are grappling daily, businesses more generally need to engage with LIBOR discontinuation too. References to LIBOR can crop up in many contracts which have nothing to do with lending. We have therefore made use of the firm's horizon scanning forums to flag the issue and enable partners in other teams to start dialogue with their clients outside the finance arena who may be impacted by LIBOR discontinuation and transition issues.

We of course now have RFR loan conventions for key currencies and LMA exposure draft documentation based on the SONIA loan conventions. Given the conventions chosen, LMA documentation has had to reference the underlying formulae for calculation of the compounded rate rather than refer to a reconciliation tool. Lawyers are often times known to be scared of mathematical formulae! However, you led on the November 2020 rate switch agreement for Seastar, which was one of the first deals in the shipping sector to use the non-cumulative compounded rate formula and the new LMA documentation. How did you find the process of getting up to speed with the new documentation and formulae?

Deciphering the formula was certainly an intellectual challenge! Even if our lender clients are ultimately responsible to ensure that the formula will reflect the way they will calculate the daily rates internally, we, as lawyers, need to understand how it works, especially when advising less sophisticated clients.

The LMA guidance and seminars were very helpful as a starting point and we did reach out to the LMA team with some specific questions. Ultimately, when the reader understands how a compounded rate or non-cumulative rate is supposed to work, then the formulas start to make sense.

Specifically on the Seastar transaction, that was a very interesting deal because it was a secured facility, involving assets in multiple jurisdictions, used compounded SOFR and also had multiple interest periods and break cost mechanics. What were some of the key discussion and advisory points on that transaction?

In terms of the rate switch provisions, there were actually not many discussion points because the lender had already thought through the provisions and developed a template they wanted us to use as a starting point. The borrower was also onboard with these provisions. As a result, this was mainly a drafting exercise for us. Our experience has been different on another transaction with a less sophisticated lender that wanted a lot more explanations on how the credit adjustment worked and which options it had, the way the bank rate central adjustment worked and whether they could insert an option to use Term SOFR if this became available.

As well as new transactions, are you assisting your clients with their legacy loan book transition? Who in your experience has been initiating legacy transition discussions (borrowers/lenders/facility agents) and what are the key areas that you are being asked to advise on?

While we have discussed legacy loans with a lot of clients, we have not yet been instructed to formally start the process. We have mainly been contacted by lenders or facility agents and the key points of discussion have been about how to best manage the process, what type of conditions precedent should be requested and whether any of the security would need to be amended or re-taken.

However, our experience is that lenders' immediate focus is on how to address LIBOR discontinuation for new loans.

How are you seeing differences in currency conventions and timelines impacting the approach to multicurrency transactions?

In ship finance and real estate finance most of our transactions do not involve a multicurrency loan. Therefore, we have adapted the LMA rate switch provisions and simplified them to refer only to one currency.

We do encounter multicurrency facilities more frequently in our leveraged finance work. However, until recently our clients have tended to opt for the LMA's recommended replacement of screen rate mechanics (for the reasons discussed earlier). We have noticed a recent shift towards rate switch agreements or "Day 1" RFR-referencing agreements, but it is still early days.

A key point this year will be the education of individuals in the loan market who have not been as involved in LIBOR transition to date (and who won't necessarily read these LMA updates). For example, there will be many lawyers within law firms who have responsibility for drafting of loan documentation but who may not yet have an understanding of the loan conventions and new LMA documentation. In addition, often times, the default is to pick up the documentation from the last deal and then just put in the latest LMA updates. This of course becomes more complex with such a big change to documentation. How are you approaching education of your fee-earners given the importance of ensuring everyone working on loan documentation is up to speed?

Educating the draftsperson is indeed very important. We have run various sessions with our fee-earners as early as 2019. Some of these sessions have been of a general nature and others have been delivered as workshops with smaller groups, allowing participants to ask questions. However, as with any change in practice, the best way to retain knowledge is when you actually apply what you have learned to a real transaction. We have provided our teams with all the templates, practice notes and other tools they need to amend legacy loans or prepare new loans with rate switch provisions or to prepare day 1-RFR loans and they have access to the PSL who have prepared these documents for any questions they may have in relation to a particular deal.

And finally, from your perspective, is there anything else that you think is needed to support LIBOR transition for the loan market?

From the ship finance perspective and the USD loan market using LMA-based forms of English law loan agreements, we think that it would be really helpful that the relevant regulators or authorities officially confirm the final milestones for USD loans. The FCA announcement of 5 March 2021 was a welcome development and we now know that 1-month, 3-month and 6-month USD LIBOR settings will cease to be representative on 30 June 2023 but the date when these settings will cease to be published remains to be confirmed. We also hope that the ARRC will publish some updated milestones to confirm when new loans should stop referencing USD LIBOR (the previous milestone of 30 June 2021 has not been officially amended, although latest statements refer to this happening as soon as possible and no later than 31 December 2021) and by when legacy loans should be amended (we assume that this is now by 30 June 2023). We also think that it would be helpful to have fewer options in terms of what lenders can use to calculate interest (e.g. simple vs compounded SOFR, even references to a potential Term SOFR) so that there is less decision-paralysis.

Dora, thank you so much for taking the time to answer all of these questions and there is certainly a lot there for law firms and loan market participants more broadly to be thinking about. I think this interview will be really helpful insight into how law firms are looking at this and ensuring fee-earners are up to speed.

Thank you once again, Kam. Wider thanks to the LMA which has been and, I am sure, will continue to be instrumental in this process.

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To access the LMA LIBOR Microsite, please visit: www.lma.eu.com/libor.