SLAUGHTER AND MAY

Transforming Interest Rate Benchmarks

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LMA's Compounded Rates Facilities Agreements - key points for borrowers

Syndicated loans are trickier to transition to risk-free rates (**RFRs**) than certain other financial instruments. For the syndicated market to function efficiently using RFRs, calculation methodologies and market conventions will need to be standardised to a substantial degree. Pricing structures will require adjustment compared to LIBOR-based norms. The use of RFRs in place of LIBOR also gives rise to questions about the continuing relevance of certain long-established documentation terms.

To provide market participants with a focal point for evaluating these issues, the Loan Market Association (**LMA**) has produced two draft term and revolving facilities agreements referencing RFRs: a sterling facility referencing SONIA and a dollar facility referencing SOFR (the **Exposure Drafts**).

This briefing highlights some of the key features of the Exposure Drafts of particular interest to borrowers.

Exposure Drafts not LMA recommended forms

There is, as yet, no market practice and therefore no official market infrastructure to support RFR-linked syndicated lending. The Exposure Drafts have been published to stimulate debate and provide a framework to facilitate the development of a RFR-linked syndicated loan market. The drafts contain significant optionality and placeholders in relation to the numerous issues to be worked through.

If transitioning the loan market to RFRs is not intended to result in any change to the all-in costs of a syndicated loan, the open questions highlighted in the Exposure Drafts might be viewed largely as issues for the lending community to solve with regulatory support. If that can be done on a timely basis, the borrower's role is to adapt its systems and operational practices to accommodate RFRs. However, transitioning to RFRs will involve some quite significant changes and choices in the context of loans, which borrowers will want to influence and anticipate by keeping up with relevant proposals.

The terms of the Exposure Drafts are already starting to be considered as the basis for the first English law syndicated deals. Those contemplating RFR-linked transactions will need to form a view on the open points as well as whether they are able to cope operationally with a RFR-linked facility in the absence of market-wide infrastructure.

Overnight RFRs compounded over a period

The FCA and the Bank of England have made clear that transitioning to RFRs requires market participants to work with the RFRs that are available now rather than waiting for forward-looking term rates to be developed.[1] The Exposure Drafts therefore provide for the use of the relevant overnight RFR, compounded in arrear to produce a percentage rate per annum that can be applied to the applicable interest period.

"I think the prevailing view [in the sterling] risk-free rate working group... is that overnight SONIA compounded in arrears, will and should become the norm in bilateral and syndicated loan markets too. The desire to use a common reference rate across linked markets... can be expected to exert strong gravitational pull towards the overnight rates in all markets. This context is one reason why we think that any firms still delaying transition until term rates arrive are making a mistake."

Andrew Bailey, July 2019

A compounded rather than an average rate was chosen for the Exposure Drafts as it is consistent with practice in other RFR-referencing financial instruments. It is also consistent with practice in the derivatives market. To hedge SONIA over a period, for example, ISDA terms use compounded SONIA and ISDA's definitions include a widely used mathematical formula for compounding the relevant RFR.

Compounding methodology not specified

In the Exposure Drafts, the "Reference Rate" i.e. the compounded RFR, is identified using a waterfall approach.

The agreements firstly provide for the use of a "Primary Screen Rate", but (in the absence of any "official" Screen Rate source of compounded RFRs in sterling or USD) do not specify its source. Instead, there is an option for the identification of a Primary Screen Rate with the consent of a specified number of lenders should one become available after the date of the agreement.

If there is no Primary Screen Rate, the Reference Rate is a "Fallback Compounded Rate". This is the compounded RFR calculated by the Agent in accordance with an agreed calculation methodology.

The Exposure Drafts do not specify a calculation methodology that would enable the manual calculation of the Fallback Compounded Rate. The parties could choose to follow the conventions used in the OIS market and reflected in

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[1] When any term rates derived from RFRs will be available remains uncertain. As far as we are aware, the Bank of England is still aiming to make a SONIA term rate available in early 2020. However, the ARRC (the US RFR Working Group) has stated that a SOFR term rate is unlikely to be feasible before 2021.

the ISDA definitions mentioned above. This would be broadly consistent with the approach adopted in the RFR-linked FRNs issued so far.

It is understood that the ISDA-style compounding formula was omitted from the Exposure Drafts as some market participants have raised technical questions about whether certain of the inputs used in other products are appropriate for loans. For example, should the RFR be compounded on all days during the period or just Business Days? What is the appropriate rounding convention?

Will “official” Screen Rates or rate calculators be made available?

Reaching consensus on the technical details of how a compounded RFR is to be calculated is important as it will enable infrastructure providers to move forward with the development of rate calculators and Screen Rates. Our expectation is that there will be an official source of compounded RFRs in due course. The most likely means of achieving consensus would seem to be for the relevant regulators or third party rate vendors to commission or develop the required infrastructure based on a suggested methodology, on which consensus can be achieved by market consultation.

The Federal Reserve has recently taken some decisive steps towards this goal. It is consulting on a proposal to publish three backward-looking compounded averages of SOFR (i.e. historic rates) with tenors of 30, 90 and 180 calendar days. It is also proposing to publish a SOFR index, which would enable the calculation of compounded SOFR over custom time periods. The consultation, which closes on 4 December, outlines the proposed calculation methodology and poses a number of questions to market participants on the parameters of the inputs and outputs.

The UK authorities have not indicated that they intend to produce any compounded SONIA Screen Rate or index or rate calculator, which suggests that third party vendors will need to step into the gap. The Explanatory Notes to the Exposure Drafts underline that the LMA has emphasised to the relevant authorities the importance of this infrastructure.

Observation Period vs Interest Period

The use of an overnight RFR, compounded in arrear, means that the amount of interest payable will not be known until each overnight rate within the relevant period has been published and the compounding calculation completed. As this is unlikely to give borrowers and Agents enough time to mobilise payments, a mechanism that enables the amount of interest payable to be determined in advance of the end of the period is required. There are a number of ways to achieve this.[2] The Exposure Drafts adopt the "lag" approach as this is consistent with SONIA-linked FRNs and other RFR-linked financial instruments. A "lag" is also the preferred solution based on market feedback to date.

In the Exposure Drafts, the RFR is compounded over an "Observation Period". This Observation Period starts a certain number of Business Days prior to the start of the interest period and ends a certain number of Business Days prior to the end of the interest period. The length of the "lag" (the number of Business Days by which the beginning and end of the Observation Period differs from the interest period) is not specified.

The length of the lag has been left blank as it is one of the many issues that the market needs to work through. In the sterling FRN market, a 5 Business Day lag has become customary in the context of 3 month interest periods. In the loan market, where the length of interest periods may vary, parties will need to weigh up the extent of advance notice required against how precisely they wish to track the relevant RFR over the period. For very short interest periods, for example, a 5 Business Day lag may mean the Observation Period overlaps only minimally with the interest period or even (if the interest period is less than 5 Business Days), not at all.

Whether there is incentive to adopt a more complex solution that varies the length of the lag for different interest periods may depend on parties' perceptions of how the RFRs behave over time. The outcome will no doubt be influenced in part by practical and administrative considerations.

Observation Period vs Interest Period (2)

Another open and complicated question is whether the "type" of days in the Observation Period should be adjusted to match the number of those types of days in the interest period.

RFRs are not published on non-Business Days in the country of the relevant currency. Whether there is a commercial impetus to match the "type" of days (e.g. Business Days and non-Business Days) in the Observation Period and the interest period may depend on whether it is determined (in accordance with swap market conventions) that compounding should take place on non-Business Days. Whether the preceding or subsequent day's rates are to be compounded on non-Business Days during the period - or whether there is no compounding on those days (and non-Business Days are thus taken into account only in the input number of days for the purposes of calculating the percentage rate over the period) - remains to be determined in the context of lending transactions.

[2] The main alternatives are discussed in the Sterling Working Group's paper "Conventions for Referencing SONIA".

The potential challenge of calculating the "winner" and "loser" based on either method at any point in time might suggest that the market will gravitate towards the more straightforward approach. It certainly seems likely that Agents will want only one approach to be adopted, rather than having to determine deal by deal whether calculations need to be adjusted or not. The Exposure Drafts do not express a view on how to address this point, although the Explanatory Notes contain some drafting suggestions for achieving a "matched" outcome if that is desired. Again, this raises the question of whether it would be helpful for the official sector and/or third party rate vendors to put forward a proposal for the market to react to in a consultation.

A new approach to funding costs

The transition from LIBOR to RFRs should be mechanical. The project is about shifting from one available benchmark to another. It is not reflective of an underlying change in lenders' funding practices nor is it intended or expected to affect the economics of the syndicated lending product – or indeed that of any other type of cash instrument. It does, however, require adjustment to the current "benchmark plus Margin" pricing model used in lending transactions.

LIBOR is not a precise representation of each lender's funding costs, but it broadly represents the costs of term funding in the London market. RFRs do not measure lenders' term funding costs in the same way as LIBOR. If lenders are to maintain yields on loan assets as the market moves to RFRs, funding costs will need to be built into pricing structures in another way.

The Exposure Drafts put forward two options for the pricing of a SONIA-linked or SOFR-linked loan. Interest is either the sum of:

- Option 1 - the Reference Rate (i.e. the compounded RFR) and the Margin; or
- Option 2 - the "Adjusted Reference Rate" and the Margin.

Option 1 is clearly the more straightforward option; the margin is increased to incorporate the cushion for funding costs that was previously inherent in LIBOR.

Option 2 involves adjusting the compounded RFR by an amount designed to be a proxy for the lenders' funding costs. The Exposure Drafts contain a placeholder for the specification of this adjustment, the "RR Adjustment Spread". How might such an adjustment be calculated? Who will calculate it? Would it be provided by a third party vendor? Will it be dynamic? If so, will it be capable of hedging? All of these questions need to be considered.

How pricing will be structured going forward is clearly an issue of headline concern to borrowers. The current lack of proposals for addressing Option 2 on a market-wide basis might suggest that Option 1 is the most likely to gain traction.

Could market disruption provisions (finally) become obsolete?

The LMA's market disruption provisions are intended to protect lenders against disruption in the inter-bank funding market. In summary, they provide that if a sufficient number of lenders notify the Agent that they are unable to fund themselves at LIBOR, interest shall be calculated by reference to the lenders' actual cost of funds rather than LIBOR.

These provisions have long been conceptually problematic from the borrower's perspective because in many deals, lenders' funding costs are such that they are theoretically capable of trigger from the date the agreement is signed. Like LIBOR itself, the provisions might be viewed as predicated on a funding model that does not reflect economic reality. As the loan market moves from LIBOR, which is intended as a proxy for term funding costs, to a pricing model built on a RFR that does not share that characteristic, such provisions may be viewed as obsolete.

The Exposure Drafts acknowledge this argument and present the market disruption provisions as optional. However, the drafts do suggest that if an Adjusted Reference Rate pricing model is adopted (Option 2 as explained above) and the pricing incorporates an overt proxy for funding costs, the parties may choose to retain the market disruption provisions.

How market practice might develop here is unclear. In the financial markets generally, lenders tend to be reluctant to let go of protections rooted in years of precedent. As the first RFR-linked loans are put together, they will no doubt be based largely on the relevant borrower's existing terms. Borrowers and their advisers might take the view that provisions such as market disruption clauses should only be retained (in an appropriately modified form) if there is justification for doing so.

Is the concept of Break Costs redundant?

The concept of Break Costs is similarly predicated on the assumption of term funding in the inter-bank market. Break Costs are payable to compensate the lenders for their broken funding costs if a loan is repaid in the middle of an interest period (i.e. the interest they would have earned to cover their matched term funding had the loan been repaid at the end of the interest period).

As the market moves to RFRs that are not a proxy for funding costs in the same way as LIBOR, Break Costs are another example of an established practice that arguably becomes redundant. From the borrower's point of view, this is clearly the preferable outcome. However, some lenders may feel that some concept akin to Break Costs should be retained. They might argue that the existence of Break Costs makes borrowers think carefully before prepaying a loan mid-interest period. More frequent ad hoc prepayments could be administratively burdensome for lenders and would (it is suggested) still result in broken funding costs of some sort.

The Exposure Drafts present Break Costs as an optional provision. They note that in the new world of RFRs, the question of whether and how Break Costs are to be quantified needs to be revisited.

What are the fallbacks for a compounded RFR?

The anticipated demise of LIBOR has thrown the importance of fallback rates into sharp focus. Existing fallbacks are insufficient to cater for the current situation, hence attempts to provide, in LIBOR deals being signed now, for the adoption of new fallbacks without the need to obtain unanimous Lender consent using the LMA's "Replacement of Screen Rate" language.

The fallbacks from LIBOR specified in current LMA terms are not thought appropriate for a RFR-linked loan for a number of reasons. First, certain aspects of current fallback provisions have fallen out of favour as either undesirable or unreliable - for example, Reference Bank Rates and the use of historic screen rates. Secondly, RFRs are economically different to LIBOR - as they are not a proxy for term funding costs.

If SONIA or SOFR is not available and the Reference Rate cannot be calculated on that basis, the Exposure Drafts provide for the substitution of a Central Bank rate in the compounding calculation. For sterling this is the Bank of England Base Rate. For dollars the suggestion is the Short Term Interest Rate Target set by the US Federal Open Markets Committee. To cater for discrepancies between these rates and the RFR, provision is made for an optional spread adjustment (the sterling Base Rate, for example, is typically lower than SONIA).

The use of Central Bank rates as fallback rates should mean fallback provisions are as robust as they can possibly be, which raises the question of whether any further fallback is necessary. The LMA has retained lenders' cost of funds as an optional ultimate fallback rate, but noting that a cost of funds fallback is only likely to be relevant if the "Adjusted Reference Rate" is used as the basis of pricing (see Option 2 above). This is because if pricing comprises the RFR plus Margin (i.e. Option 1 above), a fallback from the RFR to cost of funds would result in some double counting in terms of funding costs payable by the borrower as part of the interest calculation.

The implication that a cost of funds fallback is not needed if pricing is structured on the basis of Option 1 begs the question of whether cost of funds (or any ultimate fallback) is needed at all. If (as has been suggested on behalf of the LMA), the possibility that a Central Bank rate is unavailable cannot be ruled out entirely, why would an ultimate fallback not be put forward for both options? The Explanatory Notes acknowledge that the parties will need to take a view on whether an ultimate fallback is required.

It is also worth noting that the Exposure Drafts include the "Replacement of Screen Rate" language which should facilitate amendments to the agreement should the fallback provisions be triggered.

No multi-currency options (yet)

The Exposure Drafts are single currency facilities. The LMA decided to focus on USD and sterling facilities initially as the approach to using RFRs is most developed in these currencies. We understand that the LMA is working on a multi-currency facility capable of being drawn in sterling, USD, euro and CHF. When that will be published remains unclear.

It is thought likely that documentation for RFR-linked loans in other currencies will follow any market consensus that develops for sterling and dollars as far as possible, but there will inevitably be some discrepancies given the disparities between the RFRs by currency. For example, the RFRs for different currencies are published at different times, which will need to be reflected in documentation and operational practices. Perhaps more significantly, in the investment grade syndicated loan market, multi-currency facilities typically adopt a single margin applicable to drawings in the base currency and any optional currencies alike. The RFRs do not operate as a proxy for lenders' funding costs in the relevant currency in the same way as LIBOR. Could that mean that margins will differ by currency in multi-currency facilities going forward (necessitating more complicated tranching arrangements)?

The currency-by-currency approach to RFRs is potentially a key obstacle to the growth of the RFR-linked syndicated loan market. While significant efforts are being made to co-ordinate the output of the Working Groups looking at each LIBOR currency, the multi-currency features of many syndicated loans means that the market cannot transition fully until all of the relevant jigsaw pieces are available.

What can borrowers do now?

A priority for borrowers, especially those whose syndicated facilities are likely to require refinancing in the next two years, is to discuss internal progress towards RFR-linked loans with their relationship banks to gauge the direction of travel. Are they developing pilot products? When do they expect these to be ready? What are the key features? What are they doing to ensure that RFR-linked products will be available within the required timeframes?

Some borrowers may also have views on the design of RFR-linked loans – especially the practical implications of some of the questions raised in the Exposure Drafts. For example, should consistency across products be prioritised above solutions tailored specifically for the loan market?

It is important that the regulators and working groups who are pushing this process forward have as much information as possible about the barriers to transition within what is looking like an increasingly tight deadline, especially for multi-currency products. Steps are being taken to ensure that borrowers' views are taken into account. The Association of Corporate Treasurers is actively involved in a number of the official sector working groups and is collating views on this topic from finance and treasury professionals. Comments on the Exposure Drafts may also be sent directly to the LMA at lma@lma.eu.com, headed "Market Feedback on Exposure Drafts of Compounded RFR Facilities Agreement".

Slaughter and May are closely monitoring developments in relation to the transition from LIBOR, EURIBOR, EONIA and other major benchmarks across all of the major financial products. For further information, please contact any of the lawyers listed below or your usual adviser at Slaughter and May.

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