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THE TRANSITION FROM LIBOR TO SONIA

It is unlikely to have escaped your attention that LIBOR, the "London interbank offered rate" which appears as a base benchmark rate in countless corporate loans, is living on borrowed time. LIBOR will disappear at the end of 2021 and most UK lenders are transitioning to a new "risk free rate" known as SONIA, the "sterling overnight index average".

This briefing note considers LIBOR and SONIA, highlighting the key difference between the two and what the transition means for corporate borrowers.

WHAT IS LIBOR?

LIBOR is determined by calculating the average rate at which a group of 20 leading banks can borrow money from each other in the wholesale London lending markets on unsecured terms in five key currencies for different lengths of time. The borrowing bank would then (in theory) lend out this money to its customer at LIBOR plus a margin (being its own profit element), with the aggregate of the two being the overall interest rate charged to a borrower. LIBOR is set at the start of each agreed interest period, which will be set out in the relevant loan documentation. Margin is mostly fixed at the outset of the loan so does not change for the duration of the loan. The combination of the two gives borrowers certainty over how much interest they are going to pay at the end of each agreed interest period.

The widespread manipulation of LIBOR after the global financial crisis, together with the dwindling number of interbank borrowing transactions caused regulators to question LIBOR's future. For instance, there were only 15 interbank lending transactions of an appropriate tenor and size in 2019 for LIBOR setting purposes – hardly enough to produce a reliable industry benchmark!

Accordingly, regulators have decided it is appropriate to move away from LIBOR towards a risk free rate or "RFR". A RFR is a rate of return on an investment with zero risk of financial loss. SONIA, which is administered by the Bank of England, is the chosen RFR for sterling loans.

WHAT IS SONIA?

The SONIA rate is based on actual overnight interest rates in active and liquid wholesale cash and derivative markets - making it more robust and less volatile than LIBOR. It is also (virtually) risk free as it does not incorporate any credit risk/liquidity premium which is inherent in the calculation of LIBOR because LIBOR is predicated on banks lending to each other over longer time periods.

WHAT IS THE KEY DIFFERENCE BETWEEN LIBOR AND SONIA?

The key difference is that LIBOR is forward-looking – it is agreed at the start of an interest period. SONIA is backward-looking – it cannot be determined until the end of an agreed interest period. This means that borrowers will no longer have upfront certainty about the amount of their interest payments, and will require relatively last-minute calculations of the interest due.

The solution which has been developed by market participants to mitigate the effect of this key difference is to:

- aggregate SONIA rates on a compounded basis over an interest period to produce a term interest rate. What this means in practice is that the interest rate on a SONIA loan will essentially be reset on a daily basis, e.g. a 3 month interest period would be made up of 3 months' worth of daily rates; and
- use a "lag period" and "observation shift" to reference the SONIA rate because the actual interest rate using compounded SONIA and the related interest payment amount would only be known at the end of the interest period. What this means is:
    - the period over which the daily SONIA rate is compounded "lags" the interest period by, say, 5 working days before the start and end of the interest period;
    - the "observation shift" results in interest being calculated from the start of the lag period to the end of the lag period; and
    - this allows the compounded rate and related interest payment to be known (in this example) 5 days before the interest payment date. This will provide borrowers with a working week to move funds (if needed) in order to meet the interest payment.

However, this solution still does not enable rates to be fixed at the start of an interest period, like they are when using LIBOR. That will only be possible when a forward-looking SONIA term rate is developed (currently a work in progress – more on this below).

WHAT DOES THE TRANSITION MEAN FOR BORROWERS?

Pricing

Will SONIA based loans be cheaper? Probably not. We are already seeing that lenders will want the same "all in" interest rate return. SONIA is lower than LIBOR because it does not include the credit/liquidity risk premium noted above. Lenders are therefore likely to increase the margin or add a "credit adjustment spread" to cover the difference.

Reduced certainty over interest rates and payments

It is clearly a big change for borrowers to move from a forward-looking rate to a backward-looking one, even with a lag period and observation shift. However, borrowers can draw comfort from SONIA historically being less volatile (and usually lower) than LIBOR and tracking the Bank of England base rate very closely.

Moreover, the impact of the transition may be felt less keenly by real estate finance borrowers who, unlike trading businesses, should have a relatively consistent and stable income deriving from the rent paid by their tenants. That said, borrowers may need to manage their cash more actively towards the end of the lag period to ensure they have sufficient funds to meet their interest payments.

Documents and documentary amendments

- **Existing/legacy loans**: lenders and borrowers should review their facility agreements. Changes to existing loans are likely to be required to transition to SONIA, even where those facility agreements incorporate interest rate benchmark fallback provisions (often referred to as “replacement of screen rate” clauses). There may be a market-wide protocol to enable a seamless a transition as possible, or a lender may develop its own bespoke protocol to apply to all of the LIBOR based loans in its book. How these changes can be effected will be governed to some extent by the amendments provisions in the underlying facility agreement – in some cases, lenders may need to obtain borrower consent, whereas in others they may be able to make the change on notifying the borrower (i.e. without the requirement to obtain borrower consent).
- **New loans:** many lenders will stop offering LIBOR based loans by the second half of 2020. Facility agreements entered into between now and then should contain appropriate provisions to adopt an alternative approach when LIBOR is discontinued. Many lenders already have SONIA-based loan templates which could be used on and from day 1 – there is no need to wait for LIBOR to stop being published.

Break costs

Break costs, currently charged when borrowers repay an amount during an interest period, will (in theory) no longer be required if loans will no longer be priced against a forward-looking term interest rate benchmark. In place of break costs, lenders may require additional or increased prepayment fees to compensate them.

Hedging

Many term loans are hedged by interest rate swaps. Changing the benchmark rate within the main facility agreement is likely to cause a mismatch in payments within the related hedging documents. Borrowers should remind lenders that changes will be required across their hedging products as part of the transition.

Operational challenges

Lenders and facility agents will need to make operational changes and ensure that they have the necessary systems in place to manage the different benchmarks, including varying calculation methodologies and different times of publication during the day.

Will there be a forward-looking SONIA term rate?

Many loan market participants have said that a forward-looking SONIA term rate set at the beginning of the relevant period is essential to provide borrowers with visibility and financial certainty on their interest payments. That is not in issue. Indeed, the desire to have such a rate is one of the main reasons why the transition to SONIA in the loan markets has been quite slow – participants were hoping that a forward-looking rate would be ready by now, but it is taking time. The transition to SONIA is going to happen at end of next year or earlier, so lenders and borrowers will likely have to use compounded SONIA and the lag period/observation shift in the meantime.

The impact of COVID-19 on LIBOR transition

The COVID-19 pandemic has not altered the main assumption that lenders and borrowers cannot rely on LIBOR being published after the end of 2021.

Earlier this year, the Bank of England published a roadmap setting out various milestones and deadlines to enable a smoother transition, including one requiring funders to stop writing LIBOR-linked loans by the end of Q3 2020 (as noted above). But in a statement released on 25 March 2020, the Financial Conduct Authority, the Bank of England and members of the Working Group on Sterling Risk-Free Reference Rates noted that the coronavirus will have "an impact on the timing of some aspects of the transition programmes of many firms". We know that the UK loan market has made less progress in transition to date and remains very reliant on LIBOR, so the Q3 deadline for the cessation of new sterling LIBOR-linked loans may not be hit. We shall see…

Transition timing update: as we surmised above, the COVID-19 pandemic has indeed hit transition timing for LIBOR-linked loans. The Working Group on Sterling Risk-Free Rates issued a further statement on 29 April 2020 in which it noted that the original end Q3 2020 target was no longer feasible because the continued use of new LIBOR linked loans into Q4 2020 was necessary to, among other things, maintain the smooth flow of credit to the real economy in light of the pandemic. The Working Group has recommended that the original Q3 2020 target for no new LIBOR linked loans be pushed back to Q1 2021.

KEY CONTACTS

For further information about any of the issues raised in this guide, please contact:

Andrew Dodds
Partner
T: +44 (0)1483 734265
M: +44 (0)7557 677237
E: andrew.dodds@stevens-bolton.com

Estelle Macleod
PSL
T: +44 (0)1483 406962
M: +44 (0)7583 024524
E: estelle.macleod@stevens-bolton.com

Laura Barrett
Associate
T: +44 (0)1483 401214
M: +44 (0)7970 139413
E: laura.barrett@stevens-bolton.com