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LIBOR and the transition to SONIA: compounding the problem?

September 2019

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Introduction

In 2012, the Wheatley Review recommended reform rather than replacement of LIBOR, on the basis that a transition to a new benchmark would pose an unacceptably high risk of financial instability. Reform came in the form of a new administrator of LIBOR, a reduced number of supported currencies and maturities, and a new criminal offence through the Financial Services Act 2012. Nevertheless, in July 2017, the chief executive of the Financial Conduct Authority, Andrew Bailey, recommended that LIBOR be phased out by 2021. This article is the first in a series of articles from us, exploring the various alternative reference rates that will ultimately replace LIBOR. Here we focus on SONIA, being the sterling replacement for LIBOR. Whilst already actively used elsewhere, there is currently little use of the SONIA rate in the loan market. In this article, we will consider next steps for participants in the loan market in keeping pace with other sectors of the market.

Background

Sterling Rate: SONIA

On 7 April 2017, the Bank of England Working Group on Sterling Risk-Free Reference Rates (the "**Working Group**") selected the Sterling Overnight Index Average (or SONIA) as the preferred alternative to sterling LIBOR. SONIA measures the average of rates paid on overnight unsecured wholesale funds, denominated in sterling. In its original form therefore, it was a backward-looking overnight rate, with the interest rate being determined and published after the period.

Since the announcement, a number of sectors of the market have already transitioned across to SONIA. Speaking in July of this year, Andrew Bailey described SONIA as the market norm for new issuances of sterling floating rate notes (from financial institutions and public sector issuers), with no new unsecured listed public bonds referencing sterling LIBOR fixed past the end of 2021 since October of last year. Separately, in the derivatives market, SONIA accounted for a little over 45 per cent of notional swaps trading in sterling in the first half of this year. By comparison, the loan market is less advanced. Whilst there have been reported uses of SONIA in bilateral loans, at the time of writing, there is no use in the syndicated loan market that we are aware of.

Term Rates

In September 2018, the FCA and the Prudential Regulation Authority (PRA) had written to the CEOs of major banks and insurers asking for details of their preparations and actions in managing the transition from LIBOR. Reporting their findings in June, the FCA and PRA noted that a number of firms were waiting for a "market" solution and the need for a forward-looking term rate was identified as one of the main reasons for the slow progress in the loan market. Loan market participants voiced that forward-looking term rates were essential as the rate is set at the beginning of the relevant period, providing borrowers with visibility and financial certainty on the total interest payable at the end of that interest period.

In its July 2018 consultation paper, the Working Group noted that a forward-looking rate could be developed based on derivatives of the overnight rate, with the most feasible and robust methodology being the weighted average mid-point of the best, firm bids and offer quotes for listed SONIA-OIS products. Given that SONIA dates back to 1997 and has been used in the sterling overnight interest swap (OIS) market for many years, there is ample liquidity in the market. However, data outputs are not readily available as trading is predominately through the voice OTC market rather than a regulated electronic platform from which data may be gathered. Whilst, therefore, a term rate is a possibility (with three potential providers expressing their intention to develop a forward-looking term rate), the OIS market would need to evolve before a term rate could be made available. Best estimates suggest that a rate will not be available until the first quarter of 2020. Accordingly, in June, the Working Group, the FCA and the Bank of England stressed that whilst work will continue on developing a term rate, market participants should not wait for the availability of a term rate before making the transition. In fact, parties are advised to accelerate progress towards an immediate transition as soon as a suitable alternative becomes available (see below).

Compounding

In March 2019, the Working Group launched a discussion paper referencing alternatives to a term rate suitable for the loan market. A number of suggestions were put forward, with the most popular being compounding – whereby the daily rates are compounded over a period matching the length of the given interest period. Given participants of the loan market require details of the amount due ahead of the payment date, it was suggested that the observation period could either be set: (i) entirely in advance of the interest period (for example, for a three (3) month interest period, measuring the rates during the three (3) months immediately before the start of the interest period) or; (ii) in arrears (which involves the use of a "lag" mechanism, in which a slightly different observation period is used as against the interest period, commencing five (5) business days ahead of the relevant interest period, as seen in the bond world). In this latter case, the borrower therefore has five (5) business days to arrange the necessary interest payment, although it is acknowledged that a slightly longer period may be required for the loan market to ensure there is cash flow certainty.

Currently, the preference is towards compounding in arrears using the 'lag' approach given that operationally it may be easier to administer and reflects the rates during the relevant interest period (or as close as operationally feasible to the interest period) rather than the use of historic rates from a potentially significantly earlier time period, as seen with the compounding in advance methodology. This methodology has also been successfully used in a number of SONIA-linked note issuances. Speaking in July, Andrew Bailey stated that compounding in arrears should become the norm in bilateral and syndicated loan markets. He also stressed that whilst work will continue on term rates, its use should be limited to niche sections of the cash markets rather than applied widely and accordingly this methodology was advocated for long-term use, not a stop-gap.

The transition to SONIA and other considerations

The Amendment Process

Given the emphasis placed on making the transition speedily, we turn our attention to actions that market participants can begin taking in readiness for this new benchmark. Firstly, there are changes that can be made to documentation now. Speaking earlier this year, the Loan Market Association (the "**LMA**"), reiterated that there was no practical way of effecting the reference rate changes without amending each loan agreement individually. Instead, it has advocated the use of its Replacement of Screen Rate clause in the short-term, where appropriate, to aid the amendment process for syndicated loans by lowering the lender consent threshold from all-lender to a lower threshold (usually majority). Whilst the LMA version of this clause has been popular in the market, certain market participants have devised their own variation of this clause. With some documentation containing no such clause and others containing different permutations of it, lengthy discussions are anticipated around the consent thresholds needed to make the necessary amendments.

A by-product of these discussions is likely to be the yank-the-bank provisions. In certain top-tier sponsor deals, it has become common to see the yank-the-bank provisions apply should the Replacement of Screen Rate clause be invoked by the lenders. Whilst sponsors may have wanted to kerb the use of the Replacement of Screen Rate clause too often in ordinary circumstances, given the necessity of the transition to the new benchmark, it seems unlikely that sponsors will seek to rely on their yank-the-bank rights without due cause. In the meantime, market participants are advised to assess their loan documentation early to consider the applicable consent thresholds and, if appropriate, continue to include the Replacement of Screen Rate clause for any documentation currently being entered into that utilises the LIBOR benchmark.

New LMA Documentation

In terms of documentary changes that will be required once the new rate is available, the LMA is developing new standardised documentation for the syndicated loan market which will reference the proposed new SONIA rate, based on the compounding in arrears methodology. Drafts of a new form of facilities agreement for new loans and an amendment agreement to amend legacy loan agreements are expected in the autumn of this year.

The documentation is eagerly awaited given the complexity of the changes that are required, with the LMA noting a few points being considered as part of that exercise. Firstly, there is the issue of a spread adjustment. Currently, LIBOR rates take into account the bank's credit risk and term rate liquidity premia, whereas SONIA is understood to only include a nominal element of credit spread and will therefore produce a rate lower than the sterling LIBOR rate. A consultation is expected to be launched imminently on the correct spread to use in the cash markets to minimise the economic impact of moving to SONIA (with the LMA urging the loan market to respond, given its suggestion in August of this year that the outcome of the ISDA consultation may not be appropriate in all cases for the loan market). The LMA's Replacement of Screen Rate clause already contemplates adjustments to pricing in these circumstances and in due course, the proposed LMA documentation is expected to include the suggested spread adjustment formulation to bridge this gap.

A separate discussion point for documentation is whether it makes sense to retain the concept of break costs if we are compounding in arrears or whether it would be preferable to move to a prepayment fee structure instead (given the loan is not being priced against a term benchmark). Finally, there is the issue of new fallback options – presumably, the concept of reference banks will be completely removed, but will we still use cost of funds or will we move to using the SONIA term rate (assuming it is available)? There appears to be many questions to be answered and market participants, especially lenders, are advised to consider these points internally ahead of documentation being made available, to be ready with their own position on the changes that they require to documentation.

Related Documentation

A further consideration during the amendment process is related documentation. In the syndicated leveraged loan market, it is common to see hedging products that are tied to the loan agreement (for example a three (3)-year interest rate swap in respect of floating rate loans) as well as intra-group loan agreements that use the same interest calculation mechanics. Changing the benchmark rate within the main loan agreement is likely to cause a mismatch in payments within those related documents. It is therefore critical that parties investigate the changes required across all its financial products during this pre-amendment phase. Whilst the market can look to the LMA and ISDA for certain of these changes, sponsors may need to assess the plethora of intercompany loans within a portfolio of companies and make the necessary amendments to those too.

Operational Changes

Aside from the documentation issues, there are operational changes required. Agents need to ensure that they have the necessary systems in place to manage the different benchmarks, which are likely to encompass varying calculation methodologies and will be published at different times of the day (rather than 11:00 a.m. London time across all the currencies, as currently is the case). Financial institutions are encouraged to invest time now in obtaining the relevant technology, transferring legacy loans over to the new systems and being ready to transact on new loans. As part of this process, borrowers and Lenders/Agents will need to pay close attention to the funding timetable to ensure it accurately reflects the publication times for each relevant currency and gives them ample time to communicate rates and making the necessary payments. On a related point, whilst we are encouraged to transition across to SONIA for legacy contracts when documentation is available, this may be difficult for multicurrency loans where viable risk-free rates for other currencies are not available. For such loans, consideration will need to be given as to whether to amend the loan agreement immediately once documentation is available or to wait for the remaining risk free rates to be released to reflect all new rates in one-go. This may ultimately be a decision based on cost, but could result in parties needing to invoke the Replacement of Screen Rate clause on multiple occasions. Market participants are therefore advised to discuss the optimal amendment process early for each individual loan agreement.

Conclusion

Great progress has been made by the Working Group in identifying SONIA as the sterling alternative reference rate and its work in educating market participants on the compounded SONIA rate. The LMA is currently undertaking the arduous task of producing the necessary documentation needed to start the amendment process. The baton therefore now moves to loan market participants to get ready to make the transition – market participants should begin looking at documentation to consider consent thresholds and changes required, to keep abreast of the latest developments and to actively engage with and respond to consultations and other ongoing initiatives. The key message is that we need to focus on making a transition to SONIA now – we should not be waiting on term rates and we must embrace compounding as our friend. Whilst it is not an easy process, it is a necessary one and one we must start now.

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