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LIBOR transition – what drafting should I use in my new facility?

There has never been any doubt that the task of shifting the loans market away from LIBOR onto alternative "risk-free" benchmark rates ("**RFRs**") is a monumental one. However, over the past month we have seen a number of the pieces of the transition jigsaw start to fall into place and momentum is building apace. In particular, the Working Group on Sterling Risk-Free Reference Rates (the "**Sterling Working Group**") has published a number of key statements and recommendations, and the Loan Market Association ("**LMA**") has published various new and revised drafting and guidance.

In this article we explore some of the LMA drafting options currently available to a lender documenting a new or refinanced loan and flag some issues for lenders to bear in mind.

LIBOR transition milestones

As part of its work on LIBOR transition the Sterling Working Group has recommended that:

- By the end of Q3 2020 lenders should be in a position to offer non-LIBOR linked products to their customers.
- After the end of Q3 2020 lenders, working with their borrowers, should include clear contractual arrangements in all new and re-financed LIBOR-referencing loan products to facilitate conversion ahead of end-2021, through "*pre-agreed conversion terms*" or an "*agreed process for renegotiation*", to SONIA or other alternatives (the "**Q3 Milestone**").
- All new issuance of sterling LIBOR-referencing loan products that expire after the end of 2021 should cease by the end of Q1 2021.

The options currently available to a lender documenting a new facility

A lender wishing to document a new facility currently has three options available to it which would satisfy these milestones:

1. (Prior to 31 March 2021) the lender could offer its customers a facility which references LIBOR on day one, but which includes "*pre-agreed conversion terms*".
2. (Prior to 31 March 2021) the lender could offer its customers a facility which references LIBOR on day one, but which includes "*an agreed process for renegotiation*".
3. The lender could offer its customers a loan which doesn't reference LIBOR at all, but instead references a risk-free rate (or indeed any other non-LIBOR referencing benchmark rate) from day one.

As described below, each of these approaches (and the current associated drafting published by the LMA – much of which is still in "exposure draft" form) has potential advantages and disadvantages. The suitability of a particular approach will also always depend on a lender's internal progress with its LIBOR transition strategy. Each of the three options is discussed in turn below.

1. LMA options for documenting "*pre-agreed conversion terms*" – the Exposure Draft Rate Switch Agreement

On 11 September 2020 the LMA issued an "exposure draft" of a multicurrency rate switch agreement using lookback without observation shift methodology (the "**Exposure Draft Rate Switch

Agreement"). The LMA is currently inviting feedback on this document.

The Exposure Draft Rate Switch Agreement provides a "hardwired" approach to LIBOR transition, facilitating a change in reference rates from an initial term rate such as LIBOR to a RFR such as SONIA. It therefore constitutes "*pre-agreed conversion terms*" for the purpose of the Q3 Milestone.

Importantly, the Exposure Draft Rate Switch Agreement reflects, in documentary form, the recommendations of the Sterling Working Group on conventions for referencing SONIA compounded in arrears published on 1 September 2020 (the "**Sterling Recommended Loan Conventions**"). Therefore, for those lenders who have decided to implement, in full, the Sterling Recommended Loan Conventions, the Exposure Draft Rate Switch Agreement offers a turnkey mechanism for LIBOR transition which avoids the need for the parties to enter into a later negotiation and amendment process.

However, a lender considering using this drafting solution must be confident that the Sterling Recommended Loan Conventions align with the way in which that lender's systems and procedures have been (or will be) set up to address LIBOR transition. This is particularly important because, to date, different methodologies have been used in the market to calculate compounded SONIA in arrears.

For example, there have been two commonly used mechanisms for calculating compounded RFRs a few days before the interest payment date so as to ensure that in advance of the interest payment date the lender/agent can calculate the interest payable and provide sufficient notice to the borrower of how much interest it should pay. These mechanisms are "lookback *without* observation shift" (or "lag") and "lookback *with* observation shift". The LMA's Exposure Draft Rate Switch Agreement is based on the "lookback *without* observation shift" methodology (reflecting the recommendation of the Sterling Working Group). The different ways in which the two mechanisms work is unlikely to be economically significant. However, the calculations and methodology underpinning each works differently. This will obviously need to be reflected in the detailed drafting of a facility agreement, as well as within a lender's internal loan administration systems and processes.

Although the Sterling Working Group has recommended "lookback without observation shift" (and therefore this is the methodology reflected in the Exposure Draft Rate Switch Agreement), it has also acknowledged that "lookback with observation shift" remains a viable and acceptable alternative method for a lender to use. The LMA has recently announced that, shortly, it will also be producing an alternative rate switch agreement based on this methodology.

2. LMA options for documenting "an agreed process for renegotiation" – The Replacement of Screen Rate Clause and Supplement

The LMA's replacement of screen rate clause (the "**Replacement of Screen Rate Clause**") provides a mechanism for the parties to a syndicated facility agreement to agree a replacement benchmark rate using a lower consent threshold than would otherwise have been the case (a majority of, rather than all, lenders). A version of the Replacement of Screen Rate Clause catering specifically for LIBOR transition has been available since May 2018. The current version of the clause (which has been included in LMA recommended form agreements since February 2020) is the version which was published by the LMA in December 2018.

A Supplement to the Replacement of Screen Rate Clause (the "**Supplement**") was also published in August 2020, after the Sterling Working Group confirmed that the Replacement of Screen Rate Clause alone did not satisfy "*an agreed process for renegotiation*" for the purposes of its Q3 Milestone. In simple terms, the Supplement provides for the parties to set a date sufficiently ahead of the end of 2021 to agree, in good faith, the use of a replacement benchmark (with such negotiations to be concluded by a specified date ahead of the end of 2021).

Together the Replacement of Screen Rate Clause and the Supplement provide a quick and relatively non-contentious drafting solution which is capable of complying with the Sterling Working Group's Q3 Milestone. Furthermore, their use does not require a lender to have finalised the detail of its LIBOR transition strategy or its preferred methodologies for calculating a replacement benchmark rate.

Nonetheless there are some potential disadvantages:

- The Sterling Working Group has confirmed that "*the greatest certainty for borrowers and lenders will be achieved by setting out in advance the terms for conversion at a future date*" (i.e. by using "*pre-agreed conversion terms*" such as those set out in the Exposure Draft Rate Switch Agreement).

- The Replacement of Screen Rate Clause and Supplement assume that there will be a subsequent negotiation between the parties in relation to the replacement benchmark rate. Consequently, further negotiations over LIBOR transition will need to be held by the parties at a later date, and whatever is agreed between the parties will then need to be documented formally via an amendment to the facility agreement.
- The Supplement introduces two new dates which a lender/facility agent will need to factor into the loan administration process: one date by which negotiations relating to the replacement rate should begin and another date by which such negotiations should finish.
- Neither the Replacement of Screen Rate Clause nor the Supplement provide any new fallback mechanism if the parties cannot reach agreement on the replacement benchmark rate and the way it will work.
- The Supplement is expressed to be an agreement by the parties to negotiate in good faith. An agreement to negotiate in good faith may be held by an English court to be unenforceable. Consequently, law firms are unlikely to be unable to confirm the enforceability of this provision in any legal opinion they provide on the facility agreement.

3. Documenting and providing a facility which does not reference LIBOR from day one

From 30 September 2020 the Sterling Working Group has recommended that lenders should be in a position to offer non-LIBOR linked products to their customers. Many lenders should be able to satisfy this by offering their clients fixed rate loans or loans linked to a bank's base rate or to Bank of England base rate.

However, most lenders and borrowers acknowledge the benefits to the syndicated loan market of developing a loan product which references RFRs (such as SONIA and SOFR).

In October 2019 the LMA issued exposure drafts of two compounded RFR facilities agreements – one referencing SONIA and one referencing SOFR (the "**Exposure Draft Day 1 RFR Agreements**"). The Exposure Draft Day 1 RFR Agreements do not refer to LIBOR at all. Instead, from the outset the agreements reference SONIA or SOFR (as appropriate) as the relevant benchmark.

When the Exposure Draft Day 1 RFR Agreements were published there remained considerable uncertainty about a number of crucial issues relevant to the operation (and calculation) of the relevant risk-free rates. Consequently, the current exposure drafts include a number of blanks and placeholders.

However, the Sterling Recommended Loan Conventions have subsequently provided greater clarity in relation to a number of the areas of previous uncertainty and therefore it seems likely that an updated draft of the Exposure Draft Day 1 RFR Agreements will follow in due course. Pending any such update, it would be possible to import the drafting for compounded SONIA in arrears set out in the Exposure Draft Rate Switch Agreement. Nonetheless, as discussed above, there are potential disadvantages attached to the use of the Exposure Draft Rate Switch Agreement drafting – not least that the wording is not in "recommended form", that it reflects only one of several calculation conventions, and that the lender would need to have in place all the systems and operations which would be required to support lending referencing the relevant risk-free rate.

Of course for a lender for whom this is an option, offering a facility referencing a risk-free rate from day one is likely to be attractive because no further work relating to LIBOR transition would need to be taken for that facility.

Other currencies, jurisdictions, working groups and regulators

This article has had a clear focus on the work of the Sterling Working Group (whose recommendations underpin current LMA drafting).

However, LIBOR transition is a complex picture and involves a number of jurisdictions and their central banks/regulators.

LIBOR is currently calculated for five currencies (US dollars, sterling, euro, Swiss francs and Japanese yen). Generally, work in connection with transitioning away from LIBOR to a new risk-free rate has been undertaken by a "currency working group" for each currency. For understandable reasons, the currency working groups tend to operate in the currency's "home" jurisdiction. So, for example the Sterling Working Group has been working on sterling LIBOR transition in the UK and the ARRC has been working on US dollar LIBOR transition in the US.

However, as transition has been dealt with on a currency-by-currency basis, this has led to some divergences in approach. Whether or not this will impact on a facility will likely depend on:

(a) what regulatory regime(s) may apply to a lender in connection with the making available of the relevant facility; and

(b) whether the regulators in the relevant jurisdictions will take account of any failure to follow the recommendations of the relevant working party/ies.

Certainly in the UK the recommendations of the Sterling Working Group have been endorsed by the Bank of England and the Financial Conduct Authority ("**FCA**"). The FCA has also previously made it clear that LIBOR transition steps (or lack of them) taken by regulated firms will be a conduct issue (and are also relevant to issues such as treating customers fairly). Therefore, the UK regulators are likely to take into account a UK-regulated lender's failure to meet the milestone recommendations of the Sterling Working Group.

A lender with operations in a number of different jurisdictions will obviously need to ensure it is complying with all relevant regulation applicable to it and its facilities. However, no doubt such a lender will also want to try and achieve the greatest degree of operational and documentary consistency possible across its network. Therefore, when non-binding recommendations of the currency working groups are not completely consistent, there will be choices to be made.

The LMA's Exposure Draft Rate Switch Agreement highlights this well. The Sterling Recommended Loan Conventions have been applied throughout the Exposure Draft Rate Switch Agreement - including to currencies other than sterling (such as US dollars). The LMA explains that it has done this "*for reasons of simplicity and potential operational ease*".

However, the ARRC has issued its own recommendations for loans denominated in US dollars and, as the LMA guidance on the Exposure Draft Rate Switch Agreement points out, while there are similarities between the two sets of conventions, there are also some differences.

Looking ahead

Lenders will be relieved to hear that the complex picture for documenting new and refinanced loans which exists at present will probably be relatively short lived. 31 March 2021 is one of the key milestones set out by the Sterling Working Group. From that date lenders should cease to issue sterling LIBOR-referencing loan products that expire after the end of 2021.

Consequently, the next six months will inevitably see lenders moving away from documents referencing sterling LIBOR, and towards documents which reference alternative benchmark rates from the outset.

This article has looked at the drafting available to a lender documenting a new or refinanced facility. However, of course, this is only a part of the overall picture. Lenders will still have the substantial task of negotiating with each of their borrowers with an existing LIBOR-referencing loan in order to reach agreement on an alternative replacement benchmark rate before the end of 2021. The documentary solutions available to assist with this amendment process will no doubt become the subject of increased focus over the coming months.

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