STEPHENSON HARWOOD

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Current US dollar LIBOR transition options for ship finance lenders, agents and borrowers

Despite the pandemic, efforts to achieve a smooth transition of the loan market away from LIBOR and onto alternative "risk-free" benchmark rates ("**RFRs**") have not abated. Over the last four months, the position in both the UK and the US market has become much clearer, with the Working Group on Sterling Risk-Free Reference Rates (the "**SWG**") and the Alternative Reference Rates Committee (the "**ARRC**") publishing their respective final recommendations in terms of LIBOR transition. These recommendations have been approved by the Bank of England and the Financial Conduct Authority in the UK and by the Federal Reserve Board and the Federal Reserve Bank of New York in the US. Suggested drafting reflecting these recommendations has also been published by the Loan Market Association (the "**LMA**") for English law loan agreements and by the ARRC for US law loan agreements.

In this article, we will look at the key LIBOR transition milestones recommended by the SWG and the ARRC and explain the current LMA drafting options for ship finance lenders/agents and borrowers in respect of their existing or future US dollar loan agreements (or other relevant documentation). We will also answer some FAQs we have received from clients.

While this article is prepared in the context of conventional loans, some of the issues discussed can be similarly applied to other transaction types (e.g. sale and leaseback) to the extent they reference LIBOR in their operative provisions.

LIBOR transition milestones and recommendations

Although the SWG and the ARRC transition milestones are different, the steps to transition away from LIBOR are quite similar:

Step 1
Present position

"*Agreed process of renegotiation*" (e.g. replacement of screen rate clause). This is no longer recommended by the ARRC

OR

"*pre-agreed conversion terms*" (e.g. rate switch mechanism)

Step 2
by 31 March 2021 (SWG)
by 30 June 2021 (ARRC)

Reference to a RFR (e.g. SOFR) from Day 1 (with no reference to LIBOR)

The table below provides a very brief summary of the similarities and differences between the SWG recommendations and the ARRC recommendations in respect of the proposed rate switch mechanism and new benchmark for US dollars.

Similarities	Differences
• ***Trigger events for the rate switch:*** USD LIBOR ceases to be published (cessation trigger); USD LIBOR ceases to be representative (pre-cessation trigger); or as agreed between the parties. • ***Applicable RFR:*** SOFR. • ***Credit adjustment spread:*** Contemplated to ensure that the transition to SOFR is as economically neutral as possible (the SWG has recently recommended the use of the historical five-year median spread adjustment methodology, whereas the ARRC provides a waterfall of options). • ***Calculation on the basis of a lookback period without observation shift*** (although the SWG recommends five business days as a default, whereas the ARRC does not suggest a period). • ***Currency rounding:*** Two decimal places (for dollars). • ***Rate floor:*** Zero. • ***Day count convention:*** Actual/360 days. • ***Business Day conventions:*** For business days, holidays and weekends. • ***Break costs, market disruption and cost of funds:*** No recommendations (although the LMA provides some template drafting if these provisions are to apply to the new benchmark).	• ***Calculation of the interest rate:*** The SWG only recommends the transition to one alternative benchmark rate (daily non-cumulative compounded SOFR + credit adjustment spread), whereas the ARRC provides a waterfall of replacement rates: (i) forward term SOFR (which is not yet available) + adjustment; or, if not available, (ii) daily simple or, if the parties agree, compounded SOFR + adjustment; or, if not available, (iii) the rate selected by the borrower and the lender/agent + adjustment. Once the applicable replacement rate has been determined on the rate switch date, such rate will apply for the tenor of the loan. While the SWG foresees a much more limited need for the application of term RFRs (some examples being trade finance, Islamic finance or working capital facilities), the ARRC has identified term SOFR as the primary fallback. The ARRC expects that the second step in the waterfall (i.e. daily simple or compounded SOFR) is likely to become the default benchmark. While it recommends simple SOFR (as this is more straightforward to calculate and should not lead to a big difference from compounded SOFR), it recognises that parties are free to agree to use compounded SOFR, especially if they wish to align the calculation of interest with hedging agreements involved in their transaction (as the ISDA's approach is to compound the rate). • ***Rate rounding conventions:*** The ARRC recommends five decimal places, whereas the SWG recommends four decimal places.

Q1: Which milestones and recommendations apply to my loan?

One of the challenges with ship finance loans is to know which regulatory framework(s) will apply to any given loan. This is because regulators across the globe do not have a consolidated approach regarding LIBOR transition, and each jurisdiction's regulator has set up different transition milestones and recommendations.

In many ship finance transactions outside of the US domestic market, the loan agreement will be governed by English law (whether based on an LMA form or not) for the advance of a loan denominated in US dollars by a lender or a syndicate of lenders from different jurisdictions. In this scenario, it will be for the lender/agent to determine whether it should comply with the recommendations and deadlines of:

(i) the SWG as reflected in the LMA documents (because the loan agreement is governed by English law);

(ii) the ARRC as reflected in the LSTA documents (because it is a US dollar loan); or

(iii) its "home" jurisdiction(s) (which may depend on which branch or affiliate is lending, the lender's/agent's jurisdiction of incorporation and/or the location of its loan administration team).

This is particularly important because the recommended transition milestones of the SWG are different from those of the ARRC.

A lender's/agent's regulatory team will therefore need to determine:

(a) which regulatory regime(s) have jurisdiction/oversight of its lending activities (and which deadlines it should comply with);

(b) how to reconcile the different approaches between regimes where it is determined that it could be subject to different regimes; and

(c) whether it will be penalised if it does not follow the precise approach of any such regulatory regime.

Q2: I would like to include a rate switch mechanism in my English law loan agreement. Where do I start?

Our recommended starting point is the LMA rate switch agreement, which is based on a multi-currency term loan and revolving facility agreement (syndicated, single borrower). Legal advisers can adapt the rate switch provisions included in this LMA document to fit the form of loan agreement the parties would normally use in a ship finance transaction (whether bilateral or syndicated, for one or more borrowers and whether for a single loan or a multiple tranche loan). Then, the new schedules (with the replacement benchmark details and calculations) and any square bracketed wording will need to be amended to reflect the commercial agreement between the parties.

Q3: I would like to include a rate switch mechanism in my English law loan agreement and follow the ARRC recommendations. Can I use the LMA drafting or do I need to use the ARRC suggested language?

It is important to draw a distinction between the recommendations and the published drafting. The ARRC recommendations apply to US dollar loans in the US market, whereas the SWG recommendations apply to sterling loans in the UK market. The ARRC has published some drafting suggestions for US dollar loans under US law loan agreements which reflect the ARRC recommendations. On the other hand, the LMA has published some drafting suggestions for loans of various currencies (including US dollars) under English law loan agreements which reflect the SWG recommendations.

It is not currently clear how practice will develop with respect to US dollar loans documented under English law outside the US market. However, we expect that the parties to a London-led, English law, US dollar loan transaction involving mostly European banks will adopt the LMA drafting and therefore reflect the SWG conventions applied to SOFR.

If the intention is to amend an existing English law loan agreement or to enter into a new English law loan agreement (especially if it is or is to be based on the LMA form), it should be easier to insert the LMA rate switch mechanism provisions and adapt these to conform to the ARRC recommendations rather than to use the ARRC suggested drafting as a starting point. If, on the other hand, the loan agreement is governed by US law and based on the LSTA form, then the ARRC suggested wording is likely to be a better fit.

LMA drafting options

The remainder of this article will look at the LMA drafting options since we mostly draft (or review) English law loan agreements for our lender/agent and borrower clients.

Ship finance lenders/agents and borrowers of US dollar loans currently have three options:

1. To include the most up to date **LMA Replacement of Screen Rate clause** (as amended by an LMA Supplement published on 24 August 2020 and as further amended by another LMA Supplement published on 21 October 2020, which introduced a "pre-cessation" trigger concept based on non-representativeness). This clause provides that the parties will negotiate in good faith to replace the interest provisions at a future date with a new benchmark. The parties need to agree on a date from which the negotiations will start and another date by which they will end (such dates are likely to reflect the deadlines set out by the applicable regulatory regime(s)). For syndicated loans, it introduces a lower consent threshold (Majority Lenders, rather than all Lenders). Note that according to the SWG, the 2018 version of the Replacement of Screen Rate clause is not sufficient to constitute an "*agreed process of renegotiation*" and the August 2020 LMA Supplement needs to be incorporated in order to comply with its recommendations.
2. To include a "**rate switch**" mechanism allowing interest to be calculated on the basis of a new benchmark upon the occurrence of a trigger event. On 11 September 2020, the LMA published a marked-up LMA multi-currency loan agreement which includes rate switch mechanism provisions reflecting the SWG recommendations (including a schedule of compounded terms for US dollars).
3. To base the loan agreement on the **chosen benchmark (i.e. SOFR) from the outset** and not refer to LIBOR at all.

Q4: Which of these options is the most suitable for my new loan?

Each of these options has benefits and drawbacks, some of which are listed in the table below. A lender/agent will need to assess which option fits its LIBOR transition strategy.

Option	Benefits	Drawbacks
Replacement of Screen Rate clause	• Currently complies with the SWG recommendations. • Gives time for (i) the lender/agent and borrower to agree the commercial terms for the new rate, (ii) the LMA to publish its final recommended forms of rate switch mechanism provisions and (iii) the market and the lender's/agent's systems and working practices to settle. At this stage, the parties only need to agree dates: (a) one by which negotiations should start (based on our experience, this date is likely to be 31 March 2021), and (b) another by which the negotiated position/new rate will apply (based on our experience, this date is likely to be 30 September 2021).	• Does not comply with the ARRC recommendations. • A supplemental agreement would need to be entered into by the end of 2021 (or possibly by 30 September 2021) to amend the interest provisions (i.e. there will be further costs at a later stage). • The LMA clause does not provide a fallback mechanism if the parties cannot reach agreement on the replacement benchmark (except for the existing cost of funds clause which, for historical reasons, is likely to be commercially problematic and therefore not feasible). • The English courts may not recognise an agreement to negotiate in good faith as being enforceable. Consequently, most English law opinions will include a qualification on this point.

Option	Benefits	Drawbacks
Rate switch mechanism	• Complies with the ARRC recommendations and the SWG recommendations. • It allows the parties to rely on LIBOR until its discontinuation, while having a mechanism to switch to the new rate thereafter. Therefore, it avoids the need for a further supplemental agreement before 30 September 2021 (or by 31 December 2021 at the latest). • The LMA recommended provisions can be included in English law loan agreements (with adaptations to reflect the method that the lender or agent has chosen to calculate the new benchmark).	• The lender/agent and the borrower would need to agree the commercial terms relating to the new rate now (including areas where there is divergence between the ARRC and the SWG approaches). Market practice (and consequently documentation) is yet to settle and, until 31 March 2021, further market developments can be expected. At the time of writing, for the reasons stated, including a rate switch mechanism in club or syndicated financings is still rare. • The current LMA form is not yet a recommended form. However, any future changes are likely to be minimal and limited to adjustments to reflect market feedback.
Reference to new benchmark from day 1 (i.e. no reference to LIBOR)	• This is ahead of the current milestones. • There would be no need for negotiations and a supplemental agreement at a later date (unless there are changes to the commercial agreement).	• It means that the parties could agree now which benchmark will apply and how it will operate. As such, similar to the rate switch mechanism, this is problematic, especially in club or syndicated financings, since market practice is yet to settle. • The LMA has not published an updated recommended form yet (the exposure draft for SOFR from 23 September 2019 is now out of date). The LMA has indicated that it will update this draft in the coming months, and we expect that the updated wording will reflect the relevant provisions of the rate switch mechanism.

Q5: What about existing loans? Should I amend these now?

The first stage for a lender/agent would be to undertake a review of its ship finance loan portfolio.

Until Q3 and Q4 2021, when the SWG and the ARRC recommend that all existing loan agreements with a maturity date falling after 31 December 2021 be amended to refer to the new benchmark only, it is for the parties to decide whether they prefer to wait and rely on their replacement of screen rate clause or whether they wish to amend their existing loan agreements to introduce a rate switch mechanism (or even delete all references to LIBOR and start calculating interest based on SOFR in advance of the recommended deadlines). The considerations for each option listed in the table above for new loans also apply to existing loans.

If a loan agreement is amended for other commercial reasons, the parties may wish to take the opportunity to discuss LIBOR transition and to document their agreement accordingly. This could mean that the parties simply update their replacement of screen rate clause to include the August 2020 LMA Supplement and set out dates to start their LIBOR negotiations in 2021. Or, if the lender/agent has already developed the necessary internal systems to calculate interest using SOFR or, in the case of a club or syndicated financing, there is agreement amongst the lenders on all conventions and working practices, then a rate switch mechanism could be included to allow the parties to use LIBOR for as long as it is published and switch to SOFR automatically on the applicable switch date without the need for a further amendment to the loan agreement.

Q6: It seems clear that SOFR will replace USD LIBOR so can I simply ask my legal advisers to insert the LMA rate switch mechanism wording into the loan agreement now but finalise the details relating to the new rate later?

In addition to the considerations listed in the previous table in relation to a rate switch mechanism, it is important to understand the difference between (i) knowing which RFR will replace USD LIBOR and (ii) being clear on how the lender/agent will calculate the interest rate for each interest period using that RFR. At the time of writing, it is clear that SOFR will be used instead of USD LIBOR. However, what still remains to be determined is how SOFR will be used to calculate interest under a particular loan agreement. The lender/agent is free to decide this and there is no market practice yet on this point in the ship finance world.

Because SOFR is a daily rate, the lender/agent will need to have systems in place to enable it to calculate the interest amount accrued on each RFR business day during an interest period (and not just once at the beginning of the interest period). The interest amount will be the sum of: (a) the daily non-cumulative compounded RFR for that RFR business day (assuming this is the methodology selected by the lender/agent), (b) any credit spread adjustment and (c) the margin. Towards the end of each interest period (depending on the length of the lookback period, bearing in mind that the SWG recommendation is five business days), the lender/agent would need to add up these daily interest amounts to calculate the total amount of interest that the borrower should pay at the end of that interest period and notify the borrower (and any other finance parties) accordingly.

The way the lender/agent will calculate interest based on a daily RFR will depend on the method agreed in the loan agreement. The SWG has recommended a daily non-cumulative compounded method, which is reflected in the LMA rate switch agreement (in new schedules containing the replacement benchmark rate terms and the formulae reflecting the calculations with related definitions). However, if the lender/agent decides to follow a different methodology (for example, it prefers to use cumulative compounded SOFR or simple SOFR), then the lender/agent will need to provide different formulae (and related definitions) to its legal advisers. This is why inserting the LMA rate switch mechanism provisions is more than a simple drafting exercise. The parties must first agree on the methodology of using SOFR to calculate interest and the lender/agent must be certain that it has the technical capability to make the calculations. The documentation will then follow the chosen methodology.

Q7: I am acting as the agent for a syndicate of lenders who have settled on different methods of calculating interest. How can we reach a commercial agreement?

Obviously, all the relevant parties to the loan agreement must agree to the new benchmark and the way it will be used to calculate the interest for each interest period. However, in a syndicated facility, the obligation to calculate the interest payable falls on the agent. The agent also has the obligation to notify the other finance parties and the borrower of the total amount of interest for each interest period and to provide details of the calculation. As such, it is ultimately the agent that needs to have the ability to determine the interest accrued and payable. We therefore expect that in a syndicated transaction the agent's preference is likely to prevail. In any event, the loan agreement, once agreed, should only include a single set of interest rate calculation terms that will be applicable to the outstanding participations of all the lenders.

Conclusion

Whether you are a lender/agent or a borrower, we hope this article has helped you to understand the current position in relation to the transition away from LIBOR in the ship finance market. While there are still 14 months to go before LIBOR is expected to be discontinued, we have no doubt that, in the near future, ship finance lenders/agents and borrowers will be discussing the new benchmark terms for their existing or new loans to ensure that the transition is as smooth as possible and satisfies the transition milestones approved by applicable regulators. Clearly though, no agreement can be reached until the lender/agent has decided which conventions and methodology it wishes (or needs) to follow and until it has implemented new systems to generate interest calculations based on SOFR.

If you require further information about anything covered in this article, please contact Danae Hosek-Ugolini, Elton Chan, Gregg Johnston or your usual Stephenson Harwood contact.

Danae Hosek-Ugolini
Consultant, London
T: +44 20 7809 2277
E: danae.hosek-ugolini@shlegal.com

Elton Chan
Partner, Hong Kong
T: +852 2533 2726
E: elton.chan@shlegal.com

Gregg Johnston
Partner, Singapore
T: +65 6622 9663
E: gregg.johnston@shlegal.com