ALLEN & OVERY

GREAT FUND INSIGHTS

Risk-Free Rate and LIBOR Cessation

What does this mean for fund finance?

Our previous note entitled 'Great Expectations – IBOR Transition for Funds and Asset Managers' discussed the potential impact of IBOR transition on asset managers. This note is intended to focus on the particular impact that will be felt by borrowers and lenders who are active in the fund finance sector. A&O has acted on a significant number of these loan facilities and is therefore uniquely positioned to explain and advise banks and borrowers on the issues they are now facing.

LIBOR Cessation

On 27 July 2017, Andrew Bailey, Chief Executive of the UK Financial Conduct Authority, stated that market participants should not rely on LIBOR being available after 2021. Since then the market has been working to develop the use of alternative 'risk-free' reference rates (the **RFRs**) that will allow for the use of a different benchmark in place of LIBOR. Notwithstanding the difficulties besetting the markets due to Covid-19, the transition milestones that have been set by the relevant regulators remain mostly unchanged, and by the end of Q3 2020 lenders should be in a position to offer non-LIBOR-linked products to their customers.

LIBOR transition is going to require a significant amount of work for the fund finance market, given the large number of existing financial products currently in place that reference LIBOR. Documentation for thousands of existing matters, comprising loan and hedging arrangements, will need to be amended by the end of 2021 in order to accommodate the change. Many of these loans are syndicated, and both fund borrowers and banks will need to agree on both the replacement rate and how the transition from LIBOR should occur.

Risk-free rates

To understand how the transition will work, it is important to understand the nature of the new risk-free rates and how they differ from LIBOR. The two principal RFRs are currently SOFR (for U.S. dollars) and SONIA (for sterling). SOFR has been named by the U.S. Alternative Reference Rates Committee as its recommended alternative to LIBOR for U.S. dollar-denominated sums. SONIA has been named by the Bank of England's Working Group on Sterling Risk-Free Reference Rates as its preferred primary interest rate benchmark for sterling markets.

There are a number of key differences between the RFRs and LIBOR which will have implications for the way financial instruments referencing SOFR and SONIA are structured and the manner in which such instruments are documented. LIBOR represents the cost of interbank lending for a specified time period, so it takes account of a certain amount of credit and liquidity premium. SOFR and SONIA are based on a measurement of actual overnight borrowing costs in the relevant currency, hence why they are called 'risk-free', as they do not take account of those elements. Accordingly, those RFRs are almost invariably lower than LIBOR would be when determined over a comparable period. Further, SOFR and SONIA are overnight rates, so are both backward-looking (reporting the actual rates paid the day before on the relevant transactions).

The move away from LIBOR

What does this mean then for finance arrangements in the fund finance sector, both those already in place which reference LIBOR and those still to be executed? The dual challenge is to make sure that any new financial instruments that expire after the end of 2021 should provide for an alternative to LIBOR, and any existing transactions will also need to be revisited to either replace the LIBOR mechanics or otherwise ensure that they have appropriate fallbacks that will still work in the absence of LIBOR.

The 'approach'

For SOFR and SONIA to be suitable for fund finance facilities, it is necessary to take those overnight rates and convert them into a rate that can be applied over a given term. This is done by using the concept of a compounded rate, so that the relevant RFR is averaged over the relevant period to provide an interest rate. This allows a rate to be determined, but the nature of the RFRs means that this rate can only be calculated towards the end of the relevant interest period. This will mean there is a fundamental shift in the way that interest is calculated, as under a LIBOR loan a borrower would know what its interest costs will be at the point where or when it borrows a loan. Under the RFRs it will not know the figure until a few days before it is due for payment.

A further complication is that there are different conventions as to how the compounded formula will operate.
Two approaches have been put forward: the '*lag approach*' (which the Bank of England Working Group on Sterling RFRs (the **Working Group**) has recently recommended is its favoured approach); and the '*observation shift approach*'. Both methodologies are designed to ensure that prior notification of the interest payment can be made, but each uses a slightly different approach when weighting the relevant RFRs to determine the compounded rate.
The initial syndicated loans in the corporate debt market that used RFRs were written on the basis of the 'observation shift', though it now appears that the loan market is moving towards the 'lag approach'. It is important to note that other products and other markets may not be adopting the same standard, as the 'lag approach' has been followed in the bond market but not for swaps, so borrowers will have to deal with a need to reconcile slightly different calculations for the same period across the different instruments.

Adjustment spread

The market intention is that the move from LIBOR to risk-free rates should be economically neutral for banks and borrowers. As discussed above, LIBOR is inherently higher than RFRs because it factors in an interbank risk and the risk inherent in borrowing for a potentially longer time period. That would mean that, on a deal that is amended to replace LIBOR with the relevant RFR, this would result in lower borrowing costs if no further steps are taken.

To address this issue, market participants have included an additional spread in the form of the '*credit adjustment spread*', which is intended to bridge the gap between the level of the RFR and LIBOR. This approach has been taken in loan transctions which provide for a transition from LIBOR to RFRs, but also in deals which use RFRs from the outset. Over time it is possible that, as the parties adjust to the new rate environment, the need for an adjustment spread may fall away, as a similar effect can be achieved via an uplift in the margin.

Knock-on effects of moving to an RFR under existing LIBOR-based fund finance facilities

As well as the issues above, which need to be considered in the context of any loan transaction, there are some specific issues that are likely to be of particular relevance for subscription line facilities.

Break Costs

LIBOR-based documents assume break costs are payable upon an early prepayment of a loan. These are meant to compensate a lender for the broken funding costs they may incur on any 'matched funding' arrangements they may have in place. This is more challenging to apply in an RFR environment, partly because the RFRs are not meant to represent a lender's cost of funds, and also for the practical reason that, at the point of early prepayment of an RFR loan, it will not be possible to determine what interest the lender would have earned over the remaining part of the interest period to allow it to measure what that cost will be. To date, the corporate loans that have used RFRs have tended to deal with this issue by limiting the number of voluntary prepayments that a borrower may make in a given period. While this may work in the context of backstop corporate loan facilities, it is likely to be more challenging for subscription lines, which are intended to provide a borrower with flexibility to manage its investor drawdowns and cashflows. It is likely therefore that the fund finance space will require a different approach to prepayments and break costs to ensure that one of the advantages of subscription lines is not lost.

Optional Currencies

Many funds have varying currency requirements that reflect their operations and many subscription lines provide for the option of borrowing in a range of currencies. To date, there are RFRs for U.S. dollars, sterling, Swiss francs and Japanese yen. For euro, EURIBOR is still being used, as that rate is not yet set to discontinue at the same time as LIBOR, so for multicurrency loans, the RFR mechanics will need to co-exist with existing mechanics for EURIBOR. Where a fund requires access to other currencies, then consideration will need to be given to what the appropriate benchmark is that will need to be used, and whether there is a sufficiently developed RFR for that currency. In the corporate loan space where most of the RFR loan deals have been written, optional currencies have been limited to sterling, euro and U.S. dollars, which may not be sufficiently broad for some borrowers in the fund finance space.

Interest Periods

Unlike a LIBOR-based loan, an RFR loan facility does not need to be bound by particular borrowing periods (eg one month, three months or six months) and so, in theory, interest periods of any length can be selected. The way that the compounding formula works for RFRs means that it will almost always be cheaper to borrow for a shorter interest period, so the decision as to the length of interest periods (and therefore frequency of interest payments) is largely an operational one. In the corporate market, interest periods of one month have been commonly used. However, more consideration will need to be given to this question in the context of subscription lines, where an important factor is managing the investor drawdowns, and ensuring that these are spread over a suitable period. Monthly interest periods would seem to remove some of that flexibility, so we expect that fund borrowers will require the ability to borrow for a longer period. In turn, that then affects considerations around, for example, break costs, as longer interest periods inherently carry the risk of higher broken funding costs for lenders.

Interest Payment

As discussed above, in a LIBOR-based subscription line, the applicable LIBOR rate is determined prior to the start of the relevant interest period, so a borrower will know the exact interest payment from the moment of drawing – with that knowledge, any shortfall come the interest payment date can be topped up by a drawing from investors and/or from cashflow. Borrowers under an RFR-based subscription line will not now know the exact amount of interest until just before an interest payment date, as most RFR loan agreements to date have used a five-business day 'lag time'. In practice the borrower will be advised of the final interest amount shortly after the rate is calculated, which may mean that it has no more than a couple of business days' notice. It is highly unlikely that a borrower will have time to fulfil the requirements of the fund documents and to call down from investors to meet that payment. It seems likely that borrowers will need to be overly cautious and perhaps draw down more from investors in order to cover any shortfall, though this does not represent an efficient use of capital.

Market Approach

The approach to RFR issues in the U.S. loan market is primarily being led by the Alternative Reference Rate Committee (**ARRC**), while the loan markets in the UK/Europe look more to the recommendations of the Working Group and the LMA. At the moment the approaches being taken in the two markets are not aligned; for example, ARRC is recommending the use of certain hardwired fallback interest mechanics, whereas the LMA tends towards the use of an amendment process to facilitate the replacement of a screen rate. Many lenders and borrowers in the fund finance space operate in both markets, so participants will need to navigate a way between the different requirements and conventions.

How A&O can help you

We are helping a number of asset management and bank clients in a variety of jurisdictions to tackle the issues that the IBOR transition raises. We would be happy to answer any questions you have or provide you with more details about the ways we can support you with your IBOR transition process.