LIBOR - The End is Nigh

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On 5 March 2021, the FCA issued an announcement that LIBOR will cease to be published and cease to be representative for Sterling as from 1 January 2022 making it clear that there will be no extension of the hard deadline for LIBOR discontinuation. Any new loan facilities being originated from 1 January 2022 will no longer use LIBOR as a benchmark and existing loan facilities which use LIBOR for interest rate setting will need to be transitioned away from LIBOR by the end of 2021.

The Bank of England's Sterling Risk Free Rate Working Group has now endorsed the use of the Sterling Overnight Index Average (SONIA) as the main replacement rate for GBP loans. In our experience so far, participants in the real estate finance market are becoming familiar with loans based on SONIA. It is worth noting however, that there are a number of approaches being adopted to the transition. Some lenders are already offering loan products based on SONIA from the outset and we have assisted others with amendments to existing facilities to incorporate LIBOR/SONIA switch mechanics, whereby the existing LIBOR rate for a loan facility will be automatically replaced by SONIA at the end of the year. In addition, we have seen an increase in fixed rate loans as an alternative approach to the floating rate options.

As we get closer to the deadline for the discontinuation of LIBOR it is worth noting some of the key areas to be aware of which need to be considered as part of the transition.

Mind the gap

SONIA does not include any bank credit risk component (as it is an overnight rate based on actual transactions) and so is a better measure of the general level of interest rates than LIBOR. However, this means that SONIA is likely to be a lower rate than LIBOR and so may give rise to a pricing gap. Loan agreements which incorporate a switch from LIBOR to SONIA therefore usually include a "credit adjustment spread" to compensate lenders for this difference in value and to ensure that the amount of interest a borrower pays after a switch from LIBOR to SONIA remains largely the same. Where a loan is based on SONIA from day one, it is not essential to include a credit adjustment spread (as any difference between a SONIA based rate and the rate that would have been payable in a LIBOR based loan can simply be built into the margin from day one).

Parties in the market are, however, generally including credit adjustment spreads for such loans at present because they are used to considering margin levels in the context of LIBOR based loans and so splitting out the margin and credit adjustment spread is helpful in understanding the pricing components. It is likely that the market will move away from this approach as SONIA based loans become more entrenched.

Playing catch up

Whereas LIBOR is a forward looking rate, based on the rate that certain leading banks can borrow money from each other in the London lending market, SONIA is a backward looking rate and is based on actual overnight interest rates that banks pay to borrow sterling from other institutions. As SONIA is an overnight rate, it is compounded and calculated over an "observation period". However, because SONIA is a backward looking rate, the actual rate will not be known until the end of the interest period and so this may have implications for borrowers from a cashflow perspective who are used to loans based on LIBOR where the rate, and therefore the amount of interest that will be payable, is known at the start of the interest period. In transactions we have seen so far, SONIA has been calculated on a five day "look back" basis so that the amount of interest payable is determined five days before it is due by the borrower to provide certainty as to the amount of interest that will have to be paid on the relevant payment date.

Hedging your bets

Where loan agreements currently use LIBOR and are to transition to SONIA, any associated interest rate hedging arrangements will need to move across at the same time. It is also important to note that with regard to loans originated on a SONIA basis, consensus across the market as to SONIA methodology and fallbacks is still developing. For both existing and new loan transactions it will be important, therefore, for the parties to consider the SONIA methodology and market conventions in the loan transaction and ensure that the hedging arrangements are set up to be consistent as far as is possible.

Looking ahead

As touched upon above, certain aspects of loan transactions which need to be addressed as part of the transition to SONIA are yet to see a consistent market approach emerge. Some of the points which are likely to need further negotiation in transactions are as follows:

- The nature of SONIA as an overnight rate creates room for debate as to whether break costs remain appropriate. Lenders may, however, still look to recover administrative costs associated with non-scheduled payments through prepayment fee mechanics;
- The inclusion of central bank base rates as a fallback arguably weakens the need for lender's cost of funds as a fallback of last resort but lenders may be reluctant to remove it unless a market consensus is formed;
- Due to the issues around the calculation of compounded SONIA, parties will need to give thought to how financial covenants are to be tested and the timing of delivery of compliance certificates.

The future is bright

SONIA is already well on its way to becoming the new normal and the real estate finance market is fast adapting. There are various tools now in place to assist parties with this change, such as the recent publication by the Loan Market Association of recommended forms of Facility Agreement which use risk free rates (such as SONIA) and incorporate mechanics for existing facilities to switch from LIBOR to a risk free rate.   It has been good to see lenders, borrowers and their advisers all working collaboratively to meet the 1 January 2022 deadline.