

## The LIBOR to SONIA transition – Documentation issues

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We are fast approaching the deadline for the discontinuation of LIBOR and, as from 1 January 2022, any new floating rate loan facilities will be based on the Sterling Overnight Interbank Average (SONIA). Over the past year we have seen a number of loans based on LIBOR being actively transitioned across to SONIA, as well as new loan facilities incorporating SONIA from the outset. As we continue towards the “new normal” of SONIA based loans, it is a good time to consider some of the issues that may arise when negotiating and documenting loan facilities which incorporate SONIA.

### Break costs

Break costs are designed to compensate a lender for broken funding costs on any matched funding that they have in place on the interbank market, as a result of a loan being prepaid before the end of an interest period. SONIA based loans are, however, not priced against a forward looking interest rate benchmark and SONIA is not intended to be representative of lender’s cost of funds relevant to an interest period. There is therefore some debate as to the continued relevance of break costs to SONIA based loans and we have been involved in documenting loans based on SONIA where it has been agreed that break costs will not be included.

Notwithstanding the points above, there may still be some reluctance on the part of lenders to let go of the break costs concept. A prepayment in the middle of an interest period can present administrative difficulties for a lender and so the possibility of having to pay break costs may act as a disincentive for borrowers to prepay before the expiry of an interest period. In future, although break costs themselves are likely to be eventually phased out for SONIA based loans, we may see them being replaced with an administration or break fee or increases in the prepayment fees charged by lenders. Lenders may also look to include further restrictions on the frequency of permitted prepayments.

### Financial covenants

The move to SONIA will have an effect on how the “finance costs” element of any relevant financial covenants is calculated, such as projected interest cover tests. Given that a forward looking LIBOR rate can no longer be used to determine finance costs, there is a question as to how this finance costs limb will be determined for SONIA loans. Possible alternatives here could be to use a SONIA term rate or a compounded daily SONIA rate for the preceding interest period for the purposes of calculating finance costs. It will be interesting to see how this area develops as more and more loans are documented on a SONIA basis.

The transition will also impact on the timing for the delivery of financial covenant compliance certificates under the facility agreement. The typical market position in real estate finance is currently for compliance certificates to be delivered by the borrower five business days before the relevant interest payment date. However, where SONIA is calculated on a five business day look-back basis, this mechanic will no longer work. A possible solution here would be for the rent account waterfall to operate as normal on the interest payment date, but with any surplus funds being withheld in the rent account until a satisfactory compliance certificate is delivered after the interest payment date. The funds could then be released to the unblocked general account in the usual way once the certificate is delivered. Alternatively, it could be agreed that a compliance certificate is provided based on estimated figures. As SONIA becomes more established in the market, a consistent market approach will likely develop here.

### **Fallback interest rates and market disruption**

We are currently seeing a lot of discussion and negotiation during transactions about the fallback interest rate provisions and, specifically, the use of cost of funds as a fallback. There is a good argument that a cost of funds fallback in the event of SONIA being unavailable is not appropriate, given that SONIA is not intended to represent a lender's cost of funds over an interest period as LIBOR was. If the central bank base rate is included as an ultimate fallback, the possibility of any further fallback being triggered beyond this is arguably remote.

On a similar point, there is a strong case for market disruption clauses no longer being included for loans based on SONIA. Market disruption clauses are aimed at protecting lenders against disruption in the interbank funding market. Where a loan was based on LIBOR but a lender was unable to fund themselves at LIBOR, interest would be calculated by reference to that lender's actual cost of funds. However, risk free rates such as SONIA record the average rate of all overnight transactions and do not rely on quotations, meaning that market disruption provisions are of little relevance here.

Cost of funds as a fallback rate and market disruption provisions are, like break costs, terms which lenders are very used to seeing included in their loan facilities and there may again be some initial reluctance to do away with such entrenched mechanics. We have dealt with SONIA based loan agreements where the lender's policy has been to retain reference to costs of funds and market disruption, notwithstanding the arguments for excluding these items. This is another area where a consistent market position is likely to be settled over the next year or so.

### **Hedging**

If interest under a SONIA based loan agreement is hedged, then the hedging will need to match the interest under the SONIA loan. To assist with the transition to SONIA, ISDA produced the ISDA IBOR Fallbacks Protocol which, if adhered to by the parties, means that the interest rate swap will be automatically converted to the fallback rate specified in the protocol. The protocol provides that the fallback rates for IBORs are adjusted overnight risk-free rates (and so the fallback rate for LIBOR will be SONIA). However, under the protocol, the risk-free rate is calculated using a two business day lookback, which is inconsistent with the LMA standard position where SONIA is calculated using a five business day lookback. This mismatch will result in an imperfect hedge, the consequences of which for the parties will depend on the actual circumstances of the transaction in question.

ISDA's guidance is, however, not to simply rely on these fallbacks but instead to actively transition the hedging arrangements, for example by amending or closing out the relevant contracts and entering into new arrangements specifically tailored to the transaction. On transactions we have worked on, we have seen the ISDA protocol being disapplied where it is inconsistent with the facility agreement and the ISDA agreements being specifically amended to be consistent with the underlying facility agreement.

There has been further progress on this issue recently with the publication of new ISDA supplements which provide for a set of options and modular provisions that allow the parties to adopt a more tailored approach. These supplements essentially provide for a menu of approaches for average and compounded risk-free rates from which the parties can select the options most appropriate to the transaction. These supplements include options designed to be compatible with the LMA risk free rate terms and should therefore provide a standardised approach for transactions where close alignment between the derivative and the hedged item is required.

### Future developments

SONIA is already becoming widely used in the market and parties are becoming more comfortable in dealing with SONIA based loans and in considering the various commercial documentation issues that arise. No doubt consistent market positions will be reached in areas such as break costs and market disruption in the coming months as lenders, borrowers and advisers continue to work proactively together to make the transition away from LIBOR as smooth as possible.

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