Nearly risk-free term rates are now available for Sterling and US dollar facilities but are aimed at a small sector of the market including trade and export finance.

Definition of Term SOFR – there are likely to be a variety of definitions used in the near future.

Replacement of Screen rate/Replacement of reference rate – assuming RFRs are here to stay, a slimmed down clause based on LMA wording could be the way forward.

The drafting jigsaw: LIBOR reform and forward-looking term rates

With the birth of nearly Risk Free Reference Rates (RFRs) bringing currency specific benchmarks for interest rates to replace LIBOR, new jargon and industry and regulator guidance, how can a borrower, or for that matter a lender, start to piece together the drafting it needs for bespoke finance documents?

Finance documents, such as facility agreements and receivables purchase agreements which reference LIBOR as the basis to calculate the interest rate, default rate or a discount rate, need to be amended and new transactions using RFRs need to take a fresh approach to drafting, in the market push to replace the use of LIBOR. So, for sectors recognised by regulators as needing a forward-looking term rate, eg trade and export finance and some lending to SMEs, is the drafting just a cut and paste exercise?

The announcement by the Alternative Reference Rate Committee (ARRC) on 29 July 2021, formally recommending CME Group’s Term Rates for Secured Overnight Financing Rate (SOFR) for US dollars, should be the last piece of the jigsaw. Regulators and the market have recommended that over 90% of the market should move to rates which are calculated in arrears, (eg using Sterling Overnight Index Average (SONIA) compounded in arrears) with only a small percentage of the overall finance market justifiably using forward looking term rates, such as Term SONIA for Sterling or Term SOFR for US dollars.

JIGSAW PIECES

Whereas lenders need to work out what interest rate options they can realistically offer alongside maintaining the operational side of the business, borrowers will naturally be focussing on the financing needs of their own businesses. What drafting do we have available to help?

First, a useful starting point for determining what other pieces of the so-called “drafting jigsaw” are needed, is a comparison of key definitions and fallback provisions published by the Loan Market Association (LMA) and the Loan Syndications and Trading Association (LSTA).

Second, there is recommended documentation from the LMA, for Sterling, US dollar, Euro and other currencies under English law, and from the LSTA for US dollar transactions under New York law. At the time of publishing its exposure drafts, the LMA, understandably, applied the Sterling conventions to the US dollar RFRs, as some of the US dollar conventions had not yet been settled. However, with these now in place, it may be appropriate for lenders to consider the LSTA definitions and fallbacks as options in US dollar transactions, even for English law transactions.

Another important part of the puzzle is individual preference. Law firms acting for lenders often have preferred LMA-based precedents. Lenders and borrowers alike may have some standing instructions on some of the LMA provisions which will be informed by the requirements of the transaction itself. For example, in the context of trade or export finance, the transaction could be bilateral, (whereas the LMA only provides syndicated documentation); in US dollars or in Sterling; secured over specific assets; or based on a simplified LMA-based facility agreement precedent or on previously agreed transaction documents.

Clearly, there are commercial terms relating to the adoption of Term SONIA or Term SOFR which have to be addressed, including whether there is a credit adjustment spread to compensate for the economic difference between LIBOR and the RFR, however, this article looks at some of the key definitions for term rates and some proposals for fallbacks.

DEFINITIONS

Documentation should be clearly drafted to ensure parties understand what the interest rate is, how to calculate the interest due and when to make interest payments. Such information will be reflected in the definitions used to describe the relevant benchmark rate, as well as in the “Interest” and “Interest Periods” clauses. It is essential to draft the definition of the relevant benchmark rate to ensure it is identifiable usually covering:

- name of the rate;
- identity of its administrator;
- relevant page, screen, platform or website to access the rate;
- currency;
- reference to the relevant interest period;
- whether there would be a floor, eg zero; and
- the position on whether any intra-day adjustments are taken into account and republication times.

Before the move to RFRs, the term “Screen Rate” was used to cover LIBOR, EURIBOR and any other benchmark rate listed in a schedule to an LMA-based agreement. However, to simplify the drafting, the term LIBOR was occasionally used in lieu of Screen Rate.

One possibility for incorporating Term RFRs for Sterling and US dollars, is to adopt drafting similar to that used for LIBOR.

In relation to Sterling, the RFR for a forward-looking term rate could be the Refinitiv Term SONIA, the ICE Term SONIA or a rate from another provider. There are two LMA illustrative definitions for SONIA term
rates for Sterling transactions (see Figure 1 overleaf).

The LMA’s drafting, while helpful, covers most of the points above but still needs to be checked against the deal requirements, as for example, it does not include drafting for an interest rate floor. The term Screen Rate is no longer used in the LMA RFR documentation, having been replaced by:

- “Reference Rate” in the “Replacement of Reference Rate” clause; and
- “Primary Term Rate” in the LMA Sch 13. Schedule 13 provides the key terms for all of the reference rates for the LMA RFR multicurrency facility agreement.10

As the LMA documentation only caters for SOFR compounded in arrears, some new drafting will be needed for US dollar transactions using forward-looking RFRs. Drafting could look very much like the Term SONIA definition but referring to just the one recommended US Term SOFR provider, CME Group. Some finance documents may already include a switch mechanism, providing that on certain events or announcements, the benchmark will switch from LIBOR to the “ARRC recommended Term SOFR”. This generic term may have been adopted in the period from December 2020 to 28 July 2021 during which it was, at times, unclear whether there would be a forward-looking term rate to replace LIBOR for US dollars.

The LSTA and ARRC each have taken their own approach to defining “Term SOFR” (see Figure 2 overleaf). Many transactions under English law need the ability to provide funds in US dollars, depending on the nature of the borrower’s business or the sector in which it operates, for example, trade finance. The LMA recognises this in each of its investment grade, developing market pre-export credit facilities.

**FALLBACK PROVISIONS**

Only on the rare occasion would the market expect there to be no published benchmark rate, eg due to a cyber attack or IT hiccup, or for parties to opt to replace the benchmark altogether. Where the Screen Rate is temporarily unavailable,11 then a waterfall of methods to work out and apply a rate can be employed to apply an alternative rate on a short-term basis to enable the lender to calculate the interest and the borrower to make timely payment of the interest due without interruption. These methods both for use on a temporary or permanent basis, have come to be known as “fallbacks”.

Although the LMA’s “Unavailability of Screen Rate” clause for temporary unavailability in LIBOR transactions, provides two versions of the clause, one with six options12 and one with three,13 a mixture of the two clauses is used in practice. Until now, it has been common to opt for Interpolated Screen Rate; Historic Screen Rate; Reference Bank Rate; then Cost of Funds. As Reference Bank Rates have grown less popular, lenders often contract to move swiftly to engage the Cost of Funds provisions after exhausting one or two of the LMA suggested fallbacks.

Moving into the world of RFRs, one practical fallback for a Sterling forward-looking term rate would be to use an equivalent benchmark rate from an alternative provider, either from Refinitiv Benchmark Services (UK) Limited or ICE Benchmark Administration Limited.14 Only if all were unavailable, would parties move to an Interpolated or Historic Screen Rate as before. While Cost of Funds may still be used as the last resort, regulators have suggested that as such a subjective fallback is linked to the credit of a particular lender, it should not be used. Of course, the overriding theme of LIBOR reform has been to move away from subjective rates and move towards objective data, based on real transactions!

The LMA made additional suggestions15 for fallbacks in export, trade and developing markets documents:

- compounded in advance (also known as the “last reset method”) using the RFR from the previous period and projecting it forward; or
- RFR compounded from the week before the interest period, applied forward.

As using central bank rates is being proposed as a neutral measure, the Bank of England Bank Rate has been built into the LMA documentation for Sterling as a last option instead of Cost of Funds.16 Fixed rates are also an option in the short term.

The LSTA takes a slightly different approach in its Term SOFR documentation allowing the borrower to revoke any utilisation request once it has been notified that the benchmark rate is not available. The LSTA suggests using Daily SOFR or SOFR compounded in arrears as fallbacks on a temporary basis, even in the Term SOFR credit agreement. This could mean either including full drafting for interest compounded in arrears as well, or, preferably, including wording robust enough to be able to identify an alternative rate, (possibly SOFR in advance or SOFR Averages applied in advance17), the administrator, the periods and how to access the benchmark rate.

Permanent unavailability of the benchmark rate18 has been the focus of regulators and industry bodies who suggested, for regulated entities required, a contractual provision to demonstrate that the parties have agreed either:

- an identifiable alternative reference rate (known as “hard-wired”); or
- to enter negotiations to agree an alternative rate within a set time frame.

This led to the publication of the LMA’s suggested wording in autumn 2020 when deadlines were still fluid. It was clear there would be no new Sterling LIBOR lending by the end of March 2021. It was, however, tricky for those in the trade finance space to include a hard-wired option or a switch mechanism as there was no certainty about a viable forward-looking term rate for US dollars.19

More extensive wording was published by the LMA in separate guidance detailing the trigger points when parties should switch to a specified alternative or negotiate a replacement rate, with the consent of the Majority Lenders.20 The LMA’s Supplement21 drafted with cessation of LIBOR in mind, lists replacement trigger events including:

- insolvency of the administrator;
- announcement by the administrator or its supervisor that a benchmark rate has or will cease to be published;
- a change in the methodology;
a public announcement from the administrator or supervisor of the benchmark is no longer representative of the underlying market or is no longer representative of the underlying market or economic reality that it is intended to measure; and

that the parties do not consider the rate to be appropriate for the transaction.

Some of these events have already occurred, for example, the announcements of cessation dates of certain LIBOR tenors and currencies taking effect on 31 December 2021. So once parties use RFR term rates, are these trigger events still appropriate for Term SONIA or Term SOFR transactions? In some cases, yes, yet many of the specific terms, with LIBOR reform at their core, could be somewhat redundant. Assuming RFRs are here to stay, could we not revert to a simpler “Replacement of Reference Rate” clause where parties can agree what the alternative benchmark rate will be in these unusual circumstances?

The list of proposed new fallbacks for permanent unavailability is quite substantial. The LMA suggests choosing the Bank of England Bank Rate; SONIA compounded in advance; SONIA compounded over the week prior ("last reset method"); Bond index yields; fixed rate and alternative term SONIA rates from another provider. Parties should consider:

- which options are workable;
- whether a waterfall of options is needed; and
- whether to revert to the ability to negotiate in good faith to reach a workable solution.

The LSTA clause on Benchmark Replacement deals with the permanent change of benchmark rate assuming Term SOFR is no longer available. With no recommended alternative provider of Term SOFR, other US dollar forward-looking rates could be used. The ARRC’s amendment approach allows the borrower and the administrative agent to enter into amendments or implement a Benchmark Replacement. Its hard-wired approach, preferred by the ARRC, requires an alternative benchmark to be identified for the sake of certainty and clarity. LSTA drafting gives the administrative agent more discretion and rights to implement changes to the agreement than the corresponding Agent under LMA documentation, (eg to change the length of the interest periods if certain tenors are removed).

When it comes to LIBOR reform, the key benchmark definition for the Term RFRs for Sterling and US dollars and the fallbacks are just two areas still in flux. Inevitably, the market will see a range of wording in the next few years. Workable, pragmatic solutions achieved by dialogue between lenders and borrowers, with an eye on guidance from the regulators, are the most likely route to our new market “norms”.

2 https://www.newyorkfed.org/arrc-Alternative Reference Rate Committee
3 FMSB Standards on the use of Term SONIA reference rates 28 July 2021 https://fmsb.com/
4 Each of the LMA and LSTA sets of RFR documents are recommended forms of documents which can be used as a basis for transactions, their use is not a regulatory requirement.
5 Use of credit adjustment spreads is the subject of guidance from both the Working Group on Sterling RFRs and the ARRC for SOFR.
Illustrative definitions are contained in the LMA’s “Considerations in respect of the use of forward-looking term SONIA reference rates” 26 March 2021. LMA’s Amendments and waivers clause. LMA’s multicurrency term and revolving facilities agreement incorporating backward-looking compounded rates and forward-looking term rates with rate switch provisions (lookback without observation shift) for Sterling, US dollars, Swiss Franc and Euro, 28 May 2021. Unavailability of Screen Rate under LMA facility documentation. Interpolated Screen Rate; Shortened Interest Period; Shortened Interest Period and Historic Screen Rate; Reference Bank Rate or Cost of funds. Interpolated Screen Rate; Reference Bank Rate or Cost of Funds. See figure 1. LMA guidance “LIBOR transition considerations for the LMA’s export finance, developing market and pre-export finance documentation”, February 2021. LMA guidance “Considerations in respect of the use of forward-looking term SONIA reference rates”, March 2021. See ARRC website for details. See LMA documentation: (i) ‘Amendment and Waivers’ clause in facility documentation; (ii) Revised Replacement of Screen Rate wording; and (iii) Supplement to the Revised Replacement of Screen Rate wording. See LMA’s RFR documentation for the Replacement of Reference Rate provisions from May 2021. ARRC’s recommendation of the US SOFR Term Rate by CME Group was approved on 28 July 2021. Two thirds of the commitment or Loans outstanding. The LMA attached a Supplement to its note on the Revised Replacement of Screen Rate Clause and documentary recommendations published by the Working Group on Sterling Risk-Free Reference Rates in August 2020.

Further Reading:
- RFR term rates in a post-LIBOR landscape (2021) 7 JIBFL 471.
- LIBOR transition: demystifying the interest calculations in the LMA Exposure Draft (2021) 4 JIBFL 263.
- LexisPSL: Banking & Finance: Practice Note: LIBOR transition – legacy loan and swap RFR conventions comparison table.