COLLYER BRISTOW

REAL ESTATE BUSINESSES

GETTING TO GRIPS WITH LIBOR TRANSITION AND LOANS

A WHITE PAPER FROM COLLYER BRISTOW

INTRODUCTION

The London Interbank Offer Rate (LIBOR) is the benchmark reference rate commonly used in commercial loans to calculate interest payments in variable (floating) rate loans. LIBOR is expected to cease to exist after 2021 meaning significant changes for the loan and interest rate swap markets are imminent as participants prepare to transition to alternative rates. This will have significant implications for real estate finance in relation to both ongoing and future financing arrangements.

Following the large-scale LIBOR fixing scandal exposed in 2011, and a general decline in the importance of interbank lending within the financial markets, the Financial Conduct Authority (FCA) has indicated that it wants to move the financial markets away from using LIBOR as a benchmark. The FCA favours risk free rates (RFRs) which are based on actual transaction data and less susceptible to manipulation. As explained below, each LIBOR jurisdiction has now established an alternative to LIBOR. This includes SONIA (Sterling Overnight Indexed Average) in the UK. SONIA is an overnight rate, measured on each day over the interest period to produce a final interest rate at the end of that period. We explain in this paper how the differences between SONIA and LIBOR will impact how interest is calculated.

The FCA announced in July 2017 that it will no longer compel or encourage banks to provide quotations for LIBOR after the end of 2021 and told market participants that they should therefore plan a transition to an alternative rate based firmly on actual transactions data before then.

In March 2020, Collyer Bristow (facilitated by Estates Gazette) surveyed real estate businesses on the steps they are taking to prepare for the end of LIBOR and the introduction of new benchmark reference rates.

On 25 March 2020, in response to the COVID-19 pandemic, the FCA, after discussions with the Bank of England (BoE) and the Working Group on Sterling Risk-Free Reference Rates (Working Group), published a statement confirming that "[t]he central assumption that firms cannot rely on LIBOR being published after the end of 2021 has not changed and should remain the target date for all firms to meet". The FCA does, however, concedes that they will continue to monitor and assess the impact of COVID-19 on the interim transition deadlines and update the market if positions change.

This white paper includes:

- The findings of our research.
- The differences between LIBOR and risk free rates.
- The impact on borrowers with new loans.
- The impact on borrowers with existing loans.
- The support Collyer Bristow can offer.

COLLYER BRISTOW RESEARCH

Collyer Bristow surveyed 60 real estate business in the UK and found:

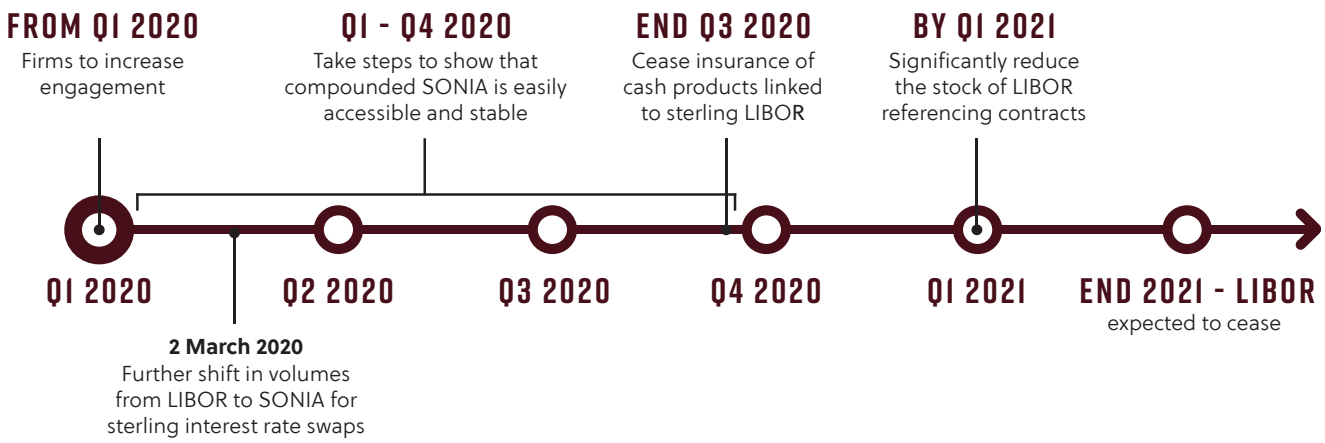
- 70% are aware that LIBOR is being phased out.
- 52% have borrowings operating beyond 2021 that use LIBOR to calculate interest, with a further 22% unsure whether their borrowing is linked to LIBOR.
- 52% have not yet spoken to their lenders to agree alternative benchmarks to calculate interest.
- 68% believe that if, as a result of the change, the amount of interest payable on borrowing was only known a few days in advance of it being paid it would have a detrimental impact on cash flow.
- 70% of property businesses said this is one of their top operational priorities [it should be noted that this survey was conducted before the current coronavirus measures were put in place].
- 25% of property businesses with borrowing and who have spoken to lenders are broadly happy with proposed preference rates to replace LIBOR.

It is not surprising that so many property businesses have borrowings that extend beyond 2021, yet it is concerning that so few have taken steps to engage with lenders over current and future borrowing requirements, or had lenders engage with them. The change to an alternative benchmark is likely to have a significant impact on a property company's cashflow management, as this white paper will explain.

ALTERNATIVE BENCHMARKS

On 16 January 2020, the Working Group, BoE and FCA jointly published a set of documents which outlined key milestones and targets in 2020 for the transition from GBP LIBOR to the alternative RFR. These include to:

- Take steps to enable a shift from GBP LIBOR to SONIA in the derivative markets by 2 March 2020;
- Cease issuance of GBP LIBOR-base cash products that mature beyond end-2021 by end of Q3 2020; and
- Establish a clear framework to manage transition of legacy LIBOR products to significantly reduce the stock of GBP LIBOR-referencing contracts by end of Q1 2021.



Each currency of LIBOR has its own existing alternative RFR identified by the relevant working group. These are summarised below.

CURRENCY	RISK-FREE RATE	ADMINISTRATOR	WORKING GROUP
Sterling	SONIA (Sterling Overnight Index Average)	Bank of England	Bank of England Working Group on Sterling Risk-Free Reference Rates
US Dollar	SOFR (Secured Overnight Funding Rate)	Federal Reserve Bank of New York	Alternative Reference Rates Committee
Euro	€STR (Euro Short-Term Rate)	European Central Bank	Working Group on Euro Risk-Free Rates
Swiss Franc	SARON (Swiss Averaged Rate Overnight)	SIX Swiss Exchange	Swiss National Working Group
Japanese Yen	TONA (Tokyo Overnight Average Rate)	Bank of Japan	Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks

There are differences between RFRs and LIBOR which are significant, especially for the loan market. As a result, in comparison to other markets such as the derivative markets, there has not yet been many transactions referencing RFRs in the loan market.

The fundamental difference is that existing RFRs are based on historical transaction data and so, unlike LIBOR, there is no element of 'forward looking' to the expected movements in interest rate market over the interest period built into the rate.

The practical and commercial effect of this is that where interest rate payments are referenced to RFRs, such as SONIA, borrowers can expect loans to be offered on terms where the borrower has less notice as to the interest payments that will be due. The reason for this is that RFRs will likely be calculated at or shortly before the date when payment is due, rather than at the beginning of the interest period, as is usual for LIBOR loans. Therefore, it will no longer be clear well in advance what will be payable. Consequently, some market participants have delayed transition plans awaiting the development of a forward looking RFR term rate.

However, although many currency jurisdictions are looking at developing a forward-looking RFR term rate, the timeline for forward-looking term rates is uncertain and forward-looking term rates may not be made available in all currencies. Regulators are therefore advising market participants that forward-looking RFR term rates should not be relied upon through the transition process and are strongly encouraging market participants to prepare operationally for loans which do not fix the interest rate in advance, and instead 'compound in arrears'.

Compounding in arrears means that the interest rate is calculated towards the end of the interest period, by reference to the actual RFRs experienced in that period. As a result, the borrower only knows the amount due towards the end of the interest period. This is in contrast to LIBOR loans, where the borrower knows the interest rate and therefore the interest due at the start of the interest period. To provide at least some notice to assist in managing cash flow for borrowers, the approach to date has been to calculate interest costs with a reference rate lag period of a few days.

WHAT DOES THIS MEAN FOR BORROWERS WITH NEW LOANS?

Borrowers in the real estate market should make sure they understand the financial and practical implications of the interest payment mechanisms and benchmarks proposed. The key questions for borrowers entering into new loans include:

- Which benchmark rate is proposed and how and when will the payment be calculated?
- Is there a mechanism to change to a forward looking RFR if one is developed?
- Is any short-term interest rate hedging required? This may be needed, for example, to ensure sufficient cash will be available if payment is required on short notice in a volatile interest rate environment.
- How will any repayment or prepayment fee be calculated if the loan is repaid/prepaid before the interest due for the period has been established?
- If there is interest rate hedging associated with the loan, is the interest rate hedge documented "back to back" or is there any remaining exposure?
- If the loan agreement includes a provision allowing the interest mechanism or benchmark to be altered, does any hedging arrangement include a similar provision?

WHAT DOES THIS MEAN FOR BORROWERS WITH EXISTING LOANS?

There is a further uncertainty in relation to existing loans referencing LIBOR that mature beyond 2021, often called legacy contracts. The market clearly anticipates that new loans referencing RFRs will be made before there is a wholesale move in legacy contracts from LIBOR to RFRs.

A key transition issue is the economic difference between the RFRs and LIBOR. LIBOR accounts for credit risk, whereas RFRs (even compounded over a period) only include a nominal element of credit spread. RFRs will therefore be lower than LIBOR. Therefore, switching from LIBOR to an RFR creates an economic differential that must be addressed.

In December 2019, the Working Group published a consultation paper on credit adjustment spread methodologies for fallbacks in cash products referencing GBP LIBOR. This paper considered four methodologies that could be used to calculate the credit adjustment spread for fallback language in sterling cash instruments. The consultation, which closed on 6 February 2020, identified a strong consensus in favour of the ISDA historical 5 year median approach as the most appropriate methodology for credit adjustment spreads. This approach looks in the past, i.e. at the differences between GBP LIBOR and the SONIA over 5 years. Because SONIA is only published daily, and does not have different tenors like LIBOR, SONA would be compounded for the relevant tenor to compare

it with LIBOR. Therefore, the credit adjustment would be calculated and published for each GBP LIBOR tenor based on historical differences between the GBP LIBOR for that tenor and the SONIA compounded rate over the relevant tenor. The results of the consultation are not binding on cash market participants. However, they will assist the market in developing conventions and reaching market acceptance on appropriate credit adjustment spread methodologies.

The key questions for real estate borrowers with legacy contracts include the following:

- What will be the contractual position after 2021 based on their loan agreement(s) as drafted?
- Is there a fallback provision specifying an alternative benchmark/mechanism to LIBOR? Does the fallback provision apply in this situation?
- Is the fallback/alternative commercially acceptable as a permanent basis for the loan going forward? Such provisions include a variety of mechanisms including using the lender's own cost of funds as the benchmark, allowing the lender to specify an alternative rate or even using the last LIBOR 'screen rate' available (which in this situation converts a floating rate loan to a fixed rate loan).
- What happens if LIBOR continues to be published but, because of the transition and discontinuance of most banks' submissions, it does not reflect market pricing, the so-called "Zombie LIBOR"? Would this situation trigger the fallback provision, or a right for the borrower to change to another rate?
- Can the lender amend the benchmark rate without borrower consent? If not, the lender is likely to seek to include such a right in advance of 2021. Borrowers should therefore carefully review any proposed amendments to their loan agreements which give the lender the right to change the rate without borrower consent (or otherwise change the position that agreement is required). Such amendments may be proposed as part of any wider, unrelated amendments or restructurings.
- If there is interest rate hedging associated with the loan do the fallback mechanisms match? Mismatches in the benchmark used after 2021 between an interest rate swap and the underlying loan creates exposure to the difference between the rates and may lead to additional cost and/or exposure.

HOW COLLYER BRISTOW CAN HELP

We can advise you on the implications for your contracts which reference LIBOR. We are able to review your contracts to assess the effect that the discontinuance of LIBOR will have on the agreement and to enable you to consider whether the terms are still commercially acceptable or require renegotiation.

For borrowers with extensive financing arrangements we can offer a tailored service to assist with the process of assessing and managing LIBOR transition, working with you to make sure the extent of the risk/exposure for the business is understood in good time and mitigated as effectively and efficiently as possible.

Details of our process are set out below.

LIBOR TRANSITION ASSISTANCE - LEGACY CONTRACTS

1. IDENTIFY

We will work with you to identify the loans, deposit facilities, derivatives and other contracts referencing LIBOR that mature beyond 2021.

2. AUDIT & REVIEW

We will review those contracts to identify the applicable "fallback" provisions and the effect of those terms.

3. ADVISE

We will advise as to your position regarding LIBOR provisions under the contracts as currently in place and on whether your contracts should be amended. We can also advise on any amendments already proposed by lenders.

4. NEGOTIATION AND AMEND

We will help you engage with lenders to agree amendments to your contracts.

5. DISPUTE RESOLUTION

We will help you engage with lenders to agree amendments to your contracts.

CONNECT

If required, we can recommend specialist financial advisors to:

1. **Quantity the potential implications of the changes for your business based on ongoing contractural arrangements**
2. **Identify the most appropriate replacement rate**
3. **Evaluate the financial implications of any replacement rate proposed by the other party.**

FOR MORE INFORMATION PLEASE CONTACT

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