Real Estate Capital

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NEWS & ANALYSIS

It's time to turbo-charge LIBOR transition

Laura Bretherton of law firm Macfarlanes explains what lenders in the UK need to do to be ready for the end of LIBOR.

Since the start of the coronavirus pandemic, real estate lenders' attention has been on the asset management required to support their sponsors. However, the countdown to the discontinuation of the London Interbank Offered Rate – better known as LIBOR and the reference rate in most floating-rate property loans – has continued uninterrupted.

Indeed, the UK's Financial Conduct Authority has confirmed that that the timeline for LIBOR transition, ahead of discontinuation by the end of 2021, will not change due to the pandemic.

Many lenders will need to accelerate the implementation of the necessary adjustments to their loan documentation, systems and operational infrastructure, to facilitate the use of new risk-free rates. In the words of the Bank of England's Sterling RFR Working Group, now is the time to "turbo-charge" LIBOR transition planning.

There is a general consensus that the replacement rate for most sterling loans will be the Sterling Overnight Index Average – known as SONIA. The conventions for compounding and referencing SONIA are now well-developed. However, relatively few lenders and borrowers have made the move to enter new SONIA-based loan transactions.

Here is what real estate lenders and borrowers in the UK property loan market need to do to be ready.

From now: make room for SONIA

Since 1 October, the FCA and Bank of England have required all new or refinanced facilities to include a clear contractual framework for either "an agreed process for renegotiation" or "pre-agreed conversion terms" to SONIA or an alternative RFR. This includes facility agreements which are amended, extended, or renewed from Q4 2020.

In other words, from now on, any changes to existing loan documents will require that a roadmap to conversion to SONIA, or another RFR, is worked into the documentation.

The Bank of England's working group has confirmed that the previous iteration of the Loan Market Association's 'replacement of screen rate' provision alone will not be sufficient to meet these requirements. That wording only stipulated that parties should agree to make the necessary amendments to reflect a replacement rate when LIBOR is discontinued. However, this does not show a clear contractual pathway towards the use of a replacement rate.

Bretherton: lenders need to act now on LIBOR transition

The most straightforward and perhaps most light-touch way to meet this requirement is to incorporate into facility agreements the LMA's recently published supplement to its 'replacement of screen rate' provisions. This provides that parties agree LIBOR is deemed to be discontinued on a particular date – to fall before the actual discontinuation at the end of Q4 2021 – and sets an agreed long-stop date by which the parties must have negotiated the transition to a new RFR.

An alternative and more robust approach is to include 'pre-agreed conversion terms' which can be achieved by incorporating a 'switch mechanism' into the facility agreement now. This effectively hardwires the necessary changes into the facility agreement, so no further amendments are necessary.

To do this, the loan parties will need to commit to the relevant rate and the mechanics to apply following the switch.

It is worth adding that lenders should now be able to offer non-LIBOR linked products. The ability to do this will largely depend on lenders' operational capabilities and borrowers' readiness to move to a new rate. In practice, as so many lenders in the real estate market can offer fixed rate loans, this requirement should not be too difficult to comply with.

From Q2 2021: time to drop LIBOR for new transactions

In less than six months' time lenders should cease issuing new loan products – which expire after the end of 2021 – which reference LIBOR. Much of the work between now and the end of Q1 2021 will ensure that both lenders and borrowers can operate effectively and can manage their loan portfolios which reference SONIA or other RFRs.

The LMA intends to publish a suite of facility agreements incorporating RFRs in advance of the Q2 2021 milestone. These documents are expected to provide for the compounding and referencing mechanics which have largely been adopted to date. It will be important for all market participants to be familiar with the documentary provisions as soon as possible, to allow for a smooth transition in the early part of 2021.

Before the end of Q4 2021: deal with existing loans

While new loans are issued using RFRs, lenders will also need to use the remainder of this year to work on the transition of legacy loans to the risk-free world. Most transactions should have a clear framework for transition, but there will still be some older agreements which have not been amended to include even the original version of the LMA's 'replacement of screen rate' provisions.

The interests of all parties involved should be aligned in promptly and accurately documenting the necessary changes, but this will of course take time. The alternative to doing so would be for lenders to be forced to rely on the contractual fallbacks in their loan documents. With LIBOR unavailable, that will in most cases involve charging 'cost of funds' which is not likely to be in the interests of either lenders or their borrowers and will hopefully provide an incentive to transition even for the most difficult legacy loans. ■

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