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REGULATORY INTELLIGENCE

Transitioning out of LIBOR – managing existing loan portfolios

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The London Inter-bank Offered Rate (Libor) underpins nearly $350 trillion in mortgages, loans, derivatives and other financial instruments on a gross notional basis, and most floating rate sterling-denominated real estate finance loans reference Libor as the lenders' cost of funds.

The Financial Conduct Authority (FCA) has said that new sterling-denominated loans should stop using the Libor by the end of the first quarter of 2021, and in July 2019, Andrew Bailey, then chief executive of the FCA and now governor of the Bank of England, said:

"I can offer no certainty to those who have not taken steps to move off Libor by end-2021. Many market participants strive for certainty in their contractual arrangements."

Now is the time to plan

All financial institutions are actively considering how this will affect them. Those with larger legacy books are adding language into their loan agreements notifying customers that changes are coming and requesting that the customer works with the financial institution to effect the transition. Few financial institutions have spelt out what those changes will be and the industry has not yet settled on a widely accepted approach.

For sterling-denominated loans referencing Libor, the risk-free rate that will replace it will be the Sterling Overnight Index Average (SONIA). The Bank of England will take responsibility for the governance and publication of SONIA. SONIA, however, is constructed differently from its predecessor benchmark which means the change-over in loan agreements will not be a simple "find and replace all" exercise.

That difference in construction can be highlighted by two of the more pressing issues to address:

1. Rate in arrears : SONIA is backward-looking and based on historic, overnight transactions. Libor is forward-looking and based on submissions in respect of the rate at which large financial institutions can borrow unsecured debt for various tenors on that day. This means that changing to SONIA will result in a need to recast the use of the underlying interest cost to enable loan agreements to forecast cost of funds while still using SONIA. For real estate finance loans that means the traditional projected interest cover test (which assesses the projected income of a borrower against its interest burden over a set period of time in the future) will have to be adapted to enable borrowers and lenders to achieve the same economic result where they are using a rate which is only available on a backward-looking basis. Solutions could include looking back one quarter and annualising but it is difficult to know if past rates are a guide to future rates and what happens to any interest rate hedging products in that calculation.

2. Communication of costs : if SONIA can only look back there is also a pressing question as to how a financial institution can communicate the rate to its borrower to enable the borrower to meet its quarterly interest burden, or calculate an historical (or projected) interest cover ratio in time for a financial institution to deem the loan to be in continuing compliance with its financial covenants.

Roadmap for a Libor transistion

There are multiple other issues which will need to be addressed and huge legacy books to change. A roadmap to carrying out a Libor transition should be as follows:

1. Audit : Conduct an audit of each financial institution's existing loan book, creating pools of loans which are categorised by how Libor is used. Among other pooling methodology, that categorisation will need to reference whether financial covenants use Libor for calculation, whether distributions to owners of the relevant borrower are subject to certain levels of financial covenant performance ("cash traps") and whether fees on early prepayment (or other event-driven fees due to the financial institution) make reference to "make-whole" or "call protection" referencing Libor and interest margin up to a certain date during the life of the relevant facility.

2. Analysis and application : Once the audit is complete a consistent approach should be taken in analysing the relevant pools of loans and applying that financial institution's methodology to each pool of loans. Doing this centrally by reference to similar types of loans has the benefit of a consistent approach but just as importantly manifests itself as a way to ensure equitable treatment for all borrowers. It also provides the added benefit that financial institutions will be able to take a more consistent approach in negotiating changes to the methodology across the loan book once negotiations commence with borrowers.

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3. Execution : Documenting the amendments required should be done in a centralised manner to ensure consistency, to reinforce the first two steps of the process and to safeguard the transaction security. Given the sheer volume of the legacy loan books, even once loans have been categorised into pools it will still take a combination of document automation, sophisticated artificial intelligence technology and streamlining IT solutions, together with careful process mapping, to get these documents ready for execution. Even then it will need qualified personnel to engage with the final amendments and any negotiations on the terms being offered for the transition. A solution that utilises technology will enable both financial institutions and borrowers to document and track the relevant amendments more easily.

Early adopters likely to have an advantage

That said, it is clear from the authors' discussions with market participants and the current lack of any clear regulatory incentives to drive the process forward that the biggest hurdle to a successful and orderly transition will be apathy. In the light of Brexit, COVID-19 and the current economic outlook, this does not sit at the top of the agenda for borrowers or even financial institutions. There is no certainty Libor will continue after 2021. Those who fail to take steps now risk being left behind as negotiations start with others. Early adopters are likely to be able to drive forward their preferred methodologies as the market looks for a unified approach; those who participate in the discussion later may find they are met with resistance if their preferences differ from those of the first movers.

Libor is going. For what replaces it, now is the time to plan.

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Complaints Procedure

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