Loan Market Association
the authoritative voice of the EMEA market

ACT LEADING TREASURY PROFESSIONALS

Syndicated loans and forward-looking term rates

Introduction

LIBOR is used extensively by corporates as the interest rate benchmark for loans.[1] Interest under syndicated loans is typically made up of a forward-looking term benchmark rate (traditionally one, three or six month LIBOR) plus a margin (being a fixed spread over LIBOR and which depends on the creditworthiness of the borrower).

Loan agreements involve actual cash flows which require advance certainty and transparency. Indeed, LIBOR was first created for use as a reference rate in pricing syndicated loans in response to market demand. As a result, today's pricing, documentation and administration of syndicated loans depend heavily on a forward-looking term rate.

Although the majority of loan agreements are based upon standard documentation, each loan is a bespoke agreement and individually negotiated between the relevant parties. Loans are not therefore suited to being administered through a clearing system, and there is considerable work involved in administering a loan, particularly if it is a syndicated or multicurrency facility which contains optionality (and which are key sources of finance for many borrowers).

A transition to overnight risk-free rates (RFRs) without the availability of a forward-looking term rate would present enormous practical and operational difficulties for borrowers, lenders and agents. There is a significant risk that in the absence of suitable benchmarks for the loan market, the ability of banks to fund the corporate sector will be impaired. For example, a transition to an overnight backward-looking RFR will impact month-end processes, loan documentation, operations and systems.

These issues are explored further below and need to be considered in the context of the importance of the loan product to borrowers, the broader economy as a whole, the desirability of maintaining flexibility for borrowers and the ability to ensure that any replacement RFR benchmarks are not detrimental to borrowers.

Key features of syndicated loans impacted by LIBOR transition

The forward-looking term structure of LIBOR drives a number of the features of the syndicated lending market which provides key flexibility to borrowers. This also creates complexity in terms of any move to an overnight RFR.

The term of a syndicated loan is effectively divided into interest periods (typically one, three or six months), selected by the borrower. LIBOR is set at the beginning of the interest period and the margin is agreed and specified at the time of signing the loan agreement, with interest being paid at the end of each interest period (or every six months if the interest period is longer than six months). The availability of a LIBOR term rate at the beginning of each interest period ensures that lenders and borrowers are able to predict the payments required at the end of the period. This is important for cashflow management for all parties.

Repayments of principal are typically made at the end of an interest period, otherwise break costs are payable by the borrower. Break costs are designed to compensate the lenders for the missing interest that would have

[1] References to LIBOR in this publication apply equally to EURIBOR, which is used extensively for loans in euros.

been paid in that interest period only. This provides borrowers with the flexibility to be able to manage prepayments and repayments without penalties.

Whilst interest periods under syndicated loans are generally one, three or six months, one area in which overnight rates are currently used in the syndicated loan market is in relation to swingline facilities. A swingline loan tends to be made available to support a borrower's commercial paper programme. They can usually be requested on a same day basis for very short drawing periods (typically one to seven days), hence the use of an overnight rate (i.e. overnight LIBOR). As a result, they are not directly comparable to the use of an overnight backward-looking RFR for longer-term drawings (i.e. one, three or six months).

Syndicated loans may be either single currency or multicurrency (i.e. available for drawing in different currencies). As LIBOR is a term benchmark which is perceived to include both bank credit and term risk, the applicable margin will typically be the same across different currencies and different interest periods under the same loan agreement. Removal of these elements from an overnight RFR means that such risks would need to be compensated for in a different way, the most likely being through an increase in the margin. This would result in less transparency for borrowers and less comparability of pricing for borrowers wishing to access multicurrency financing. It would also make it more difficult for adjustments to be made to reflect changing market conditions, such as an increase in term yield curves.

Implications for borrowers

Borrowers have indicated a need for certainty and transparency of interest cost. Given that LIBOR is pre-determined and publicly available at the start of an interest period, this provides both transparency and certainty of funding costs, as the interest payable will be known and capable of verification in advance. This is also important for borrowers who wish to make a repayment of principal or refinance their loan mid-interest period, since any calculations can be carried out in advance of the event. This is of relevance to both smaller and larger corporates, albeit potentially for different reasons. Smaller borrowers may have less surplus liquidity, and thus need to manage their cashflows to tighter limits; larger borrowers need to consider and balance cash management logistics across group companies and indeed across geographies. Regardless of borrower size, a move to an overnight RFR would require treasurers to retain additional cash balances to accommodate possible interest rate movements during the period, making cash management less efficient than is currently the case.

Absent a suitable forward-looking term rate, borrowers would have to use a backward-looking or overnight rate. Whilst a backward-looking rate may be suitable for some clients (particularly if the rate is compounded and the amount payable is specified a few days in advance of the required interest payment), unless the relevant computation is carried out by a third party and subsequently published, it will be a much more onerous process to calculate and verify it. In addition, many firms' systems also require a pre-determined, forward-looking floating rate payment structure. Global closing cycles which use closing data, and therefore need a known number, would be expensive and time consuming to change. Booking rates for a transaction need to be known before they happen and daily moves are unhelpful to a large number of corporates. Incorporating the necessary changes to systems and infrastructure will be time consuming, inconvenient and costly, which may also result in market dislocation as different corporates will have different capacities to adapt. For some corporates, the preference may be to simply find alternative trusted benchmark rates and/or products which better suit their financing needs. This also illustrates the importance of ensuring that further alternatives are readily available in addition to overnight RFRs, so that corporates are able to select the best product for their needs and do not feel that they are being pressured to accept a rate that does not work for their business (for whatever reason). Furthermore, the provision of more than one option will assist those borrowers who are not able to adapt their systems before any LIBOR discontinuance.

Whilst it may be possible to envisage alternative methods of creating a forward-looking payment structure absent a forward-looking term rate (for example, entering into a set of rolling quarterly OIS contracts to create

a forward-looking payment structure), this would involve corporates having to incur additional cost for additional hedge liabilities in order to create the forward-looking term structure that they need. There are also questions about whether such rates are workable or appropriate in all cases. Contracts of this nature may not be a universal solution to the challenges of managing overnight RFR based loans, particularly because forward hedging arrangements will be a novel concept for many corporates accustomed to using LIBOR. Some corporates may simply not have the capacity – or the budget – to accommodate them. Futures will also introduce complexity into lending transactions, not least in terms of counterparty risk analysis. Furthermore, the result of pushing mid-sized and smaller companies into the derivatives market could bring about the need for additional regulatory scrutiny for the derivatives market.

In addition, despite the existence of LMA recommended form facility agreements, each syndicated loan agreement is individually negotiated and requires individual amendment. This process becomes more difficult in the context of larger syndicated loan facilities where syndicates can range in size (with up to 500 lenders possible in a large leveraged transaction). Changes to interest rate payments usually require all lender consent (although majority lender consent may be provided for in a loan agreement). The amendment process will involve significant time and cost implications and there can be no guarantee of a favourable outcome. If the parties to an agreement fail to reach consensus on necessary amendments and existing fallbacks have to be relied on, possibly ultimately to individual lender cost of funds, this would be unsustainable on a widespread basis and could cause huge disruption to the market.

Whilst there may be some corporates who might be able to adapt to the use of overnight or compounded rates, these are likely to be larger corporates with more sophisticated financing infrastructures. On the whole, the feedback that has been received (including through the sterling sub-group on transition issues in syndicated loan markets) is that many borrowers would find the transition to overnight or backward-looking RFRs extremely difficult and that even many sophisticated borrowers will not find it practical to use an overnight rate for daily risk management purposes.

Implications for lenders

On the lender side, fundamentally, an overnight RFR does not compensate a lender for bank credit or term risk: a perceived key feature of LIBOR. Under a syndicated loan, lenders are making longer term funds available and need to be compensated for doing so. Whilst the compounding of an overnight RFR over a period of time could give a RFR term rate, such compounding does not reflect the increased risk of lending for longer periods than on an overnight basis. Lenders would therefore need to be compensated for providing longer term funds in the margin, which is arguably less transparent for borrowers.

On the operational side, the administration of a backward-looking rate that fluctuates daily is not currently supported by the loan product systems used by most lenders (for example, some systems require input of the interest rate prior to effecting a payment for drawing). Adjustment of the rate each day to capture an overnight RFR would be a manual process carried out by each agent/lender (absent the development of an automated feed); this would not only increase the possibility of error, but also be operationally intensive. Whilst systems could be constructed to accommodate this process, the market currently uses a range of IT products, either built and supported in-house, or provided by various third party vendors, all of which would need to be adapted. Whilst the substitution of a new term rate would probably have less of an impact on such systems, a daily rate compounded and applied retrospectively could present significant design challenges. Such changes will take time to design, build, test and implement, with timeframes differing across the market, leading to market fragmentation. Depending on the complexity of the system, certain smaller lenders may be disinclined to make the additional investment. The cost of entry for new lenders may also increase, reducing overall liquidity in the market.

Conclusion

The challenge of transitioning a whole market to a new interest rate benchmark will be lessened if the successor rate has at least some features in common with LIBOR, or is not the sole rate available to borrowers. Ultimately, transitioning from a forward-looking term rate to a backward-looking daily rate will involve more radical surgery to documentation, processes and systems than a move from one term rate to another.

The desirability of maintaining flexibility for borrowers, ensuring that any replacement RFR benchmarks are not detrimental to market operations, and the goal of producing a forward-looking term rate for use in cash products, have been recognised across the different currency working groups. It will be important for loan market participants to keep informed of the proposals, and to respond to any public consultations issued, by the currency working groups in this respect.

This publication is dated 20 July 2018.

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