LIBOR phase out of Sterling and the US Dollar markets

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11/08/2022

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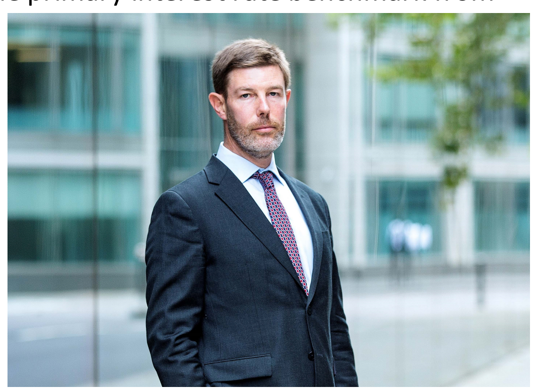
After decades of service, LIBOR (London Interbank Offered Rate) effectively ceased to be used as an interest rate benchmark at the end of 2021 in most markets. Synthetic LIBOR will continue to be published for Sterling until the end of 2022 but only to support legacy deals that hadn't transitioned to an RFR (Risk Free Rate) by the end of 2021.

Although USD LIBOR was given a bit longer than other currencies to cease being used, that too will no longer be published after 30 June 2023. As such, lenders and borrowers have had to adjust to a post-LIBOR world in which RFRs (which are generally slightly lower than their LIBOR equivalents) are used as the primary interest rate benchmark from which to calculate interest on floating rate loans.



LIBOR was traditionally based on banks reporting the rate at which they are able to borrow in the interbank market. Although there were a number of reasons for the phase out of LIBOR, 2 key considerations were:

- the limited number of underlying transactions that LIBOR was based on, meaning that expert judgement was often used instead of real pricing data
- the risk of creating systemic risk in financial markets because of the widespread use of LIBOR as a convenient benchmark beyond its original intended use in the syndicated loan market

LIBOR's replacements – SONIA and SOFR

LIBOR was published for a number of currencies until the end of 2021 and separate RFRs have now been identified for these. The RFRs for Sterling and USD are SONIA (Sterling Overnight Index Average) and SOFR (Secured Overnight Financing Rate) respectively. RFRs are based on recorded transactions in highly liquid overnight borrowing markets. This provides an objective and reliable benchmark for individual transactions. By definition, RFRs provide historical data and this has a practical impact for lenders and borrowers who historically relied upon LIBOR as a term rate to calculate how much interest they would receive/pay on a loan, for example in one, 3 or 6 months' time. Using an RFR as an interest rate benchmark requires a calculation to be carried out using a compounded RFR in arrears for each day on which interest is charged up to the date when the amount of interest is calculated.

Because time is needed to arrange and make payments between bank accounts, there is generally a 5 BD lag period built into RFR interest rate provisions in loan agreements such that the borrower should be aware 5 BDs in advance of an interest payment date of what amount will be due then. The complexity of interest calculations based on a daily compounded rate in arrears has meant, in practice, that many borrowers are entirely reliant on facility agents and

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lenders to calculate the interest due on their loans.

The lack of forward visibility on interest rates when using RFRs is particularly relevant to project finance transactions, especially where contracted revenues – such as availability payments – don't allow the borrower much flexibility in relation to its financial covenants such as debt service cover ratios. The use of SONIA for such transactions means that additional focus is brought to bear on the borrower's hedging arrangements and the time available for remedies such as equity cure rights (whereby equity is injected to a project company by a sponsor to cure a financial covenant breach).

Another area in which project finance transactions are impacted by the use of RFRs from a practical perspective is in emerging markets transactions that require central bank approval for borrowers' payments to lenders in hard currency. In such cases, a borrower may not have time to get the necessary approvals to be able to make interest payments based on accurate calculations within the 5 BD lag period available to them.

Use of SONIA looking forward

Undoubtedly some borrowers and lenders using Sterling would prefer a forward-looking term rate instead of overnight SONIA, compounded in arrears, for reasons including those set out above. Term SONIA, (also known as TSSR – Term SONIA Reference Rate) is now available but the Bank of England, FCA (Financial Conduct Authority) and Sterling Risk Free Rate Working Group (£RFR WG) are not supportive of its use and it is not expected to become widespread as a replacement for LIBOR. The £RFR WG have stated that if use of TSRR becomes widespread it would risk reintroducing the structural market vulnerabilities associated with LIBOR. TSRR is not deemed to be suitable for loans in excess of £25 million, which would more or less rule out its use in project finance transactions. For smaller loans, trade finance and Islamic finance the £RFR WG suggest using fixed rate products or the Bank of England's Bank Rate as an alternative to TSRR.

Use of SOFR looking forward

In the US, the ARRC (Alternative Reference Rate Committee) has a more favourable view of Term SOFR. In July 2021. ARRC formally recommended Term SOFR as an alternative to USD LIBOR and the £RFR WG has accepted that Term SOFR would be relevant for USD business in London. Notwithstanding the potential benefits of using Term SOFR, especially in emerging market project finance transactions, the availability and pricing of swaps (interest rate and FX swaps are a key source of risk management on project finance transactions) has been flagged as a potential barrier.

Conclusions

It seems that the regulators and market participants are moving in different directions on either side of the Atlantic. In London, the preference for regulators is for Sterling deals to use SONIA compounded in arrears whereas in the US, and more widely where USD loans are provided in emerging markets, those parties who are familiar with LIBOR based loan facilities are also looking favourably upon Term SOFR as an alternative. However, when the final decision is made as to whether Term SOFR or SOFR compounded in arrears is used on a specific transaction we would expect pricing, including the cost of swaps, to be the determining factor.

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