Baker McKenzie.

In Practice

Authors Prof Dr Lukas Glanzmann, Samuel Marbacher, Dr Philip Spoerlé and Dr Markus Wolf

Approaching the endgame: LIBOR transition in the Swiss syndicated loan market

As readers of JIBFL will be well aware, it is expected that LIBOR will no longer be available after the end of 2021, with the exception of certain tenors for USD LIBOR that will be published until the end of June 2023 and, potentially, a synthetic LIBOR for certain currency-tenor settings. While EUR LIBOR will cease to be available, there are no current plans to discontinue EURIBOR. With the Swiss franc (CHF) being one of the five LIBOR currencies and CHF LIBOR being used as reference rate for the calculation of interest in virtually every CHF denominated syndicated credit facility agreement, LIBOR transition poses an immense challenge to the Swiss syndicated loan market. Although we have seen the first pathfinder transactions using risk free rates,[1] the Swiss market is yet to experience a big shift.

FINMA GUIDANCE ON LIBOR TRANSITION ROADMAP

On 4 December 2020, the Swiss Financial Market Supervisory Authority (FINMA) issued regulatory guidance in which it states that it considers the end of LIBOR to be one of the principal operational risks facing its supervised institutions. The guidance contains a roadmap that proposes ambitious target dates for supervised institutions' transition to alternative reference rates (ARR). In particular, FINMA recommends that:

- by 31 January 2021 lenders should be ready to make loans based on ARR and "tough legacy" contracts (defined as contracts without legally and operationally robust fallback clauses or written agreement regarding an ARR) should no longer be entered into;
- by 31 March 2021 lenders should implement plans for the reduction of tough legacy contracts;
- by 30 June 2021 new loan agreements should in general be based on ARR and lenders should take specific measures to mitigate risks emerging from remaining tough legacy contracts; and
- by 31 December 2021 all new loan agreements should be based on ARR.

NWG RECOMMENDATIONS

In Switzerland, the National Working Group on Swiss Franc Reference Rates (NWG) has taken the lead in catalysing a market-led transition from CHF LIBOR. For syndicated loans, the NWG has recommended the use of the Swiss Average Rate Overnight (SARON) compounded in arrears as the reference rate for calculation of interest. In terms of compounding conventions, the NWG recommends the cumulative methodology and a five banking days' lookback with observation shift, although lookback without observation shift is recognised as a viable option in international transactions. Further, it is recommended that a floor, if any, be applied to the compounded rate rather than the daily rate. However, the application of a floor to the daily rate is recognised as a viable option in international transactions.

It is important to note that the conventions recommended by the NWG deviate from those recommended for compounding in arrears by other currency working groups such as the Sterling Working Group on Risk-Free Reference Rates (£RFR WG) or the US Alternative Reference Rates Committee (ARRC). The most notable difference is the NWG's recommendation for the use of the cumulative rather than the non-cumulative convention. Under the cumulative approach, the compounded rate is calculated at the end of the interest period and applied to the whole period, resulting in one static interest rate for the entire period. By contrast, under the non-cumulative approach, a daily compounded rate is computed and interest is calculated daily, so that the interest rate and the interest amount vary on a daily basis. Importantly, the daily interest amount is not compounded but only added up. Any such compounding could be problematic under the Swiss law prohibition on compounding of interest. As a result, model documentation published by the Loan Market Association (LMA), which is based on the £RFR WG conventions, and by the Loan Syndications & Trading Association (LSTA), which is based on the ARRC conventions, cannot be used without adaptation if market participants want to follow the NWG recommendations.

NWG ENDORSED FORM OF CHF RATE SWITCH AMENDMENT AGREEMENT

In a pro bono project for the NWG, Baker McKenzie Switzerland drafted a form of amendment agreement (Skeleton Agreement) for Swiss law governed syndicated credit facility agreements. It introduces a mechanism for the switch from CHF LIBOR to compounded SARON based on the NWG's recommended conventions. The document also contains the optionality to use the lookback without observation shift methodology. It can be downloaded from the NWG's website.[2]

The Skeleton Agreement assumes that the underlying facility agreement to be amended is a CHF single currency credit facility agreement in the English language, governed by Swiss law, prepared on the basis of the most recent LMA recommended forms of investment grade facility agreements using CHF LIBOR as a base rate. It does not aim to stipulate a formally recommended wording but rather to facilitate the transition for legacy agreements by way of amendment (rather than

Biog box

Prof Dr Lukas Glanzmann and Samuel Marbacher are partners, Dr Philip Spoerlé and Dr Markus Wolf are senior associates in Baker McKenzie's Banking and Finance team in Zurich. Email: lukas.glanzmann@bakermckenzie.com, samuel.marbacher@bakermckenzie.com, philip.spoerle@bakermckenzie.com and markus.wolf@bakermckenzie.com

a restatement). Commercial points (eg break cost) are intentionally left blank or are indicated as optional (eg zero floors). Even though the Skeleton Agreement was prepared for legacy agreements, its approach can also be used for new CHF single currency credit facility agreements and with a few twists even for multi-currency agreements where the non-CHF currencies remain term rate currencies (eg EUR). The following elements of the Skeleton Agreement are worth being discussed in more detail.

Dealing with intra-interest period events

Due to the NWG's recommendation to use a cumulative approach to the compounding of SARON, the amount of interest payable for an interest period of a loan can only be calculated at the end of the observation period relating to that interest period (ie shortly before the end of that interest period). However, intra-interest period events, such as a mandatory prepayment, may result in the need to advance that calculation to an earlier point in time (ie to the time of the prepayment). The Skeleton Agreement addresses this point by introducing a new mechanism to shorten interest periods for the purposes of such interest calculation (new cl 10.2A). This automatically shortens the observation period for the interest period, as the observation period is defined by reference to the interest period.

This contrasts to the situation under the LMA's exposure drafts for rate switch facility agreements (Exposure Drafts), which adopt the non-cumulative convention recommended by the £RFR WG. Under the LMA's exposure drafts, intra-interest period events do not require a shortening of the interest period because the application of the non-cumulative convention results in the daily calculation of interest. Therefore, the amount of accrued interest is known on each day of an interest period for a loan.

An intra-interest period event may further result in the reporting day, which is the day relevant for determining when a lender must report any market disruption, being shifted to the past as it is defined in relation to the end of an interest period. The Skeleton Agreement addresses this point in the definition of reporting day by moving that day forward (by reference to the day on which the agent notified the lenders of the shortening of the interest period) if it would otherwise fall into the past. To our knowledge, this aspect is not yet addressed in the Exposure Drafts.

Credit adjustment spread

In order to prevent any transfer of economic value from one party to another as a result of the replacement of CHF LIBOR by compounded SARON, the Skeleton Agreement contemplates the addition of a credit adjustment spread. Like the Exposure Drafts, the Skeleton Agreement provides for the optionality to fix the credit adjustment spread directly in the amendment agreement, either as a single number or as a ratchet depending on the length of the interest period. It further provides for the optional use of the credit spreads calculated and published by Bloomberg using the historical five-year median spread adjustment methodology. However, readers should be mindful of any use restrictions associated with the Bloomberg credit adjustment spreads until their fixing. For the interim period, the Skeleton Agreement proposes alternative wording.

Timing of rate switch date

The Skeleton Agreement contains a number of options for the rate switch date. One option is to fix the date, which may or may not coincide with the effective date of the amendment agreement. Alternatively, the rate switch date can be left open for the agent and the company to define, optionally combined with a long-stop date. From the lenders' perspective, operational readiness is going to be the decisive factor for the rate switch date.

Dealing with term rate loans outstanding on the rate switch date

The Skeleton Agreement differentiates between term rate loans (ie LIBOR referencing CHF loans) and compounded rate loans (ie SARON referencing CHF loans). As from the rate switch date, the compounded reference rate (ie compounded SARON plus credit adjustment spread) will replace LIBOR for the calculation of interest. Since under a credit facility agreement several loans with different interest periods may be outstanding at the same time, the rate switch may not coincide with the end of an interest period. Therefore, the Skeleton Agreement stipulates that if the rate switch date falls before the last day of an interest period for a loan, that loan shall continue to be a term rate loan for the remainder of that interest period. As an alternative, users may agree that the relevant interest period be shortened to end on the rate switch date.

Dealing with unavailability of SARON

The Skeleton Agreement provides for fallbacks in case of the unavailability of SARON. Those fallbacks have been drafted on the basis of the NWG's Discussion Paper on SARON Floating Rate Notes dated 2 July 2019. They provide for a waterfall that differentiates between a cessation event having occurred with respect to SARON (ie SARON no longer being representative or published) and no such cessation event having occurred. The waterfall ultimately ends with the policy rate of the Swiss National Bank.

CONCLUDING REMARKS

With less than ten months left until the cessation of LIBOR, transition to alternative reference rates is an immense challenge for all market participants in the Swiss syndicated lending space. Its complexity should not be underestimated. While there is no one-size-fits-all-approach, it is hoped that the NWG-endorsed Skeleton Agreement will be an important cornerstone in helping market participants deal with this change – one of the loan market's most profound to date. ■

The authors advise lenders, borrowers and sponsors on leveraged acquisition, corporate, project, export and property financing transactions. Baker McKenzie drafted the NWG-endorsed form of rate switch amendment agreement.

1 The CHF 525m facility for dormakaba Group signed in early December 2020 was the first Swiss law governed syndicated facility agreement with an in-built switch mechanism to SARON. Baker McKenzie Switzerland drafted the documentation as lenders' counsel.

2 https://www.snb.ch/en/ifor/finmkt/fnmkt_benchm/id/finmkt_NWG_documents