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Distressed Debt & Claims Trading ADVISORY ■

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What You Need to Know About Changes to LMA Secondary Trading Documents Due to Shift from LIBOR-Based to RFR-Based Loans

The Loan Market Association (LMA) recently published revised secondary debt trading documentation that will apply to bank debt trades entered into on and after January 4, 2022. The LMA standard terms and conditions for par and distressed trade transactions (STCs) and LMA trade confirmation largely remain the same, but key revisions were made to the language regarding delayed settlement compensation for risk-free reference rates (RFRs). These changes were necessitated by the transition away from the London inter-bank offered rate (LIBOR) in the corporate syndicated loan market to RFRs (such as the sterling overnight index average (SONIA) applicable in the British sterling market and the secured overnight finance rate (SOFR) applicable in the U.S. dollar market).

Modifications to Delayed Settlement Compensation Under the STCs

Under the STCs, unless the parties expressly agree otherwise, delayed settlement compensation starts to accrue during the delay period, which, for par trades, is the trade date plus 10 business days (T+10) and, for distressed trades, is the trade date plus 20 business days (T+20). Historically, the cost of carry rate applicable during the delay period was based on the 1-month inter-bank offered rate (IBOR) for the pertinent currency. As noted in the LMA's revised User's Guide, this cost of carry approach is no longer adequate for syndicated loan facilities that have shifted from use of IBOR to RFR.[1]

IBOR-based loans

Under Section 11.1(a) of the updated STCs, if interest accrues on the traded portion under a credit agreement by reference to an IBOR rate, cost of carry shall be calculated the same way as historically done by averaging the applicable 1-month IBOR rate currency over the course of the delay period. If the relevant 1-month IBOR is no longer available, the cost of carry rate will be the daily simple risk-free rate for such currency.

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1 *Secondary Debt Trading Documentation (Par and Distressed) – User's Guide* at 10, LMA (Jan. 4, 2022), https://www.lma.eu.com/documents-guidelines/documents.

RFR-based loans

Under Section 11.2(a) of the updated STCs, the default cost of carry rate for traded portions accruing interest under a credit agreement on an RFR basis is now a simple daily risk-free rate.[2] For such transactions, cost of carry is calculated by averaging the simple daily risk-free rate over the course of the delay period. In addition, a credit adjustment spread (CAS) equal to the CAS payable under the credit agreement must be added to the daily risk-free rate unless CAS is not payable under the credit agreement or the parties specify in the confirmation that CAS does not apply.

The default daily simple risk-free rate is not mandatory, and the parties may specify that a compounded index, such as a compounded SONIA index, will be used for cost of carry purposes instead of a simple daily risk-free rate. If the parties elect to use a compounded index, this election must be detailed in the confirmation along with the applicable index for each currency. Due to operational complexities and limitations of electronic settlement platform capabilities that generate pricing for market participants, we expect the majority of LMA bank debt trades to follow the default daily simple risk-free rate convention for calculation of cost of carry for RFR-based loans.

The delayed settlement compensation provisions in the STCs also cover situations where interest accruing on the purchased assets under the credit agreement switches during the delay period from IBOR based to RFR based. If this happens, delayed settlement compensation will be based on the current 1-month IBOR rate methodology for each day during the delay period that the purchased assets are subject to an IBOR rate and for the remainder of the delay period will be payable on the basis of the new daily simple RFR (plus credit adjustment spread, if any).

Very helpful examples of how to calculate delayed compensation in connection with the new risk-free rate methodology have been added in the schedule to the LMA revised User's Guide. In addition to understanding the new methodology, for anyone looking to better understand how delayed compensation is calculated generally, review of such examples will be an instructive learning tool.

LMA Trade Confirmation (Bank Debt)

Other terms of trade

The main revisions to the confirmation are located under the Other Terms of Trade (OTOT) section.[3] Under this section, the parties, as before, may opt to forgo delayed compensation, but now have two new checkbox options to select that will affect the economics of the trade.

Exclude CAS for cost of carry?

The first of these new checkbox options is the ability to exclude the credit adjustment spread for the purposes of cost of carry. In deciding whether to exclude CAS for cost of carry purposes, each party should be aware that a CAS is typically used to reconcile the economic differences between IBORs and RFRs, which, in turn, is intended to limit the value transfer between the parties during the transition to RFRs. However, parties should not take this at face value because, although LIBOR is credit-sensitive (unlike SONIA and other RFRs), it still trends alongside other RFRs, such as SOFR. Thus, when a transaction involves a CAS, parties should carefully examine the applicable IBOR and RFR trends to determine whether including CAS for cost of carry purposes does, in fact, limit the value transfer between

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2 *Standard Terms and Conditions for Par and Distressed Trade Transactions (Bank Debt/Claims)* at 34, LMA (Jan. 4, 2022), https://www.lma.eu.com/documents-guidelines/documents.

3 LMA Trade Confirmation (Bank Debt) at Section 14, LMA (Jan. 4, 2022), https://www.lma.eu.com/documents-guidelines/documents.

the parties. As a practical matter, end buyers will prefer to exclude CAS in the calculation because this will lessen the cost of carry amount owed to a seller for the delay period. Market participants should specify at the time of trade whether CAS will be excluded for cost of carry computations.

Does a zero floor apply?

The second new checkbox option is the application of a "zero floor" for cost of carry purposes. By checking the zero-floor box, the parties ensure that the cost of carry cannot be a negative number and therefore payable by the seller to the buyer. As noted in footnote 3 of the new confirmation, if agreed to, "a zero floor will apply to the cost of carry rate when calculated for RFR Currencies on the basis of a Daily RFR (and a Compounded RFR) before the addition of CAS if applicable and for IBOR Rate Currencies on the basis of a Relevant IBOR Rate." The zero-floor checkbox could prove to be a point of contention among parties. Naturally, sellers will prefer to have a zero floor because it ensures they will not have to pay buyers in situations where the cost of carry calculation yields a negative number. On the other side, buyers will prefer no zero floor, allowing them to reap the benefits of a negative interest environment.[4] In order to avoid such disputes, parties should determine at the time of trade whether a zero floor applies when calculating cost of carry.

Other Modifications – Default Interest Under LMA Participation

The transition from IBORs to RFRs also required the LMA to change how default interest provisions are calculated in the LMA standard form participation agreements. Before the revised trading documents, default interest owed by either a grantor to a participant or by a participant to a grantor for late payments was equal to 2% *plus* the relevant interbank market for overnight deposits offered by leading banks in the applicable currency and for an amount equal to the unpaid balance. Under the updated LMA participation trading documents, default interest will now be equal to 2% *plus* the rate at which the party owed the money would be able to obtain by placing on deposit with a leading bank an amount equal to the unpaid balance.[5]

Takeaways

Buyers and sellers should be aware that the default cost of carry rate for traded portions accruing interest under a credit agreement on an RFR basis is now a simple daily risk-free rate. Along with this new default rate comes the ability to exclude CAS or apply a zero floor for cost of carry purposes. As the exclusion of CAS and applicability of zero floor have economic impacts on the buyer and seller, such elections should be agreed upon at the time of trade. Otherwise, such economic elections may become contentious and hold up settlement of open trades.

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4 Since the global financial crisis between mid-2007 and early 2009, several central banks around the world, including the European Central Bank, have added the utilization of negative policy rates to their toolboxes. The central bank of Sweden, in July 2009, was the first to move one of its policy rates into negative territory. The European Central Bank introduced its negative interest rate policy in 2014. Negative interest rates have now been in place for close to eight years in the euro area, and markets expect such rates to be in place for the foreseeable future. Grégory Claeys, "What Are the Effects of the ECB's Negative Interest Rate Policy?" at 8–9, Policy Department for Economic, Scientific, and Quality of Life Policies (June 2021).

5 *LMA Master Funded Participation Agreement (Par/Distressed)* at Section 4.5, LMA (Jan. 4, 2022), https://www.lma.eu.com/documents-guidelines/documents.

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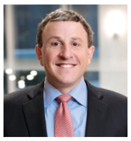
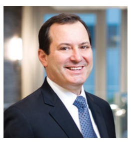
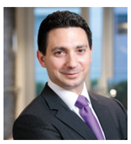
Contributors



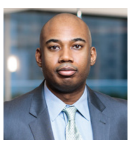
Ken Rothenberg
212.210.9594
ken.rothenberg@alston.com



David J. Hoyt
212.210.9490
david.hoyt@alston.com

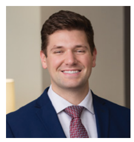


Russell Chiappetta
212.210.9403
russell.chiappetta@alston.com



Mathew Gray
212.210.9410
mathew.gray@alston.com

Jason Cygielman
212.210.9511
jason.cygielman@alston.com



Thomas Kelly
212.210.9491
thomas.kelly@alston.com

Andrew Petersen
+44.0.20.3823.2230
andrew.petersen@alston.com

Dominic Olins
+44.0.20.3823.2225
dominic.olins@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ▪ Suite 21B2 ▪ No. 7 Guanghua Road ▪ Chaoyang District ▪ Beijing, 100004 CN ▪ +86.10.85927500
BRUSSELS: Rue Guimard 9 et Rue du Commerce 87 ▪ 3rd Floor ▪ 1000 Brussels ▪ Brussels, 1000, BE ▪ +32.2.550.3700 ▪ Fax: +32.2.550.3719
CHARLOTTE: One South at The Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: Chase Tower ▪ 2200 Ross Avenue ▪ Suite 2300 ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
FORT WORTH: Bank of America Tower ▪ 301 Commerce ▪ Suite 3635 ▪ Fort Worth, Texas, USA, 76102 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LONDON: 5th Floor ▪ Octagon Point, St. Paul's ▪ 5 Cheapside ▪ London, EC2V 6AA, UK ▪ +44.0.20.3823.2225
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RALEIGH: 555 Fayetteville Street ▪ Suite 600 ▪ Raleigh, North Carolina, USA, 27601-3034 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ▪ Suite 2100 ▪ San Francisco, California, USA, 94105-0912 ▪ 415.243.1000 ▪ Fax: 415.243.1001
SILICON VALLEY: 1950 University Avenue ▪ Suite 430 ▪ East Palo Alto, California, USA 94303 ▪ 650.838.2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.239.3300 ▪ Fax: 202.239.3333