Transitioning Away From LIBOR: A Practical Guide To Project Financings

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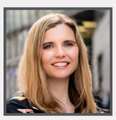

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In 2019, the UK's Financial Conduct Authority ("FCA") announced that 35 of the London Inter-Bank Offer Rate ("LIBOR") settings would formally cease from 1 January 2022, with USD overnight and 12-month LIBOR continuing until the end of June 2023. Since such announcements, the market has been transitioning away from LIBOR, with preparations increasing in urgency as the deadlines for the cessation of LIBOR draw nearer and with the regulators having indicated that there should be no new USD loan origination using LIBOR as the interest rate going forward from the 2021 year-end.

In the project finance market in particular, the LIBOR transition has thrown up numerous ramifications that lenders and borrowers need to consider, including some that extend beyond the guidance provided by the Loan Market Association (the "LMA") owing to various project finance specific factors. Project finance loans are often provided in multiple currencies by numerous types of financing institution globally (each subject to different regulatory regimes and with varying institutional policy requirements). They typically feature long tenors and tend to reference floating interest rates that are commonly required to be hedged. In addition to the loan documentation, there are a number of project document and project specific non-LMA considerations to account for the introduction of a risk-free rate ("RFR"). LIBOR replacement is therefore a multi-faceted area for particular attention in project financings and we set out some of the sector specific considerations below.

CALCULATING THE MINIMUM DSRA BALANCE

The transition from LIBOR has a particular impact on those provisions that rely on benchmark interest rates being forward-looking rates. Project financing structures and cash waterfalls typically include an obligation of the borrower to accrue and maintain a minimum debt service reserve balance ("Minimum DSRA Balance") in a secured account, which is calculated as the amount projected to be payable by way of principal and interest on the next following payment date. This helps to ensure that there are sufficient funds held separately to provide for all debt service (i.e., interest and principal) to be paid on the next following payment date when due.

As LIBOR is a forward-looking rate, it is a relatively straightforward task for the agent to determine the Minimum DSRA Balance with near certainty prior to the start of the relevant interest period/ repayment period. However, as many RFRs, including the Secured Overnight Financing Rate ("SOFR") and Sterling Overnight Index Average ("SONIA"), are back-ward looking rates, which become known at the end of the corresponding application period, calculation of such rates by the agent for such periods is a more challenging task and parties must carefully consider the assumptions that should be applied for the calculation of such amounts. As a helpful point of reference, the Bank of England now publishes the SONIA Compounded Index and the Federal Reserve Bank of New York publishes the SOFR Index, each index simplifies the calculation of interest rates by providing a standardised basis of reference to an official source. Consequently, we have seen agents apply such indexed rates as upfront estimates to calculate RFRs for the forthcoming interest period/repayment period and then compare such rates with the relevant backward-looking rate at the end of the relevant period. To mitigate the risk of a misalignment between the two calculations, some agents have adopted a process of monthly look-backs to capture historical data and some lenders are requiring a buffer of circa 5-10% to be added to the Minimum DSRA Balance to accommodate any discrepancies. As finance documents tend to provide for a definition of debt service reserve balance that refers to the payment of scheduled debt service generally, it will be interesting to see whether following the movement to RFRs this definition evolves to become more prescriptive.

Worth noting, however, that the sizing of the Minimum DSRA Balance can be less important in project financings of power projects and mines that are heavily hedged, as in such circumstances, the lenders will look to the fixed rate hedging in place when calculating the debt service reserve balance.

FINANCIAL MODEL

For new money deals, all financial models should, of course, reference the relevant RFR elected by the parties so that the modelling and cash flow needs of the project are properly understood. For legacy project financings, the borrower is likely to be sensitive to re-opening the economics of the project by issuing an updated financial model, particularly as given the long tenors of such projects, the day one assumptions set out therein could have been set years previous. It may be that the finance documentation already provides for updates to cashflow modelling which are triggered by the cessation of LIBOR, in which case, the choice as to whether to request a revised financial model would sit with the lenders. We have found, however, that even when presented with the option, the lenders may request that the change is captured in the financial model by re-labelling the LIBOR-related assumptions with the name of the rate adopted, only.

Parties must, however, take care that the relevant assumptions in the financial model are agreed and updated according to the stipulated process in the finance documentation.

FINANCIAL RATIO COMPLIANCE

New money deals should, of course, calculate financial ratios by reference to the RFR elected by the parties. With respect to updates to the financial model in legacy contracts, it may be that financial ratio compliance is largely unaffected by the LIBOR transition. We do, however, note that similar to the ramifications on determining appropriate debt service reserves (described above), forward-looking interest rates of the type traditionally used in project finance loans are important when calculating future cover ratios such as the projected or prospective debt service cover ratio ("DSCR") and the loan life cover ratio ("LLCR").

INTEREST RATE HEDGING REQUIREMENTS

Project financings typically include minimum interest rate hedging requirements to be complied with by each relevant borrower. From a hedging perspective, Milbank's recent experience is that corporate and investment manager clients are being encouraged to accede to the ISDA 2020 IBOR Fallbacks Protocol (the "ISDA IBOR Protocol") to ensure that their "legacy transactions" (i.e., those entered into before 25 January 2021) incorporate the RFR fallbacks and applicable spread adjustments recommended by ISDA following cessation of the LIBOR. Hedging contracts entered into on or after 25 January 2021 that incorporate the 2006 ISDA Definitions (e.g., interest rate transactions) automatically incorporate such RFR fallbacks pursuant to the ISDA IBOR Supplement.

PROJECT AGREEMENTS

Project agreements may also refer to LIBOR, perhaps most commonly, as a reference for calculating default interest on late payments. Parties should be mindful of the time it may take to agree any such changes with multiple project document counterparties, especially in less developed countries and particularly if the intention is to align such changes with any corresponding amendments to the finance documents.

A larger potential issue that arises from the replacement of LIBOR in project documents, is in connection with power purchase agreements and concession agreements. Under such documents, a

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procuring authority may be obliged to pay a termination payment in certain circumstances. Such termination payments are often sized to cover "Senior Debt" (including principal, interest and hedging termination amounts). The definition of "Senior Debt" is usually fixed and based on the terms of the finance documents as at the signing date. It is sometimes the case that any amendment to such definition for the purpose the relevant project document, requires the consent of the relevant procuring authority, which may be difficult to obtain if transition from LIBOR to a RFR reduces the interest amount, with the consequence that the procuring authority's financial exposure is increased.

Local counsel will also need to be engaged to consider any local law specific ramifications of the move to RFRs in the non-English law governed project documents and to liaise with the relevant counterparties with respect to such issues.

DOCUMENTARY PROCESS FOR LEGACY CONTRACTS

Legacy contracts can be amended via long-form amendment and restatements effected by amendment and restatement agreements though, the more commonly adopted approach appears to be for such amendments to be set out in discrete amendment agreements. Notwithstanding the method adopted, lenders commonly request legal opinions which speak to the enforceability of the documents effecting the amendments/ being amended as condition precedents to entering into such documents. This is particularly the case where any guarantees are amended as the lenders will require confirmation that these remain in full force and effect (which they will also seek from the guarantor itself).

In the context of transactions that are not yet signed, but in respect of which commitment letters are in issuance, lenders are keen to ensure that these are updated to make clear that going forward from the year end 2021, interest on the relevant loans will be calculated on the basis of a replacement rate to be determined between the lenders and the borrower prior to signing. Institutions differ in their approach to the level of detail required to be reflected, however, given uncertainties around availability of hedging products relating to SOFR and also recognising that the first few months of 2022 will help establish the new market for transactions moving forward.

NEXT STEPS

The transition from LIBOR continues to be a focal point for many of our clients, particularly as no market standard has yet been developed either in relation to current or future contemplated transactions. Financial institutions and borrowers will all have their own in-house policy considerations informing their documentary approach and, for practical reasons, will most likely want to achieve consistency across all of their new money, committed and legacy transactions to the extent possible.

As industry leading laws in the project finance market, with experience of the challenges faced by a multitude of institutions across multiple jurisdictions, we are available to assist with any questions you may have pertaining to the LIBOR transition and the implementation of RFRs. As the deadlines for effecting the LIBOR transition draw nearer, we urge market participants to prepare for the use of replacement benchmarks as soon as possible.

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