Understanding the Transition from LIBOR to SOFR and its Implication for Transactions Involving Nigerian Counterparties

Introduction

For advisers involved in negotiating foreign currency denominated financial contracts, “LIBOR” is a term often encountered in relation to interest rates payable under such contracts. The ongoing transition from the London Inter-Bank Offered Rate (“**LIBOR**”) to alternative benchmark rates is no longer news. This article sheds light on this transition, the alternative options for US dollar-linked loan transactions, as well as how it affects Nigerian counterparties involved in these transactions.

Phasing Out LIBOR

The decision of the Financial Conduct Authority (“**FCA**”) to phase out the LIBOR by the end of 2021 was informed by a rate rigging scandal[i] that came to light sometime in 2012, which alleged that a number of the panel banks involved in the daily submission of rates for publication of the LIBOR fudged their data and manipulated the rates in order to rip off unsuspecting traders. In addition, the interbank transactions that should form the basis of the LIBOR were almost non-existent.

Following the FCA’s decision, the one-week and two-month USD LIBOR, British pound LIBOR, Japanese yen LIBOR, Swiss franc LIBOR and euro LIBOR rates have been phased out as of January 1, 2022, while the remaining USD LIBOR rates will be discontinued by June 30, 2023[ii]. The Alternative Reference Rates Committee (“**ARRC**”) came up with the Secured Overnight Financing Rate (“**SOFR**”) as a preferred replacement rate for LIBOR-linked dollar-denominated loans and securities. The SOFR is a broad measure of the cost of borrowing US dollars overnight, with treasury securities posted as collateral[iii]. The SOFR is considered a risk-free reference rate because it is based on actual overnight treasury transactions that take place in the United States treasury repurchase market, rather than estimated borrowings.

Some Transition Options and Challenges

The SOFR is not a novel rate. It has been in use in the derivatives market. It is expected that by the time LIBOR is completely phased out, SOFR would have gained traction in the loan market. The US Government has set the pace by enacting the Adjustable Interest Rate (LIBOR) Act (the "**Act**"), signed into law by U.S. President, Joe Biden, on March 15, 2022. The Act effectively replaces LIBOR with SOFR for all contracts governed by US law that lack or contain insufficient mechanisms to deal with the cessation of LIBOR.[iv]

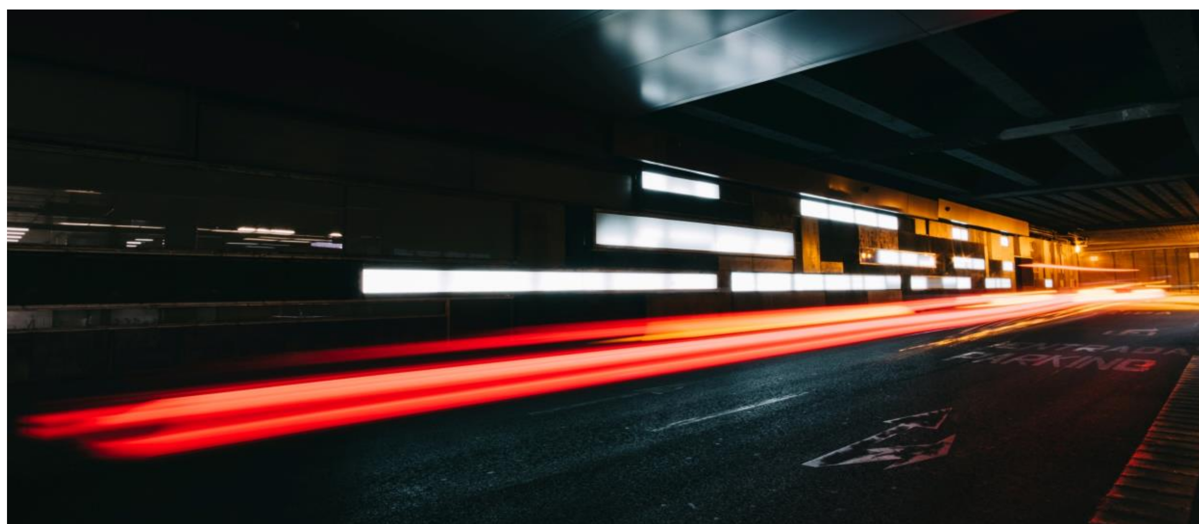
The ARRC released a white paper[v] in April 2019, proposing methods that may be adopted by market participants in the use of SOFR for cash products namely, compound or simple averaging[vi]. SOFR may be compounded in arrears or in advance. SOFR compounded in advance ("**Advance SOFR**") calculates the interest payable during Y period on the basis of the interest averaged during the prior X period (X, being an equivalent period occurring prior to Y). SOFR compounded in arrears ("**Arrears SOFR**") calculates the interest rate payable during Y period by compounding the daily rates from the beginning of Y period to the end of Y period.

Advance SOFR provides certainty for the parties at the beginning of the interest period on what the interest payment will be on the due date. However, the parties stand the risk of a volatile change in interest rate as the interest rate being applied does not represent the current state of the market during the interest period. On the other hand, Arrears SOFR results in an interest rate that accurately reflects the state of the market during the interest period. The disadvantage is that the interest payable by the parties will not be known until the end of the interest period. This poses challenges to borrowers, who require adequate time and preparation to source for funds required for interest payments and to even decide if the facility is worth borrowing. The lenders may eventually have to defer payments for a few days, which comes with its own attendant challenges.

Term SOFR – best practice for loan transactions?

One of the major transition challenges that came to fore was the recognition that adapting an overnight rate to certain contracts may be difficult. Hence, the need for a term rate[vii]. The Term SOFR rate is computed by compounding the overnight rates of the prices of futures contracts[viii] over a particular period. The benefit of the Term SOFR lies in its forward-looking nature, which allows the rate to be known at the beginning of the interest period, just like the LIBOR. With the phase-out of LIBOR, the use of Term SOFR as a reference rate in US dollar-denominated loan transactions appears to be gaining wide acceptance. On July 28, 2021, the ARRC formally recommended the Term SOFR rates administered by the CME Group[ix] for use in the business loans market and in end-user facing derivatives.

One of the underlying principles for the recommendation of the Term SOFR as best practice for loan transactions is that there must be a robust and sustainable base of derivatives transactions on which the Term SOFR is founded. Provided that there is a consistent, robust and active futures market, Term SOFR rates are expected to remain stable and immune to manipulation.



Implications of the Transition for Loan Agreements Involving Regulated and Non-Regulated Nigerian Corporates

Just like the LIBOR, SOFR-linked rates are contractually agreed upon by parties. An agreement to transition from LIBOR to a risk-free interest rate such as SOFR would be binding on the Nigerian counterparty subject to any qualifications set out herein.

Non-Regulated Nigerian Corporates: For loan agreements involving Nigerian companies that are not regulated entities, the transition considerations appear to be more straightforward from a corporate governance and regulatory point of view. The companies should ensure that they contract within the scope of their constitutional documents, and applicable corporate and credit approvals. Recourse must also be had to any third-party consent requirements relevant to the facility. Nigerian courts will recognise a binding agreement between parties at

law provided that the following factors are present: (i) competent parties; (ii) competent subject matter; (iii) legal consideration; and (iv) mutuality of agreement[x].

Regulated Nigerian Corporates: With respect to regulated entities such as commercial banks, there are other considerations that must be noted in addition to the general ones already stated above. Nigerian banks, for instance, are mandated to ensure that the net open position of their overall foreign currency assets and liabilities (both on and off-balance sheet) does not exceed 10% of shareholders' funds unimpaired by losses[xi]. The implication of this is that in making adjustments to the applicable interest rates in their outstanding loan agreements, Nigerian banks must have regard to this restriction and ensure that whatever rates are selected would not result in an exposure beyond the regulatory limit. While Nigerian banks generally do not require consent from the Central Bank of Nigeria ("**CBN**") for foreign borrowings[xii], Nigerian banks must ensure that any amendments to their outstanding LIBOR-linked agreements does not have an adverse effect on their balance sheet or result in the CBN having to treat their accounts differently by virtue of the new exposure. As with commercial banks, each regulated entity must have recourse to extant laws, prudential and other guidelines, circulars, *etc.* to which they are bound.

Recommendations for Nigerian Corporates on Loan Documentation: Parties to new loan agreements are required to provide for a replacement rate outright, preferably Term SOFR, and also ensure that robust "fallback" language[xiii] is included in their agreements to ease the transition. Given the present rate of inflation in Nigeria, procuring foreign exchange in the Nigerian foreign exchange market has proven to be increasingly difficult. This makes the Arrears SOFR method unsuitable for application to Nigerian borrowers, as they will require adequate notice to make provision for funds required to repay interest. Utilizing the Advance SOFR method, on the other hand, may be prejudicial to lenders as the interest rate for the period will be stale. The Term SOFR is also not without its cons. For parties who may want to consider the SOFR averaging, the ARRC also published its recommendations on the mechanisms[xiv] which may be applied to mitigate the challenges associated with either method. For older contracts which will not mature before LIBOR is phased out, parties may need to renegotiate (where possible) and/or amend their loan agreements to make room for the transition process, taking into account market conventions and activity, credit risk adjustments, best practices and litigation-proof procedures.

Conclusion

As with all other benchmark rates, the extent to which any market participant decides to implement or adopt the SOFR is voluntary. With few months to go before the total phase-out of the LIBOR, it is advisable for legal and business teams involved in drafting and negotiating LIBOR-linked financial contracts to get conversant with the scope of the use of SOFR. In repricing outstanding contracts and/or developing SOFR-based documentation, Nigerian counterparties should treat each loan agreement on an individual basis; carefully taking note of credit risk considerations and mapping out a roadmap to ease into any of the transition options which the parties find most suitable.

References

[i] Fernando, J., "The LIBOR Scandal", January 12, 2021, available at https://www.investopedia.com/terms/l/libor-scandal.asp.

[ii] FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks.

[iii] Federal Reserve Bank of New York, "Secured Overnight Financing Rate Data", available at https://apps.newyorkfed.org/markets/autorates/SOFR.

[iv] See the Consolidated Appropriate Act, 2022, available at BILLS-117hr2471enr.pdf (congress.gov) pages 777 to 786.

[v] The Alternative Reference Rates Committee, "A User's Guide to SOFR", April 2019, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Users_Guide_to_SOFR.pdf.

[vi] Ibid, page 2.

[vii] A term rate is a non-variable interest rate calculated for a particular period, taking into account current transactions, comparable securities and prevailing market conditions.

[viii] Given that futures are used to either hedge or speculate price movements of underlying assets, it prevents losses occasioned by unfavourable price changes.

[ix] The Alternative Reference Rates Committee, "ARRC Formally Recommends Term SOFR", available at ARRC_Press_Release_Term_SOFR.pdf (newyorkfed.org). See also ARRC_Press_Release_Term_Rate_Scope_and_Conventions.pdf (newyorkfed.org).

[x] See *Niger Classic Investment Ltd. v. UACN Property Development Co. Plc et al.* (2016) LPELR-41426 (CA).

[xi] Central Bank of Nigeria, "Review of the Limit on Foreign Borrowing by Banks", available at https://www.cbn.gov.ng/out/2017/bsd/circular%20on%20the%20%20review%20of%20the%20limit%20of%20foreign%20borrowing%20by%20banks.pdf.

[xii] Ibid. The aggregate foreign currency borrowing limit is 125% of shareholders' funds unimpaired by losses.

[xiii] See the recommendations provided by the ARRC at bilateral loans, syndicated loans and supplemental for syndicated and bilateral loans.

[xiv] ARRC "User's Guide to SOFR", ibid, pages 10 to 14.

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