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LIBOR transition in Switzerland – Where do we stand?

It has been a busy year for everyone working in the loan market with the programmed discontinuation of LIBOR for various currencies, including Swiss Francs. There are only a few more months to go. This Newsletter analyses what has been going on in the Swiss lending market and what remains to be done before the end of 2021.

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The London Interbank Offered Rate (**LIBOR**) will be discontinued for most currencies, including the CHF LIBOR, by the end of 2021 and the financial markets are transitioning to use risk free rates. In Switzerland, lenders are set to switch to the Swiss Average Rate Overnight (**SARON**) recommended by the National Working Group on Swiss Franc Reference Rates (**NWG**).

Lenders and borrowers must act to ensure a smooth transition from LIBOR to SARON. The Swiss regulator, FINMA, has requested banks to implement system and process changes as well as mitigation mechanisms for "tough legacy" cases (i.e. contracts lacking robust fallback clauses). Since mid-year, in general all new contracts shall be based on SARON and the full operational readiness shall be achieved by end of year.

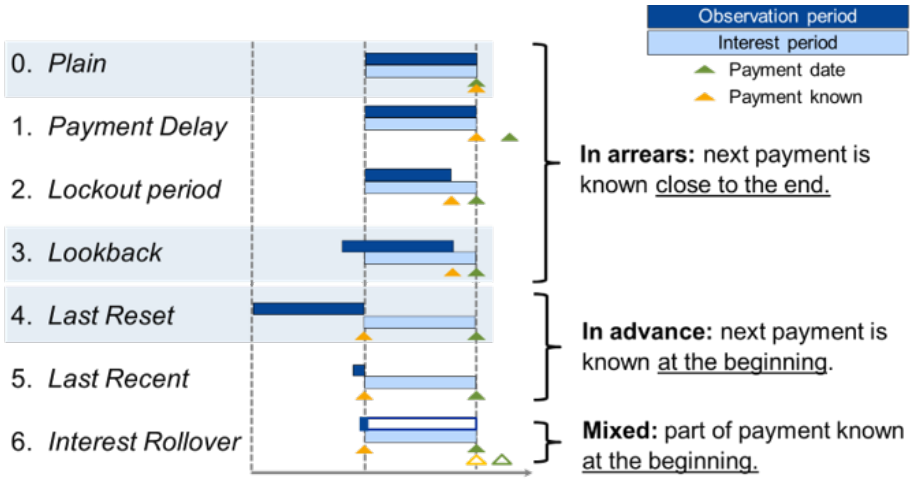
This newsletter focuses primarily on the LIBOR transition for bilateral loans and syndicated facilities and how it is currently being handled in the Swiss lending market. It is intended for specialists in this field such as banks, CFOs, group treasurers and inhouse counsel in charge of a company's facilities.

A few introductory remarks

The SARON is based on the Swiss repo market, the most liquid segment of the Swiss franc monetary market where banks and insurance companies provide overnight secured loan transactions to each other. It is derived from real values, rendering it inevitably more reliable than the LIBOR.

One of the main differences between the two reference rates is that the SARON is backward looking based on transactions that have taken place, whereas the LIBOR is forward looking. This has consequences on the calculation of the SARON and on certain typical clauses of the loan documentation that need to be amended.

Although the preferences vary depending on client segments and currencies, the most attractive methods used for calculating the compounded SARON are 0 (Plain), 3 (Lookback) and 4 (Last Reset), with a strong preference for the option 3 (Lookback) with an observation shift of five business days:



Source: NWG, Press release of 6 February 2019.

For option 0 (Plain), the observation period and the interest period are of identical lengths and they overlap, which inevitably causes practical issues in the calculation of the interest on the last day. Whereas with option 4 (Last Reset), the interest rate is known on the first day of the interest period, similar to LIBOR at present, but it is never current due to the fact that observation and interest periods don't overlap.

With option 3 (Lookback), the length of the observation period is the same as the interest period but slightly shifted, usually five business days. If rates change, this will only affect part of the overall interest rate. This option gives the bank and the borrower sufficient time for settlement and payment.

The lookback option is itself divided between (i) lookback with observation shift ("shift" methodology) and (ii) lookback without observation shift ("lag" methodology). The difference lies in the way the non-business days are accounted for in the overall calculation of the interest. If there are 2 non-business days (take a Friday for example), the interest of the last business day before the non-business day (here Friday) is multiplied by the number of days until the next day the interest is published (Monday) and thus multiplied by 3 in our example. We have to differentiate between the actual interest period and the observation period from which we are taking the daily SARON rates. Shall the daily SARON rates be weighted according to whether the non-business days fall in the interest period or in the observation period? Under the method with observation shift, the daily SARON rates are weighted according to when the days from which they are taken fall in the observation period. Under the method without observation shift ("lag"), the daily SARON rates are taken from the observation period but weighted according to when the days upon which they are used fall in the interest period.

For syndicated loans, the NWG recommends using the "shift" method for the domestic market, and the "lag" method when international consistency is required. This corresponds to what we observe in the market where the lookback method with observation shift is used for domestic financings and the lookback method without observation shift (lag) where this was requested by foreign lenders participating in the syndicate.

Compounding and prohibition of capitalisation of interests

There are two ways of calculating the risk-free rate, either by simple averaging or by compounding. Averaging is calculated as the simple arithmetic mean of the daily reference rate. The advantage is that it is easier to use averaging from an operational perspective. On the other hand, the compounded interest takes into account the fact that the borrower is not repaying interests on a daily basis and it allows to keep track of interests accumulated that have not been paid yet. In brief the daily rate of interest is applied both on the principal amount and the accumulated and unpaid interest. The difference between averaging and compounding the interest is marginal – even more so if the interest is low and the compounding period is short. The compounding allows to use for instance a monthly or quarterly interest period without causing a loss in interest for the lender.

The NWG has recommended the use of the compounded SARON, instead of a simple averaging, because it is the standard convention on the swap market and it reflects more accurately the correct interest rate from an economical standpoint.

According to Art. 314 para. 3 CO, the parties cannot provide for the interest to be added to the capital and itself produce interest (*Zinseszinsverbot*). Thus, compounding of interest is prohibited if it is agreed upon in advance. In the course of the discussions within the NWG, the question was raised whether a compounded SARON could be problematic and thus void.

It was analysed in two expert opinions addressed to the NWG and concluding that this should not be an issue, both for the cumulative compounded SARON as well as for the non-cumulative compounded SARON (see explanation below on the difference between the two methods). This is mainly justified by the fact that (i) the purpose of Art. 314 para. 3 CO is to ensure a certain determinability of the interest to be paid – even though a knowledge of the exact interest rate is not required, a formula allowing the objective determination of the interest is sufficient –, (ii) the interests are paid at the end of the interest period and not added to the principal amount, (iii) the compounded SARON is only one element of the formula and the other elements, the margin and a possible credit adjustment spread, do not change, and (iv) the difference between the compounded SARON and the arithmetical mean is marginal.

We share this view of the expert opinions and consider it rather a compounding of the rate, which is only one part of the formula and not as a compounding of interest, which is paid at the end of the interest period. This position is widely supported in the market and we have only seen the use of compounded SARON in the Swiss loan market.

Relevant case law

In the context of transitioning from LIBOR to SARON, there are a few Court decisions to take into consideration:
The Federal Supreme Court considers that it is up to the lender to provide proof of the facts allowing the conventional interest rate to be calculated at the decisive moments (ATF 134 III 224). If a loan agreement does not contain a robust fallback clause or a rate switch provision, then the lender might not be able to prove the applicable interest rate.
In another ruling, the Federal Supreme Court established that when it is certain that the lender and the borrower have agreed to pay interest, the judge must set

the rate at 5% by analogous application of Art. 73 para. 1 CO, if the lender has not been able to establish the rate (ATF 126 III 189). It should be pointed out that in this decision the rates which the lender wished to see applied were higher than 5% and that the lack of evidence provided by the lender was interpreted to its disadvantage. It is, however, unlikely that the same position would be adopted in times of negative interest rates.
In a further case, when analysing the implication of a negative LIBOR rate, the Federal Supreme Court had taken into account in its interpretation the fact that the loan agreement had been concluded at a time when the transition of the reference index to negative territory was not foreseeable (ATF 145 III 241). With this in mind, a Court will probably take a different view on contracts concluded before the planned interruption of LIBOR, as opposed to contracts concluded after that point in time when its end was foreseeable.

Transition clauses

Fallback clauses

In Switzerland, most loan agreements and facilities agreement that have been drafted or amended over the last few years contain some sort of fallback provisions with an obligation for the lender and the borrower to agree on a new rate commonly used in the market or, if no agreement is met, such rate which would be chosen unilaterally by the lender. Such a mechanism is generally enforceable under Swiss law whereby there is no case law covering its application to interest rates, which constitute one of the essential elements of a loan agreement.

Rate switch provisions in syndicated facilities

The Loan Market Association (**LMA**) has published multicurrency term and revolving facilities agreements incorporating rate switch provisions with and without lookback observation shift (the **LMA Rate Switch Agreements**). The switch provisions allow the current forward-looking rates (e.g. CHF LIBOR) to remain until a transition to a compounded backward-looking reference rate (e.g. SARON) is triggered by a switch triggering event or a long stop date (usually prior to 31 December 2021) to be determined in the agreement. It also contains an appropriate provision in case of change to the reference rate during an ongoing interest period or even a possibility to force the switch to the new reference rate during an ongoing interest period at a rate switch date falling before the end of the interest period.

This implies a change from the current fallback wording included in the interest definition which was mainly aimed at setting out an agreed process for negotiation between the lenders and borrowers. In the LMA Rate Switch Agreements the change to the new pre-agreed reference rate takes place automatically once triggered by an objective criteria, such as a fixed date, a communication by a supervisory authority or an announcement by the administrator of the reference rate that it has ceased or will cease to provide the screen rate for that reference rate.

The LMA Rate Switch Agreements are provided based on the recommendations of the Working Group on Sterling Risk Free Rates and primarily applies to the SONIA loan market, but it also contains provisions relating to reference rates in other currencies including US dollars and Swiss francs transactions for which the SOFR and the SARON would be used.

A draft Swiss rate switch amendment agreement has been developed as a working document for the NWG (the **Swiss Rate Switch Agreement**). The Swiss Rate Switch Agreement differs from the LMA Rate Switch Agreements. One of the differences is that the Swiss Rate Switch Agreement refers to a cumulative compounded rate, whereas the LMA Rate Switch Agreements use daily non-cumulative compounded rates.

The cumulative compounded rate calculates one single compounded rate on the last day of the interest period with the data gathered during the observation period and applies it to the entire period. With this method, the interest rate is known only at the end of the relevant observation period.

The daily non-cumulative compounded rate is obtained for a given day by calculating the cumulative compounded rate for the prior day and subtracting it from the cumulative compounded rate for that given day.

Although both methods lead to the same result if the same rounding convention is used, the advantage of a daily non-cumulative compounded rate is that it allows a more accurate calculation of interest in the middle of an interest period, e.g. where needed in connection with a prepayment or in case of loan trading and risk participations.

For what we have seen in the market so far, the LMA Rate Switch Agreements is more widely used for multi currency facility agreements for which various reference rates apply or for cross border transactions with foreign lenders participating in a facility, whereas the Swiss Rate Switch Agreement is used for Swiss domestic financings with Swiss lenders. We have also seen multi-currency facilities being amended to only keep USD as a currency, given that the USD LIBOR will only be discontinued in June 2023 and thereby allowing the lenders to wait to see how the market develops before implementing a risk-free rate in the facilities.

Credit adjustments spread

Because SARON is a risk-free rate as it is based on secured overnight transactions, it is inherently lower than CHF LIBOR which includes a component to reflect the cost and risk incurred for non-secured inter-bank loans with a pre-determined term.
In the context of the transition from LIBOR to SARON for existing agreements, the question of credit adjustment spreads was inevitable to account for the differences in economic value between

the two rates. It is fair to say that the introduction of a credit adjustment spread is therefore widely accepted in the market and it is usually a fixed percentage. There are various methodologies to calculate the credit adjustment spread, whereby the ISDA historical median approach seems to be the favoured one, by comparing the CHF LIBOR and the SARON for an equivalent tenor looking back over a period of 5 years prior to the date on which the credit adjustment spread is to be determined.

Break costs

Originally, break costs have been included in loan documentation to protect the commercial interest of a lender who would have provided a loan backed by another loan, i.e. by borrowing the same amount for the same interest period on the interbank market. If the loan is prepaid before the end of the interest period, the lender still has to honour its loan and the break costs are foreseen to cover the ensued costs.
For risk-free rates, it can be argued that a lender can obtain funding on a rolling overnight basis and thereby undermining the economic rationale for the application of break costs. On the other hand, it can be argued that the break costs shall still apply to cover certain administrative costs incurred by the lenders in the course of a prepayment before the end of an interest period.
Neither the LMA Rate Switch Agreements nor the Swiss Rate Switch Agreement provide an example for the calculation of the break costs and take the view that it will depend on the relevant transaction. In any case, the calculation of break costs (if any) would have to be different for a backward-looking risk-free rate, but it should nonetheless be considered as there is otherwise a risk that a revolving credit facility is simply used as an overdraft facility without taking into account the costs for the agent/lenders upon prepayment. Simple methods that we have seen used are for instance to apply a percentage of the margin as break costs for the remaining part of the interest period or to apply an administrative fee.

New agreements using SARON

When drafting interest provisions in new loan agreements, lenders must determine how to calculate the compounded SARON and what wording they will include in this respect. They should fix the various elements that we have discussed in this newsletter, including calculation method (daily non-cumulative compounded rate or cumulative compounded rate), observation period and its duration. Although a credit adjustment spread and the difference in economic value that it represents can be included directly in the margin, we still see agreements where the compounded SARON is fixed from the outset. The aforementioned comments on the break costs apply likewise for new agreements using only the compounded SARON.
The definitions in the Swiss Rate Switch Agreement can certainly be used as inspiration in order to prepare new Swiss bilateral loan agreements using the compounded SARON.
For syndicated facilities, the Swiss market has used a Swiss law LMA type of agreement in the past. There is not a specific model and the available LMA standards have simply been adapted depending on the needs for the contemplated transaction. There is not a clear established market practice yet for risk-free rate facilities. Here the wording used for the compounded SARON in the Swiss Rate Switch Agreement can be used one to one for new syndicated facilities agreement after removing the switch mechanism. Time will tell whether the Swiss lending market will stick with using cumulative compounded rate or whether it will align on the daily non-cumulative compounded rate as set out in the form agreements proposed by the LMA.

FINMA transition roadmap

The FINMA published in October 2020 a roadmap detailing the steps that should be taken throughout 2021 in order to ensure a smooth transition from LIBOR to SARON. It included the implementation of system and process changes and mitigation of risks for remaining "tough legacy" contracts before end of June 2021.
As of 30 June 2021, any new agreements concluded shall in principle be based on the SARON. It goes without saying that lenders can still use fixed rates or other ways of calculating the interest rates, such as for example the lender's cost of funds which is often applied in trade finance transactions. Furthermore, the FINMA has then communicated to the banks that they shall ensure that all required contractual changes in loan agreements and facility agreement should be implemented before the end of September 2021. The rate switch date and the end of ongoing interest periods for fixed advances can, however, take place after that date but in any case, before 31 December 2021.
By the end of the year, the full operational readiness should be achieved and all new contracts should then be based on SARON.

Conclusion

The discussion around the transition from LIBOR to SARON began a long time ago within the NWG. They have become more tangible over the last few months. The pace for the transition has increased for lenders and will further accelerate as the deadline of 31 December 2021 is getting closer.
The market practice will still evolve over the next few months and we recommend following it closely, in particular with regard to new facilities using only compounded SARON.