LIBOR to SOFR – Making a Successful Transition

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The London Interbank Offered Rate (LIBOR) has been used for over three decades as the global standard benchmark for pricing all types of financial transactions, from small business loans to globally syndicated derivative structures. Now, that will soon be changing and financial institutions will need to adjust their loans to a new benchmark, the Secured Overnight Financing Rate (SOFR). What is involved in this transition?

LIBOR Background

Following banking reforms instituted after the 2008 financial crisis, money market interbank funding activity experienced a sharp and sustained decrease in activity. As such, the surveyed rates underpinning LIBOR have increasingly relied on "expert judgment" as opposed to actual transactions. This reliance on fewer underlying transactions has created growing concern about LIBOR as an accurate reference for trillions of dollar transactions tied to LIBOR. The concern has accelerated over recent years, as the financial institutions providing the surveyed rates will no longer be required to do so after 2021.

SOFR Benchmark

Responding to these concerns, the ARRC established the Secured Overnight Financing Rate (SOFR) as the replacement index for USD LIBOR in 2018. The FRBNY then launched publication of SOFR on April 3, 2018 and publishes the index daily by 8:00 a.m. Eastern Time.

So, what is SOFR? SOFR is a broad based measure of the cost of borrowing cash overnight, collateralized by Treasury securities . As SOFR is a secured rate comprised of essentially "risk-free" funding, it will tend to be lower in rate versus LIBOR, which reflects interbank funding credit risk in its rate.

Transitions Impact

Due to the difference in calculation and sources between SOFR and LIBOR, spread adjustments will be necessary to maintain the consistency of transaction economics. In determining the necessary spread adjustment, it is very important to ensure consistency of the existing economics or at the very least minimize changes to economic value. The fair value of the transaction before and after the transition can be determined using LIBOR and SOFR yield curves respectively for the value assessment.

Proactive Solutions

The good news for bankers is that we still have a few years before a full-fledged transition. Yet, there are some potential challenges you may need to address.

1. Watch for higher levels of contract variation and adjust your contracts, especially new commercial loans, according to the appropriate index
2. Address borrowers' concerns over the loss of visibility into their cash flows with this change
3. Banks need to fine-tune pricing, terms and disclosures for any new LIBOR-linked lending over a period of time
4. Perform periodic assessment of economic impacts and spread adjustments necessary to preserve transaction economics
5. Track the SOFR vs. LIBOR relationship as you manage your existing loans and underwrite new transactions ■

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