January 2021

Life After LIBOR: Is the LIBOR Transition for Business Loans Finally Accelerating?

By Jim Shanahan, CFA
Vice President, Financial Regulatory Compliance
CoBank ACB

Inside…

The transition from the U.S. dollar London Interbank Offer Rate (USD LIBOR) to alternative reference rates continues to evolve. CoBank's third report in the "Life After LIBOR" series explores the reluctance of the business loan market to accept alternative reference rates and how the market is responding.

Introduction

The business loan market is one of the slowest sectors to begin the transition from the USD LIBOR indexes to alternative reference rates. Borrowers and lenders alike are reluctant to adopt the Federal Reserves' Alternative Reference Rate Committee (ARRC) recommendations to move to the Secured Overnight Financing Rate (SOFR) as the alternative for USD LIBOR.

The business loan market's slow transition is based on aspects of the SOFR structure, interest calculation methodologies, and macro issues that impact the stability of SOFR.

- Borrowers are frustrated by the selection of SOFR as the recommended alternative reference rate for USD LIBOR, primarily because SOFR is currently available as a daily rate only.
- Lenders are critical of the structure of SOFR which is only determined by an actual repurchase transaction collateralized with U.S. Treasury securities. As a consequence, SOFR lacks a credit/liquidity component as part of the index, some lenders to feel that the SOFR index represents the costs of acquiring funds for the large money center banks and broker deals but ignores the acquisition costs for regional and community banks. There is also concern about the behavior of SOFR in constrained markets, such as financial crisis or systemic events, when liquidity can become scarce and the costs of acquiring new funds would increase for financial firms.
- Some are critical of the ARRC and industry groups that advocated for SOFR interest calculation methodologies which included daily compounded interest calculations. The compounded interest calculations are complex to calculate

and create implementation problems for many loan accounting systems. Additionally, many daily compounded interest methodologies cannot be applied to revolving business loans and other USD LIBOR legacy loan structures.

- There is inconsistency between the SOFR derivative markets. For example, the International Swaps and Derivatives Association (ISDA) recommends the use of daily compounded SOFR alternative rates and the cash market (i.e. loans, investments, debt) since the ARRC is recommending implied forward-looking term SOFR or daily simple average alternative rates for business loans. The inconsistencies between conventions can create ineffectiveness for hedges of loans and other floating rate transactions.
- SOFR was selected as a market driven rate and the effects of the COVID-19 pandemic, the 2020 financial crisis and the intervention of the Federal Reserve into the repo markets which SOFR is calculated have changed the characteristics and volatility levels of SOFR.

Despite these concerns, the transition to SOFR is full steam ahead. U.S. and international regulators insist that financial institutions and their customers do not execute LIBOR transactions after the end of 2021 and should define fallback language in the agreements for all USD LIBOR indexed (discussed further below). The fallback language will be applied when USD LIBOR is no longer available.

“It is imperative that market participants stop writing contracts that do not account for the discontinuance of LIBOR,” said Morgan Stanley’s Tom Wipf, Chairperson of the Federal Reserves’ ARRC. “It’s time that all market participants transition their products away from U.S. Dollar LIBOR where possible and we encourage the use of SOFR now, but those that continue to use LIBOR need to make sure they have very strong fallbacks in place.”

“It is imperative that market participants stop writing contracts that do not account for the discontinuance of LIBOR.”

- Tom Wipf, Morgan Stanley and Chairperson of the Federal Reserves’ ARRC

Accelerating the Transition: Evolving Conventions

The good news is that recently revised transition documents and newly proposed conventions for business loans could be a real game changer for the loan market and accelerate the transition to SOFR and other alternative reference rates.

ARRC Revised Recommended Fallbacks for Business Loans

Over the last two years, financial institutions worked to place USD LIBOR fallbacks in existing floating rate business loan facilities through the use of addendums. This was based on the ARRC’s recommended “amendment” approach since the market had yet to define what form of alternative reference rates and required spread adjustments would be utilized in the transition away from USD LIBOR.

The key to amendment approaches is that they allow for the transition to alternative rate indexes by defining events that would trigger the transition of legacy LIBOR transactions. Upon trigger, the loan’s USD LIBOR rate converts to a commercially reasonable alternative reference rate that includes interest calculation conventions and appropriate spread adjustments to minimize any transfer of value between the parties.

Without clear definition of the alternative reference rates, the ARRC’s initial “hardwire” recommendation language, published in 2019, had very limited acceptance and the market has been seeking revisions to the ARRC Business Loan Work Group recommendations for the last year.

In the summer of 2020, the business loan markets started to gain consensus on the details of the alternative reference rates and spreads when the ARRC released its revised recommended “hardwired” fallback language for syndicated loans and then bilateral loans. In addition, the ARRC published SOFR business loan calculation conventions for SOFR interest rate calculations tied to the revised hardwired fallbacks interest calculation methodologies.

The following are the hardwired fallback waterfalls for the replacement indexed rates and spread adjustments from the revised ARRC recommended language:

REVISED Benchmark Replacement Waterfall

Step 1: Forward-Looking Term SOFR and Adjustment
Step 2: Daily Simple Average SOFR and Adjustment
Step 3: Lender Selected Rate and Adjustment

Benchmark Replacement Adjustment Waterfall

Step 1: ARRC Approved Adjustment
Step 2: ISDA Approved Adjustment
Step 3: Lender Selected Adjustment

While the revised language is an improvement, it is worth noting that forward-looking term SOFR indexes (the first step in the Benchmark Replacement Waterfall) do not currently exist. Additionally, the Federal Reserve Bank of New York, which publishes daily SOFR, has stated they will not publish the term SOFR indexes. As such, a third party vendor needs to be selected to derive the forward-looking term SOFR indexes from the SOFR derivative markets (futures and swaps).

The ARRC issued a request for proposal for a third-party vendor which will publish the indexes for 1-Month and 3-Month Term SOFR. The response period closed at the end of October 2020, but the ARRC has not yet selected a vendor.

Following the selection of a vendor, the ARRC will need to endorse the calculation methodology for Term SOFR. The final step will be regulatory approval of these Term SOFR indexes for use in financial transactions, most likely by the Federal Reserve Board or Prudential Banking Regulators. This regulatory approval will hinge on the determination that volumes in the SOFR derivative markets have reached a level of depth and liquidity that meet the requirements of the guidelines established in the “Principals of Financial Benchmarks Report,” published by the International Organization of Securities Commissioners Organization. As a consequence, there is not a clear date on when the 1-Month and 3-Month SOFR indexes will be available but is expected by mid-2021.

Lastly, the first step in the Benchmark Replacement Adjustment Waterfall (ARRC Approved Adjustments) is also not currently being published. However, the calculation methodology has been endorsed by the ARRC and will be consistent with the ISDA Approved Spread Adjustments. The ARRC closed a request for proposal for a third-party vendor in October 2020, but has not selected the entity as of the publication of this article.

New SOFR Indexed Business Loans

Currently, there has yet to be any significant adoption of SOFR, in any form, in business loan transactions. Some loan transactions have been completed with fixed rate or USD LIBOR initial periods and will move to SOFR in the future, but these structures are not widely adopted. However, the release of the ARRC revised Business Loan Conventions and the Loan Syndication Trading Association (LSTA) release of the revised Daily Simple Average SOFR Loan Concept Credit Agreement just might give the market enough clarity to begin moving new loan transactions to SOFR later this year. The highlights of the agreement are as follows:

- The agreement is intended for new SOFR term loans and applies a “SOFR plus the pricing spread” methodology. This methodology can be adapted for revolving loans and legacy LIBOR loans.

- The agreement's interest calculations are based on Daily Simple Average SOFR in Arears with a lookback period (five days is emerging as the standard) and does not have any adjustments related to an observation shift. Since there is not an observation shift, the stated SOFR index rate can be utilized without any additional adjustments to the index.
- The agreement also allows for a transition to term SOFR indexes, if it becomes available. This is referred to as "flip forward" and can be done without any need to re-document the loan.
- All spreads added to the indexes are also simple average throughout the interest period.

These calculations can be handled with minimal changes to existing loans systems and can be reconciled by borrowers.

The revised LSTA Concept Credit Agreement also contains language that could adapt the agreement to a simple compounded method, but this method is not consistent with the currently published Federal Reserve Bank of New York's compounded SOFR average rates. The LSTA is hoping to release another revised Concept Credit Agreement in the first quarter of 2021 with Daily Compounded SOFR interest calculations.

Farm Credit SOFR-based Index

The Farm Credit Banks have jointly produced a SOFR-based index which addresses some of the borrower's issues with daily SOFR rates. This newly created index is the Farm Credit 1-Month SOFR Index and is calculated and published by the Farm Credit Funding Corporation (Funding Corp). The Funding Corp is the entity which issues the Federal Farm Credit Bonds on behalf of the Farm Credit Banks and CoBank, including Floating Rate Notes (FRNs).

The Farm Credit 1-Month SOFR Index synthetically creates a monthly rate based on the 1-Month SOFR swap rate (receive 1 day compounded SOFR and pay 1 Month fixed) plus 12 month average of FFCB funding spread for 1 year SOFR FRN. The 1-month SOFR swap rate is consistent with how forward looking term SOFR rates will be calculated. Funding Corp began publishing the index on September 23, 2020 on their Funding Cost Index page on the public part of the website.

Daily Compounded SOFR Loans

The daily compounded SOFR calculation methodologies are considered to be very economically correct, but the complexity and difficulty of applying this interest calculation methodology has met resistance in its adoption. Despite these issues, the ARRC and LSTA continue to create the framework and documents related to the compounded SOFR adoption for business loans.

The Federal Reserve Bank of New York publishes the 30-day, 90-day and 180-day historical SOFR compounded averages for each business day, but might not be consistent with the LSTA recommendations. The averages are consistent with the ISDA recommended fallbacks for derivatives.

The ARRC and LSTA continue to work with the market participants (particularly loan accounting system vendors) to develop additional conventions for the interest calculation methodology for business loans. Additionally, the LSTA is in the process of revising a Daily Compounded SOFR Concept Credit Agreement which they hope to finalize in early 2021.

Forward Looking Term SOFR Indexes

The ARRC has stated that it hopes to have forward looking term SOFR indexes for 1-month and 3-month tenors in mid-2021. Following the publication of the indexes by the third-party vendor, the ARRC and LSTA will develop documentation and conventions for the use of the indexes in new business loans and legacy USD LIBOR fallbacks.

CoBank will continue to monitor developments in the market recommendations by regulators and advisory groups, and will provide periodic updates to our customers. ■