Transitioning From LIBOR

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KeyBanc
Capital Markets

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History of LIBOR – London Inter-Bank Offering Rate

When is LIBOR going away?

In November 2020, the Federal Reserve Board, OCC and FDIC jointly issued supervisory guidance encouraging banks to stop entering into new credit facilities that use USD LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021.

On March 5, 2021, the ICE Benchmark Administration announced it will cease publication of USD LIBOR Currency settings immediately after such dates:

1-week, 2-month: December 31, 2021

All other settings (Overnight, 1-month, 3-month, 6-month, 12-month): June 30, 2023

On June 8, 2021, regulators announced the recommendation that swap dealers replace the trading of LIBOR-based swaps with SOFR-based swaps.

History (continued)

When is LIBOR going away?

On July 26, 2021, interdealer trading conventions changed from LIBOR to SOFR for USD linear interest rate swaps.

On September 10, 2021, Ford became the first U.S. Company to issue a broadly syndicated SOFR loan which replaced their LIBOR benchmark reference rate.

Q3-Q4 2021 banks ceased quoting / originating LIBOR indexed loans and began taking steps to remediate LIBOR based loans and swaps.

As the market became aware that LIBOR was going to cease, banks began adopting a “hardwired” approach in credit agreements that eliminates a need for an amendment to replace LIBOR by using a pre-determined replacement benchmark and setting an index spread adjustment. In some cases, this creates complexity and limits flexibility, but at a minimum it provides “insurance” should the transaction not be remediated prior to June 2023.

SOFR – Secured Overnight Financing Rate

What is the difference between LIBOR and SOFR?

The Alternative Reference Rates Committee (“ARRC”) recommended replacement for LIBOR is Secured Overnight Financing Rate (SOFR), produced by the New York Fed in cooperation with the Office of Financial Research. It was chosen because of its transparency and depth of market.

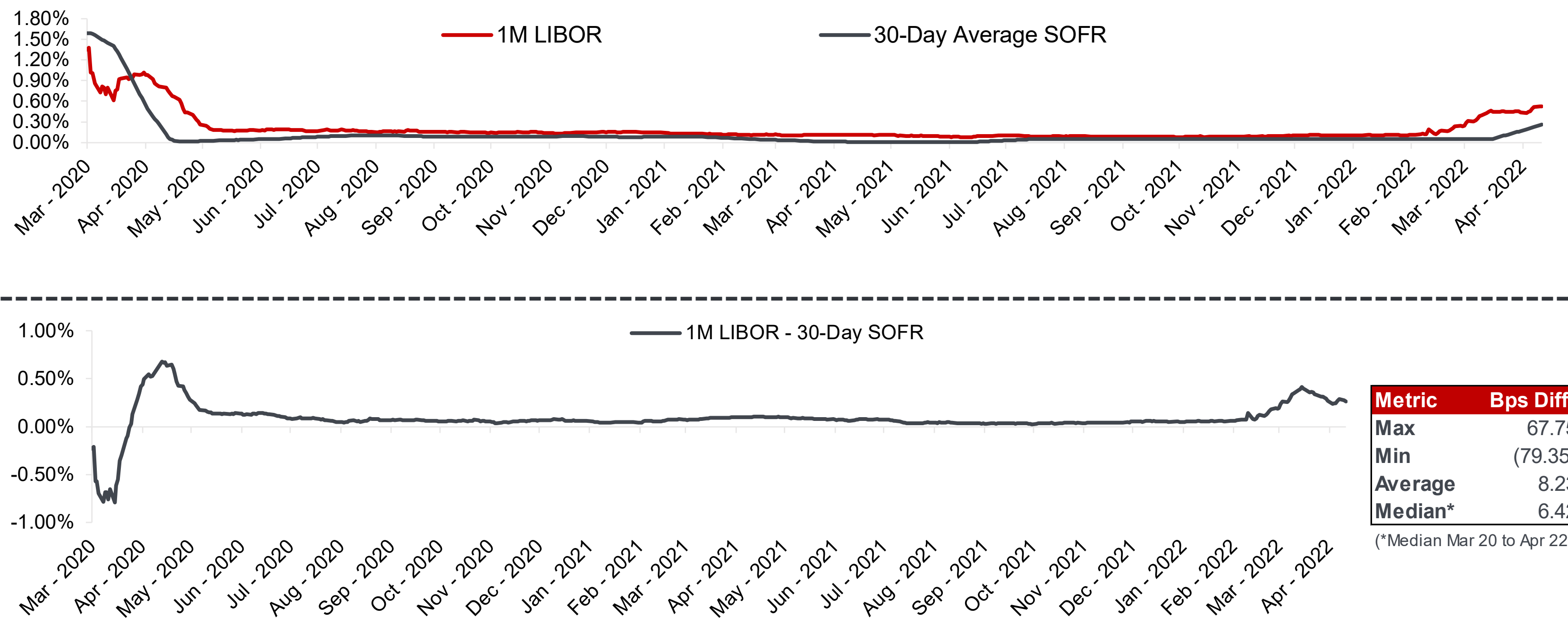
To address the fact that SOFR is considered a risk-free rate (and therefore has historically been lower than LIBOR), the Alternative Reference Rates Committee (“ARRC”) recommended the application of a one-time benchmark replacement adjustment (“credit spread adjustment”) in order to arrive at a comparable all-in rate. This credit spread adjustment is documented as an addition to the SOFR rate.

Based on the March 5, 2021 UK Financial Conduct Authority announcement on the future cessation and loss of representativeness of LIBOR benchmarks, International Swaps and Derivatives Association (“ISDA”) has set the Spread Adjustment for SOFR as follows:

1 Month: 11.45 bps   3 Month: 26.16 bps   6 Month: 42.83 bps   12 Month: 71.51 bps

SOFR vs LIBOR | Historical and Current Divergence

LIBOR vs SOFR



Metric	Bps Diff
Max	67.75
Min	(79.35)
Average	8.23
Median*	6.42

(*Median Mar 20 to Apr 22)

- One month and 30-day average SOFR in arrears have tracked each other over time.
- The divergence of the rates highlights LIBOR's embedded credit sensitive component.

Note: Comparison references 1M LIBOR from start of a period versus 30d compounded average SOFR realized for that period.

Source: (i) Federal Reserve Bank of New York and (ii) Bloomberg

Remediation

Why should clients consider remediating soon?

- Given that LIBOR will go away, the client and lender will need to amend an existing LIBOR deal to address cessation. This amendment work will entail time, legal review and dollars spent on both parties' behalf.
- The timing of remediating a LIBOR loan has implications to the risk of delay and lender flexibility:
  - If waiting until LIBOR is actually gone, banks and lawyers will likely be swamped with numerous deals that need to be amended which may cause delays.
  - If waiting until LIBOR is actually gone, lenders and clients will have to adjust every loan consistently, limiting ability to negotiate. When entering into a SOFR deal ahead of cessation, lenders and clients will gain flexibility.

Tax-Exempt Debt and LIBOR to SOFR Substitution

Things to Consider:

There are key considerations for substituting LIBOR with SOFR as a reference rate in tax exempt debt.

The substitution of LIBOR to another index could pose serious issues for tax-exempt debt.

A change in the interest rate as a result of a substitution index could affect the tax-exempt status of the debt.

If any tax-exempt debt is modified in any way (particularly relating to changes in interest rate provisions), bond counsel should make or review the modifications.

- Bond counsel will be hired by the issuer of the debt.
- Banks will want to receive an opinion of bond counsel stating that the changes made to the documentation will not cause the debt to lose its tax-exempt status.

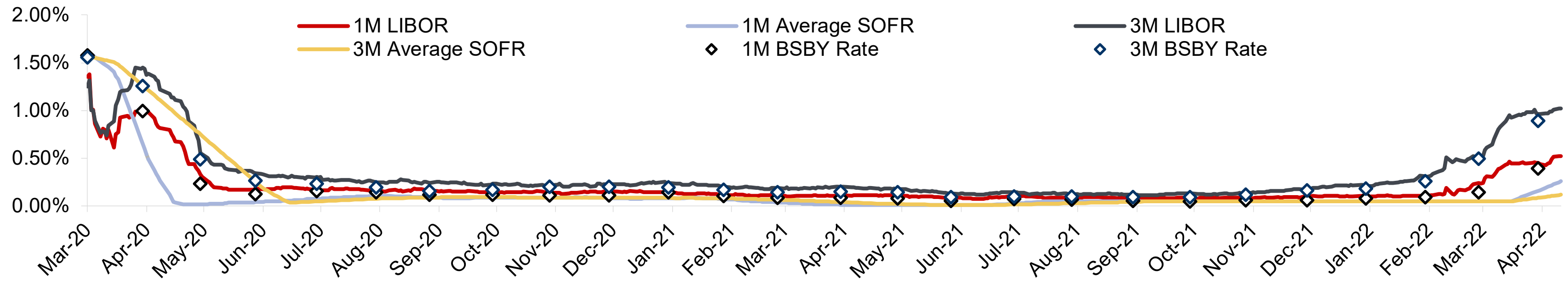
Alternative Reference Rates

Credit Sensitive Rates:

- Some lenders view an index with a credit sensitive component and term structure to more closely match the profile of their cost of funds especially in times of economic stress.
- Some alternatives currently proposed and being used by some institutions include:
  - Bloomberg Short-Term Bank Yield Index (BSBY): In use by certain larger institutions. Has O/N, 1M, 3M and 6M options.
  - Ameribor: An overnight rate with a Term30 option, used among some smaller regional banks.
- If contemplating one of the rates be sure to consider hedging implications.
- Recent public regulatory statements strongly support SOFR and in certain instances, portray Credit Sensitive Rates in a negative light. The overall market for CSRs continues to evolve.

SOFR vs LIBOR | Historical and Current Divergence

LIBOR
SOFR
&
BSBY



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