



## LIBOR To SOFR - How To Make The Transition

hedging   lending   SOFR

**Summary:** Banks will soon need to adjust their loans to a new benchmark known as the Secured Overnight Financing Rate (SOFR). What is involved in this transition?

There are lots of things to do in London, like seeing Big Ben, Buckingham Palace, the Tower of London and riding the London Eye observation wheel.

In the banking industry, one of the biggest reference rates also came from London -- the London Interbank Offered Rate (LIBOR). It has been used for over three decades as the global standard benchmark for pricing all types of financial transactions. As we have highlighted before, that will soon be changing and banks will need to adjust their loans to a new benchmark known as the Secured Overnight Financing Rate (SOFR).

**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 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 the trillions of transaction dollars tied to the index. The concern has increased over recent years, as the large banks providing the surveyed rates will no longer be required to do so after 2021.

**SOFR background.** The Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. Since SOFR is a secured rate comprised of essentially "risk-free" funding, it will tend to be lower in rate versus LIBOR, which reflects bank to bank (interbank) funding credit risk. The New York Fed launched publication of the SOFR on April 3, 2018 and publishes the index daily by 8 a.m. ET.

Due to the difference in calculation and sources between SOFR and LIBOR, spread adjustments will be necessary as this shift occurs. In determining necessary spread adjustments, 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 any transaction before and after the transition to SOFR can be determined using LIBOR and SOFR yield curves respectively for the value assessment.

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.

With new commercial loans for instance, look for higher levels of contract variation and adjust them based on the proper index.

Next, be ready to address any concerns borrowers have over the loss of visibility into their cash flows with this change, if a longer term rate cannot be provided with SOFR.

Third, banks will need to be ready to adjust pricing, terms and disclosures for new LIBOR-linked lending over a period of time.

Fourth, where possible try to perform a periodic assessment of economic impacts and spread adjustments necessary to preserve transaction economics.

Finally, begin tracking the SOFR-LIBOR relationship as you manage your existing loans and underwrite new transactions.

We are here to help community banks during this transition and have online tools to assist you too. Call if you need assistance because SOFR will be the new benchmark before you know it!

## A DEEPER LOOK AT SOFR

PCBB's white paper, **Moving from LIBOR to SOFR: Smoothing the Transition for Your Financial Institution**, takes a deeper look at how community financial institutions will need to adjust for the new benchmark. [Request your copy today.](#)

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