LIBOR To SOFR – Next Steps To Keep You On Track

hedging lending SOFR

Summary: Since many community financial institutions have syndicated loans that are pegged to LIBOR, its discontinuation is especially important. Here are the next steps to take in the move from LIBOR to SOFR, including contract reviewing and using fallback language, for a seamless transition.

We thought it was interesting to find out that the term "scuttlebutt" has its origins from 1800s naval history, as this was what contained drinking water for those on the ship. A ship's version of a company water cooler where sailors gathered to share information. The end of LIBOR is definitely more than just water cooler talk or scuttlebutt. So, today, we give you the latest update.

The end of LIBOR matters to financial institutions all over the world, because so many interest rates are pegged to the sunsetting standard. But community financial institutions have a particular reason to care about LIBOR's end: the syndicated loans that many CFIs hold on their balance sheets, many of which are still pegged to LIBOR.

Review your institution's current contracts

The financial markets have known for years that LIBOR would be discontinued. Even so, plenty of existing contracts are still pegged to LIBOR. In fact, some agreements that cite this benchmark are still being written.

In many instances, says the New York Fed, credit agreements have fallback language, but the provisions aren't economically appropriate or sufficiently robust. The key distinction is how much input lenders have in determining the new rate.

For a smooth transition from LIBOR to SOFR, banks need to check their loan agreements, determine which contracts lack sufficiently robust, economically appropriate fallback provisions for LIBOR's retirement, and amend those agreements.

Use robust fallback language

In June 2020, the Alternative Rates Reference Committee (ARRC) issued refreshed fallback language that CFIs can use, either as part of syndicated loan credit agreements that they're originating or as an amendment to existing agreements before LIBOR ends.

This language essentially says that when LIBOR is no longer a benchmark, a LIBOR-pegged loan will fall back to a variation of SOFR plus a spread adjustment. The adjustment is based on the historical relationship between the two benchmarks and is intended to minimize the economic impact from the change in benchmark basis. The verbiage is highly recommended for institutions to use, even though it isn't mandated.

Robust fallback language should be part of any new loan or refinancing made on or after September 30, 2020. As of June 30, 2021, lenders should not originate any additional loans that are indexed to LIBOR.

Stay on top of relevant updates

Not only do you need to document your transition, but keeping a file of the applicable updates will help show your efforts towards a transparent and smooth transition. This way regulators and auditors see your good faith in managing through this evolving process even as dates may shift or technical details may change.