Industry Adoption of SOFR Slower Than Expected

lending LIBOR SOFR

Summary: Though the clock is ticking down to the ultimate cessation of LIBOR, the banking industry's adoption of SOFR has been slower than regulators might have expected. We discuss reasons for the delay and legislation that can ease the process.

A trip to Cuba can feel like a trip back in time when it comes to automobiles. There are still roughly 60K classic American cars from the 1950s, 1940s, and even the 1930s that travel the country's roads daily. Following the Cuban Revolution in 1959, Cubans were banned from importing American cars or automobile parts. Cuban families who were fortunate enough to already own American automobiles have maintained these cars in innovative ways, including everything from adapting engine parts from other vehicles to actually making certain parts themselves.

Much like Cuba's embargo on US automobiles failed to bring an end to these American classics in Cuba, the transition away from the London Interbank Offered Rate (LIBOR) has not been as expeditious as regulators may have wanted. Financial institutions (FIs) are scrambling to transition a large number of loans away from the longtime benchmark in early 2023.

Change Underway

Though no new LIBOR exposures were allowed after the end of 2021, the longtime interest rate relied upon by FIs has yet to completely go away. Five US dollar LIBOR settings will continue to be published for existing loans: the overnight, 1-month, 3-month, 6-month, and 12-month rates. The overnight and 12-month LIBOR rates are set to be completely eliminated on June 30, 2023. However, the Financial Conduct Authority (FCA) has requested that the ICE Benchmark Administration, LIBOR's administrator, keep publishing the 1-month, 3-month, and 6-month US dollar LIBOR settings through September 2024. If the request were honored, these three settings would be calculated based on synthetic methodology.

While many FIs have already made the switch from LIBOR to the Secured Overnight Financing Rate (SOFR), five out of every six US institutional loans have yet to transition to SOFR, according to data from the Credit Suisse Leveraged Loan Index. As a result, industry experts expect that FIs will be busy transitioning a large number of legacy transactions to SOFR in the next few months.

Slow Uptake

A survey from the Alternative Reference Rates Committee (ARRC) found that roughly half of lenders and borrowers prefer to transition existing loans to SOFR through new loans. According to LevFin Insights, one reason cited for the slower-than-anticipated transition to SOFR is the fact that loan activity, including refinancings and repricings, was significantly down in 2022. Refinancing, dividend recapitalization, and repricing transactions were down by close to 90% YoY in 2022.

Pickup Expected

To ease the transition, Congress passed the Adjustable Interest Rate (LIBOR) Act in March 2022. It created safe harbor, which set up a way for certain legacy contracts to transition from LIBOR to a board-specified index for SOFR including a spread, without requiring the consent of the borrower. In addition, the ARRC created blanket fallback language for FIs to insert into certain legacy contracts linked to LIBOR. Such standardized language was created in hopes of simplifying the transition for trillions of dollars worth of existing floating rate debt and securitized loans — including student loans and mortgages based on LIBOR — that were viewed as a threat to financial stability.

While the financial industry's transition to SOFR has been far slower than regulators initially anticipated, the writing is ultimately on the wall. If your CFI has yet to transition existing LIBOR-based loans to a different index, now is the time to begin doing so. PCBB is available to assist with the transition and answer any questions on steps needed to convert loans away from LIBOR and toward an alternative index, such as SOFR.

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ECONOMY & RATES

Rates As Of: 03/06/2023 09:58AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	4.91	0.03	0.49
6M	5.18	0.01	0.42
1Y	5.03	0.03	0.33
2Y	4.88	0.06	0.45
5Y	4.26	0.07	0.25
10Y	3.96	0.04	0.08
30Y	3.89	-0.03	-0.08

FF Market	FF Disc	IORB
4.57	4.75	4.65
SOFR	**Prime**	**OBFR**
4.55	7.75	4.57