The LIBOR-to-SOFR Transition: What You Need To Know

hedging LIBOR SOFR

Summary: The financial industry has been preparing to transition from LIBOR rates to SOFR rates for over two years. Now that the LIBOR cessation date is here, CFIs may still have questions. We discuss what the SOFR rate options are, how the LIBOR Act could impact your remaining LIBOR-based loans, and where to find helpful resources.

In late 1999, the world was on the brink of a new millennium, and many feared the "Y2K bug." News spread that the two-digit format used by computers to represent the current year would glitch when the clock turned from "99" to "00", wreaking havoc on the computer systems our society was being built around. Little did the public know, computer experts were working behind the scenes to ensure that nothing out of the ordinary happened. When the year 2000 appeared, bringing no ill effects, the fear quickly dissipated and became a laughing matter.

Another urgent transition that's taking place tomorrow, June 30, is the long-awaited transition away from the London Interbank Offer Rate (LIBOR) index. The Ice Benchmark Association announced in March of 2021 that it would cease publication of the one-, three-, six-, and 12-month LIBOR settings, the last tenors to cease. The UK Financial Conduct Authority (FCA), International Swaps and Derivatives Association (ISDA), and Alternative Reference Rates Committee (ARRC) followed suit with announcements of their own about the end of LIBOR rates, as well as guidelines and protocols for the transition from LIBOR to SOFR.

In response to the LIBOR cessation, Congress enacted the LIBOR Act to provide certain safe harbors for use of indices identified by the Federal Reserve Board as replacements for LIBOR. This act provides a blanket solution for tough legacy contracts that lack adequate provisions for replacing the LIBOR-based rates after the June 30, 2023 cutoff. The LIBOR Act established SOFR-based benchmark rates that would replace all tenors of LIBOR in contracts that fall within the legislation's qualifications. While it's a relief to know that the government has a plan in place, what does that mean for your institution? What else do you need to do to prepare? We dive into some of the common questions community financial institutions (CFIs) still have as the end of LIBOR looms.

What To Expect as the LIBOR Index Ceases

Even though the transition from LIBOR is here, you might still find that you have LIBOR-based loans without sufficient provisions on your books. This is where the LIBOR Act comes in handy. CFIs that have loans lacking LIBOR transition provisions will fall back to the identified SOFR benchmarks for cash products and derivatives. There is no consent required of borrowers for contracts covered by the Act, but they should be notified of the replacement index prior to the transition date. It is important to note that hedged loans should follow the fallback designation for their related derivatives to avoid settlement mismatches, ineffectiveness, and broken hedges.

CFIs that choose to use other alternatives than the ARRC guidelines will have to independently amend the related loans to their alternative index and get consent from any borrowers whose loans will be affected prior to the June 30, 2023 transition date. If there is no consent from related borrowers, the loans should transition according to the ARRC guideline provisions in the loan documents or the LIBOR Act (if lacking adequate provisions). It's important to note that, for related interest rate hedges, amendments to other indices than the Fallback Rate (SOFR), which is inclusive of a compensating static spread adjustment, will incur costs, resulting in unfavorable economics for the swaps.

Differentiating the Three Types of SOFR Rates

SOFR is a broad measure of the cost of borrowing cash overnight that is collateralized by US Treasury securities. There are three different SOFR-based rates to consider following LIBOR cessation — Fallback Rate (SOFR) for the replacement index in legacy LIBOR contracts, Daily Compounded SOFR, and Term SOFR for new transactions. Here are the differences between the three:

1. **Fallback Rate (SOFR).** Fallback Rate (SOFR) is the index replacement that the ARRC, ISDA, and LIBOR Act have designated for legacy LIBOR derivatives contracts. It's also the rate that PCBB will use for its own customers' legacy LIBOR-hedged loans. Fallback Rate (SOFR) is based on the Daily Compounded SOFR rate, plus a static spread adjustment for the related LIBOR tenor. It is a retrospective compounded rate, over a specified interest accrual period, published by Bloomberg.
2. **Daily Compounded SOFR.** This is the daily SOFR, published by the Federal Reserve Bank of New York, retrospectively compounded over a specified interest accrual period.
3. **Term SOFR.** The Term SOFR Reference Rates benchmark is a daily set of forward-looking interest rate estimates, published by the CME Group. These rates are calculated and published for one-, three-, six-, and 12-month tenors.

Making Sure You're Ready to Implement SOFR

Learning about something and putting it into practice can feel very different. So, despite the many months of preparation, it's natural if your institution still has some trepidation about whether you're fully prepared to transition from LIBOR to SOFR. Here are some of the basic details you need to know to get started with SOFR:

- **SOFR-based rates are precalculated.** This means that you won't have to crunch any numbers on your end to start using the SOFR index. Instead, SOFR rates will be published by their respective agencies and updated daily.
- **SOFR needs a connection to your core system.** The easiest way to access SOFR rates is to connect it to your documentation and core systems. Your core provider and your internal IT team will need an open line of communication and some time to test to ensure that the connections are sound and working correctly.

Troubleshooting SOFR

If your team experiences any obstacles in starting the SOFR process, there are helpful resources you can turn to (aside from chatting with PCBB's expert team) if you have questions:

- PCBB's SOFR resources center
- ARRC resources

As the financial industry transitions from LIBOR to SOFR, it's important to be aware of which SOFR rate you're using, where it's being published, and whether it's connected to your core system adequately. For those relying on the LIBOR Act to settle any remaining LIBOR-based loans, it would be wise to keep an eye on these loans to ensure they're transitioning as they should. PCBB's team is here to help with any questions you may have.

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ECONOMY & RATES

Rates As Of: 06/29/2023 05:07AM (GMT-0800)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.44	-0.08	1.02
6M	5.47	0.01	0.71
1Y	5.40	0.26	0.70
2Y	4.89	0.48	0.46
5Y	4.13	0.37	0.12
10Y	3.83	0.18	-0.05
30Y	3.88	0.02	-0.08

FF Market	FF Disc	IORB
5.07	5.25	5.15
SOFR	**Prime**	**OBFR**
5.06	8.25	5.06