LIBOR to SOFR: What Community Banks Should Know to Make a Successful Transition

By Earl Charneske

The London Interbank Offered Rate (LIBOR) has been used for over three decades as the global standard benchmark for pricing all types of financial transactions, from small business loans to globally syndicated derivative structures. Now, that will soon be changing and financial institutions will need to adjust their loans to a new benchmark, the Secured Overnight Financing Rate (SOFR). So, what is involved in this transition and how can banks minimize the potential risks?

The Background of LIBOR

Since its launch over three decades ago, LIBOR has been the market standard benchmark for pricing all types of financial transactions; from small business loans to globally syndicated derivative structures. It represents the average of money market funding rates surveyed from about 16 leading banks in London.

However, 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 surveyed 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 trillions of dollars of transactions tied to LIBOR. The concern has accelerated over recent years, as the financial institutions providing the surveyed rates will no longer be required to do so after 2021.

What is SOFR?

Responding to these concerns, the ARRC established the Secured Overnight Financing Rate (SOFR) as the replacement index for USD LIBOR in 2018. The FRBNY then launched publication of SOFR on April 3, 2018 at 1.80%. The FRBNY publishes the index daily by 8:00 a.m. Eastern Time.

So, what is SOFR? SOFR is a broad-based measure of the cost of borrowing cash overnight, collateralized by Treasury securities.[i] As SOFR is a secured rate comprised of essentially "risk-free" funding, it will tend to be lower in rate versus LIBOR, which reflects interbank funding credit risk in its rate. At SOFR's launch, the launch rate was 8 basis points lower vs. 1-month LIBOR and 12 basis points higher vs. overnight U.S. Fed Funds.

SOFR Compared to LIBOR

As a secured rate, during periods of credit stress, SOFR may not exhibit the wild rate swings observed with LIBOR. This absence of a credit risk element will therefore have to be taken into account when benchmarking to SOFR. On balance, SOFR should track well with the general direction of interest rates, as it is highly correlated to existing LIBOR and Fed Funds benchmarks.

The Estimated Timeline for SOFR

Given the enormity of existing transactions tied to LIBOR (over $200 trillion in the interest rate swap market alone), the transition from LIBOR to SOFR is expected to be carefully implemented, including key milestones, before widespread adoption. As such, it's important to follow the progress and make the necessary adjustments.

The Expected Transitional Impact

Due to the difference in calculation and sources between SOFR and LIBOR, credit spread adjustments will be necessary to maintain the stability of transaction economics. In determining the necessary credit spread adjustment, it is very important to ensure consistency of the existing economics. The adjustment can be determined from a historical mean/median of the SOFR vs LIBOR index spread, or from the basis difference in fair values using the respective SOFR and LIBOR yield curves at transition.

Key Steps Community Banks Can Take

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.

- Watch for higher levels of contract variation and adjust your contracts, especially new commercial loans, according to the appropriate index.
- Address borrowers' concerns over the loss of visibility into their cash flows with this change.
- Fine-tune pricing, terms and disclosures for any new LIBOR-linked lending over a period of time.
- Perform periodic assessments of economic impacts and spread adjustments necessary to preserve transaction economics.
- Track the SOFR vs. LIBOR relationship as you manage your existing loans and underwrite new transactions.

Even if the transition to SOFR doesn't need to be completed until 2021, steps need to be taken long before then to ensure the integrity of your loan portfolios. Transitioning from LIBOR to SOFR does not need to be difficult. Yet, it is important to understand the nuances involved. ■

For more information on rates and the transition to SOFR, contact Earl Charneske.

---

[i] Composed of tri-party repo, General Collateral Finance (GCF) repo and bilateral Treasury repo cleared through the Fixed Income Clearing Corporation (FICC)

Earl Charneske
SVP, Regional Manager | PCBB
847-531-0890
echarneske@pcbb.com
pcbb.com