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Lucas White

Focused on the future

From LIBOR to SOFR

Making a successful transition

Earl Charneske
SVP, Regional Manager
PCBB
echarneske@pcbb.com

PCBB is an associate member of the Indiana Bankers Association.

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. That will soon be changing, and financial institutions will need to adjust their loans to a new benchmark, the Secured Overnight Financing Rate (SOFR). What is involved in this transition, and how can banks minimize the potential risks?

The background of LIBOR. Since its launch, 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.

Following banking reforms instituted after the 2008 financial crisis, however, money market interbank funding activity experienced a sharp and sustained decrease in activity. 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 Alternative Reference Rates Committee (ARRC) established the Secured Overnight Financing Rate as the replacement index for USD LIBOR in 2018. The Federal Reserve Bank of New York then launched publication of SOFR on April 3, 2018, at 1.8%. The FRBNY publishes the index daily by 8 a.m. Eastern time.

SOFR is a broad-based measure of the cost of borrowing cash overnight, collateralized by Treasury securities.* As SOFR is a secured rate comprised of essentially "risk-free" funding, it does not reflect interbank funding credit risk in its rate (unlike LIBOR). At SOFR's launch, the launch rate was 8 basis points lower vs. one-month LIBOR and 12 basis points higher vs. overnight U.S. Fed Funds.

SOFR compared to LIBOR. 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. SOFR is sensitive, however, to volatility in the overnight funding markets that determine its value. It is also highly likely to react disproportionately to other funding rates during periods of economic stress when investors pile into the safe haven of U.S. Treasury securities.

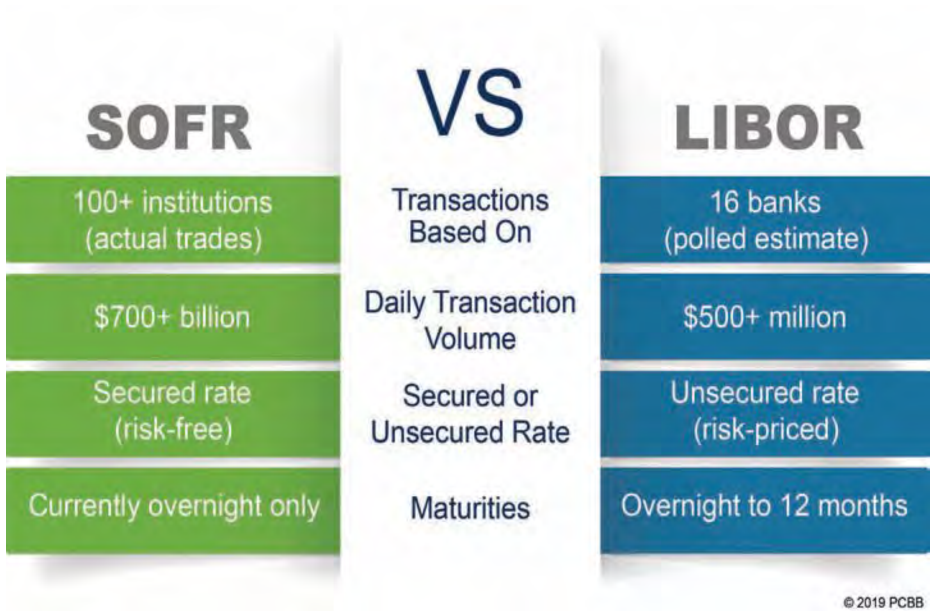
Estimated timeline for SOFR. Given the enormity of existing transactions tied to LIBOR (about $200 trillion in the interest rate swap market alone), the transition from LIBOR to SOFR is expected to be carefully implemented, including key milestones, before widespread adoption. It is important to follow the progress and make the necessary adjustments.

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 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. This is a simple approach and, therefore, is the primary method recommended by the ARRC and adopted by the International Swaps and Derivatives Association. For counterparties that prefer and agree on a forward-looking approach, the adjustment can be determined 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 couple of years before a full-fledged transition. Yet there are some potential challenges you may need to address earlier rather than later.

- **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 the end of 2021, steps will 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. **HB**

* Composed of tri-party repo, general collateral Finance (GCF) repo and bilateral Treasury repo cleared through the Fixed Income Clearing Corp. (FICC).

C2C Video

Alliance Bank, Francesville, assisted at the Benton County Farm to Fork dinner on Sept. 11, raising funds for area fire departments. This annual event brings together about 200 neighbors and community leaders in support of a different cause each year, while showcasing locally produced food. Click on the icon above in HB Digital to view a Commitment to Community video.