SOFR Transition - Contracts And Communication

lending business customers risk management

Summary: All banks should have the LIBOR-SOFR transition on their list and move it up in importance, as the 2021 deadline draws near. We give you some helpful tips.

A recent Bank Director survey of management and directors finds some of the top compensation challenges are: managing compensation and benefit costs (44%), tying compensation to performance (40%), succession planning (37%), recruiting commercial lenders (31%) and retaining key people (29%).

Let's face it. Whether dealing with compensation-related issues, risk or something else, banks have a lot to manage. One more thing banks must manage is the impact on all things banking due to the 2021 transition from the London Interbank Offered Rate (LIBOR) to the Secured Overnight Financing Rate (SOFR).

This is no small task, since it is estimated LIBOR underpins some $350T in loans and hedging instruments, and it is used worldwide to benchmark and price corporate and banking funding options.

To help US banks and companies with this massive task, the Alternative Reference Rates Committee (ARRC) selected SOFR as the most appropriate reference rate to replace LIBOR. This is because it's compliant with international benchmark standards; is fully transaction-based; encompasses a robust underlying repo market with more than $700B in daily transactions; is an overnight nearly risk-free reference rate that correlates closely with other money market rates; and covers multiple repo market segments allowing for future market evolution.

Currently, regulators are spurring the development of liquid derivative markets referencing SOFR to serve as a base, and by the end of 2021 expect to have established SOFR term rates for "cash products," including variable-rate loans and time deposits.

For now at least, adoption of SOFR is voluntary and for a time, it will co-exist with LIBOR. Nonetheless, all banks including community banks should have this on the project list and moving it up in importance. This will affect loan pricing, deposit pricing, contracts, documentation and existing loans already on the books for the vast majority of banks nationwide. To help, here are some things to think about.

Contracts and Documentation:

Banks that rely on LIBOR will need to include robust LIBOR fallback language in their LIBOR-linked contracts. For new transactions and legacy transactions maturing beyond 2021, you can incorporate more detailed replacement or fallback language to prevent ambiguity and provide index clarity in your contracts. According to ARRC, the fallback language should include: the triggers, the benchmark you will use instead, and the spread adjustment used to minimize the impact to the contracts.

This will need to be detailed whether or not banks choose to use SOFR or another reference rate, such as Prime or the Fed Funds Rate, to protect themselves when LIBOR is unavailable.

Communication Plan:

In this conversion, banks should also start talking to customers about how the eventual transition will impact them. Now may be the time to start crafting a communication plan, so that you can be sure you cover all your bases, especially as we get closer to the transition. Your borrowers will increasingly want to know what changes will be made to their loan and how this affects their cash flows. You will want to be ready to answer these inquiries.

If you have questions about any of this, contact us today.

WHITE PAPER: TRANSITIONING TO SOFR

Bankers have heard that SOFR will replace LIBOR as a benchmark in 2021. But, what is involved in this transition? To learn more about the impact and how your bank can plan for it, download our white paper, "Moving from LIBOR to SOFR: Smoothing the Transition for your Financial Institution" now.