U.S. market brief

Wealth Management

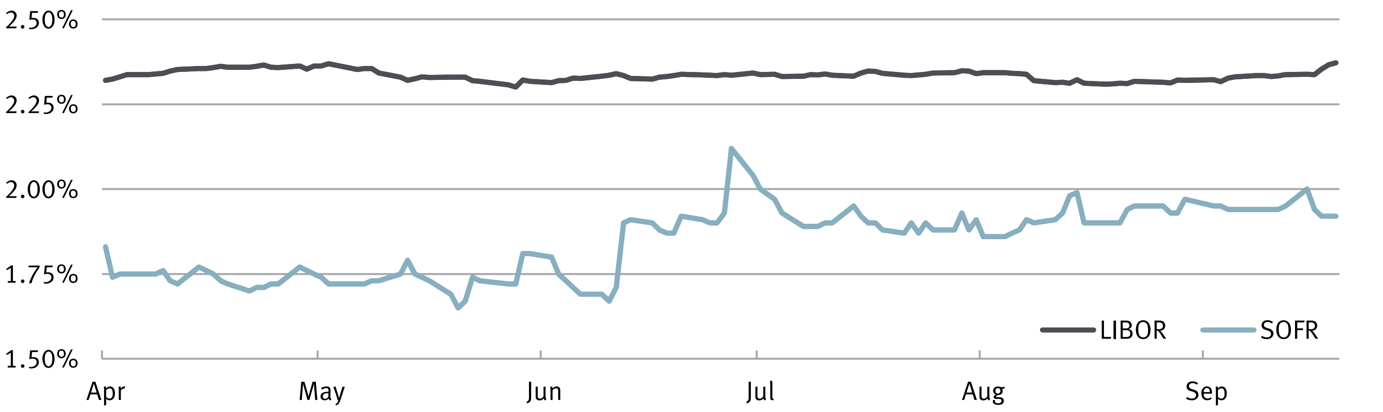
LIBOR to SOFR transition uncertainty

The London Interbank Offered Rate (LIBOR) has been the global benchmark interest rate since the mid-1980s, and is the benchmark interest rate for roughly $350T of outstanding loans, mortgages, and securities. But banks will no longer be required to submit LIBOR quotes past 2021. After 2021 and likely before, LIBOR's status as the global interest rate benchmark will be passed to its heir apparent—the Secured Overnight Financing Rate (SOFR). There are benefits to the change, but there are also marked differences between the two benchmarks.

Genesis of change

In 2012, United Kingdom financial industry regulators discovered several financial institutions were manipulating the LIBOR rate-setting process for their own gain. Market participants were able to manipulate the rate because LIBOR is based on "expert judgment" as opposed to observable transactions. In response, the Federal Reserve Board along with the Federal Reserve Bank of New York established best practices for creating an alternative benchmark to replace LIBOR. In June 2017, SOFR was presented as LIBOR's replacement.

Three-month LIBOR vs. spot SOFR



Source - RBC Wealth Management, Bloomberg

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SOFR 101

SOFR is a secured overnight rate based on daily repo transactions. The new benchmark, which the NY Fed began publishing on April 3, 2018, is based on the observable cost of borrowing cash overnight collateralized by U.S. Treasury securities. The benchmark is considered extremely robust because it is derived from over $750B of observable daily transactions.

Benefits and differences

The fundamental advantage of SOFR over LIBOR is the integrity of the benchmark because rates are derived from observable transactions as opposed to “expert judgment,” which is much easier to manipulate.

But there are also key differences between the two rates. First, SOFR is a nearly risk-free interest rate because the overnight loan is backed by U.S. Treasury securities, whereas LIBOR is an unsecured rate that exposes the counterparty to the borrowing bank’s credit risk. Appropriately, LIBOR includes a risk premium to reflect the underlying bank credit risk on an unsecured basis. The SOFR rate does not require this risk premium because the loan is collateralized. Apparently, the market is trying to devise a credit spread adjustment to help approximate the credit risk component of LIBOR, but the potential adjustment using a static number versus a dynamic number creates more uncertainties.

The second key difference (although likely to change) is the SOFR benchmark is solely a spot rate without rates for longer-time periods. In contrast, LIBOR is quoted for seven time periods with one-month and three-month LIBOR being the most popular. On the previous page is an illustration of the disconnect between the three-month LIBOR and spot SOFR. The lack of longer tenor for SOFR does not allow for a seamless substitution into existing LIBOR contracts.

Existing loan document ambiguity

A large uncertainty we see is that existing loan documents may not provide adequate fallback provisions when LIBOR resets are phased out. Some loan documents outline fallback provisions, but only address a temporary disruption in the LIBOR rate as opposed to a permanent elimination of the rate. As an example, some loan documents set the interest rate at the last available LIBOR rate, which effectively would convert a floating rate obligation to fixed rate after 2021. Other loan documents are completely silent in the absence of a LIBOR rate, which naturally causes great uncertainty. As such, the financial markets must find a practical solution to those legal shortcomings. While it may be difficult, the legacy securities’ contracts must be amended to reflect events that were unforeseen at the time of issuance.

Conclusion

The eventual phase-out of LIBOR and resulting transition to SOFR is a significant undertaking that will require market participants to address the gaps between the two interest rate benchmarks. According to the New York Fed, roughly $36T in obligations tied to the LIBOR benchmark will be outstanding when LIBOR is phased out in 2021. As such, the financial markets must tackle the legal shortcomings of many of those legacy debt obligations, and find an acceptable credit spread adjustment proxy to neutralize the inherent differences between the collateralized SOFR and unsecured LIBOR.

On a positive note, the financial markets have begun incorporating applicable fallback language into new credit agreements in anticipation of the upcoming change. The identification of SOFR in June 2017 as the preferred rate marked a significant step toward the full replacement of LIBOR; however, we believe more work is required to make SOFR a feasible solution in the loan market.

Overall, while we appreciate there are many questions surrounding the transition from LIBOR to SOFR, we believe suitable solutions will be found to address these uncertainties. We also feel SOFR is a better alternative given its observable transparency, assuming the credit spread adjustment proxy can be satisfactorily addressed and longer dated time periods can be created.

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Third-party disclaimer

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