BENEFIT STREET PARTNERS

A Franklin Templeton Company

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# LIBOR is Ending: Is anyone ready?

**Key Takeaways**

- LIBOR is scheduled to phase out by the end of 2021
- The primary reason for LIBOR's replacement has to do with the outdated methodology which consists of a panel of banks that report their expected funding rates
- US officials favor reliance on the Secured Overnight Financing Rate (SOFR), and rates based on actual transaction data in other major countries
- Differences between LIBOR and SOFR include security and tenor
- To ensure a smooth transition Benefit Street Partners is working towards including fallback language in all its credit documents

Most investors and borrowers have a rough sense of the London Interbank Offered Rate (LIBOR). Despite the scheduled phase out of LIBOR, it continues to serve as the world's most used benchmark for hundreds of trillions of dollars in mortgages, consumer loans, corporate debt, derivatives, and other financial instruments. Its influence as a market barometer is wide reaching. Variations in the spread between LIBOR and other benchmarks act as a key indicator of changing investor sentiment in global financial markets. LIBOR will be around until at least late 2021, when the British Supervisory Authorities will no longer require compliance with reporting requirements. The expectation is that banks will not wish to voluntarily comply after that date because of liability concerns.

You might be wondering why LIBOR needs to be replaced at all. One reason is that the rate can be manipulated, but the primary reason has to do with outdated methodology. The methodology for calculating LIBOR rates involves a daily survey of a group of large banks, known as panel banks, reporting their funding rates. Those numbers are adjusted and released daily. Since the Great Financial Crisis, significantly fewer panel banks have been reporting, and that reporting is based on a limited number of transactions. As a result, in 2014 the U.S. Federal Reserve commissioned the Alternative Reference Rates Committee (ARRC) to recommend a benchmark interest rate to replace LIBOR. US officials favor the secured overnight financing rate (SOFR) and comparable SOFR rates in other major countries.

SOFR is a broad Treasuries overnight repurchase (repo) financing rate published by the Federal Reserve Bank of New York, and it has had the endorsement of ARRC since June of 2017. It is a median of rates that market participants pay to borrow cash on an overnight basis, using Treasuries as collateral. A major international effort, coordinated by the Financial Stability Board (FSB), is in progress to help lenders through this transition process. At this point, it seems unlikely that an alternative to SOFR will emerge in the US. Globally, there is an alphabet soup of names for similarly derived risk-free benchmark rates that are being proposed for adoption.

**Exhibit 1: Proposed Global Rates**

| Country | LIBOR Rate | New Risk-Free Rate | Transition Committee |
|---|---|---|---|
| United States | USD LIBOR | SOFR | Alternative Reference Rates Committee |
| United Kingdom | GBP LIBOR | SONIA | Sterling Working Group on Risk-Free Rates |
| Japan | TIBOR, JPY LIBOR and Euroyen TIBOR | TONA | Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks |
| Europe | EURIBOR and EUR LIBOR | ESTER | European Money Markets Institute (EMMI) and Euro RFR Working Group |
| Canada | CDOR | CORRA | Canadian Alternative Reference Rate Working Group (CARR) |
| Switzerland | CHF LIBOR | SARON | The National Working Group on Swiss Franc Reference Rates |
| Australia | BBSW | RBA Cash Rate (AONIA) | Australian Financial Markets Association |
| Hong Kong | HIBOR | HONIA | Treasury Markets Association's Market Practices Committee |

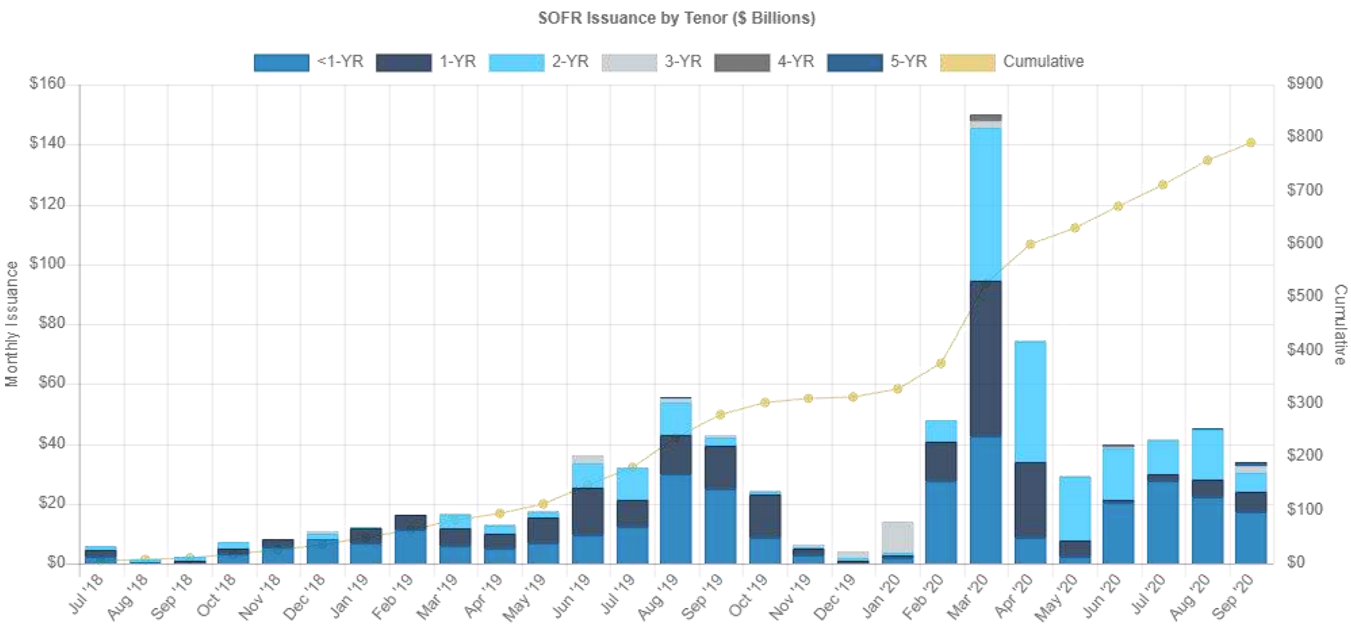
Source: Morgan Stanley Research, Oct 2019, https://www.morganstanley.com/ideas/libor-its-end-transition-to-sofr

As of September 30th, there has been a total of $792 billion of SOFR-linked debt issued, with $495 billion outstanding.[1] With over $200 trillion of LIBOR linked debt and derivatives[2], why has only a small fraction of the market started to adopt the new benchmark?

A key reason for the delay in SOFR's adoption by the large money center banks is thought to be SOFR's status as a domestic, rather than a uniformly accepted global standard. As illustrated above, many large economies have developed their own alternative reference rates, which vary from SOFR in both formulation and administration. If that is not enough of a headache, the replacement plan to use SOFR raises two fundamental issues: credit risk and maturity risk.

Regarding maturity risk, there is currently no SOFR term pricing. LIBOR rates are produced daily in a variety of forward-looking maturities up to one year. However, SOFR and other risk-free reference rates are only produced based on actual overnight maturity. The official hope is that the term problem will be solved by a robust derivatives markets that will create a market-based term structure for SOFR-based term rates. A "big bang" switch of interest rate swaps on $80 trillion of notional debt transitioned on the weekend of Oct 17$^{th}$, 2020.[3] This converted all swap futures from the daily Effective Federal Funds Rate (EFFR) to SOFR discounting. Market participants expect that there will be turbulence in pricing. Clearing houses (LCH Ltd. and CME Group Inc.) are counteracting the changes in swap values caused by the big bang so no one is better or worse off due to the transition. ARRC recently published an RFP for an administrator to create a Term SOFR index, which would be more of an 'apples-to-apples' replacement for USD LIBOR. While a robust derivatives market should over time solve the term risk problem, it does not address the of loss of credit risk pricing in SOFR.

**Exhibit 2: SOFR Issuance by Tenor**




Source: CME Group, October 2020, https://www.cmegroup.com/trading/interest-rates/secured-overnight-financing-rate-futures.html

Unsecured LIBOR rates included some credit risk, while SOFR, by its design, is a risk-free rate. LIBOR reflects both the risk-free rate plus the market's view of the riskiness of large banks. In "normal" market environments both rates move together on average, and closely track central bank interest rates. On the other hand, large divergences in these rates can occur during funding market dislocations. In some ways not including credit risk is a positive since users will no longer be exposed to the movement in bank credit risk premiums that do not relate to their own creditworthiness. However, the lack of inclusion of credit risk in SOFR means that it cannot alone act as a substitute. The Loan Syndications and Trading Association plans to follow International Swaps and Derivatives Association's lead, who has declared that the credit spread adjustment will be the five-year historical median difference between SOFR and LIBOR for each tenor. In the future the missing credit risk could be derived from any other market-determined bank rate. Some obvious alternatives might be the rate on commercial paper issued by large banks or the rate on marketable CDs.

The pricing of credit without LIBOR will be different since SOFR is not a direct replacement, but the challenges of replacing LIBOR with SOFR are solvable. Benefit Street Partners has been including the ARRC recommended Fallback Contract Language for cash products in credit agreements where possible.

The language incorporated in new contracts that reference USD LIBOR ensure these contracts will continue to be effective if LIBOR is no longer available in 2022. This amendment approval language states that when LIBOR goes away the prevailing new market standard will be used. The hope is that neither the borrower nor lender will be negatively impacted by incorporating a SOFR-based rate plus a new credit premium. The use of SOFR should increase the transparency in debt pricing for all market participants. Our hope is that the industry moves swiftly to adopt the new reference rates globally to allow for a smooth transition in 2022.

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**Note: UNLESS OTHERWISE NOTED, VIEWS EXPRESSED ARE THOSE OF BENEFIT STREET PARTNERS L.L.C.**

[1]Source: CME Group, October 2020, https://www.cmegroup.com/trading/interest-rates/secured-overnight-financing-rate-futures.html
[2]Source: Federal Reserve Bank of New York. August 7, 2020, https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_SOFR_Summer_Series_Event_SOFR_Explained.pdf
[3]Source: American Banker, October 15, 2020. https://www.americanbanker.com/articles/banks-brace-for-big-bang-switch-on-80-trillion-worth-of-swaps

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