LIBOR Transition: If You're in Neutral on SOFR, You're Probably Falling Back

Theodore Roosevelt is known to have said, "In a moment of decision, the best thing you can do is the right thing, the next best thing is the wrong thing, and the worst thing you can do is nothing."[1] On its surface, many of us subscribe to Roosevelt's maxim, but we do so with an unspoken addendum -- that is, Thomas Palmer's "if at first you don't succeed, try, try again." As it applies to the LIBOR transition, market participants must play their roles to reach a *best*, rather than a *next best* outcome, before LIBOR sunsets.

It turns out, few of us realized LIBOR was the Swiss Army knife of financial markets. The Alternative Reference Rate Committee's (ARRC) decision to promote SOFR for use in U.S. markets continues to be met with disagreement and ambivalence by some. The ARRC's choice of SOFR was really Sophie's Choice, in large part because LIBOR met so many needs, while requiring very little effort and collaboration. Neither SOFR nor any known alternative can slot in perfectly for LIBOR. But for all LIBOR did, it did not provide relevant, transaction-based data,

[1] Commonly attributed to Theodore Roosevelt, however the event-source is unknown.

which made it easy. There is no reference rate panacea hiding in plain sight. Now, the market is moving forward with imperfect replacements.

This article urges banks – while there is still time – to incubate their activities in SOFR or other alternative reference rates, whether that means a "SOFR-plus" approach, Ameribor, OBFR, etc. Here's why your bank should launch alternative rate lending now:

- **Learning curve:** Time is dwindling to scale a steep learning curve, and hoping for a LIBOR extension is not a transition strategy.
- **Peer pressure:** SOFR adoption in some market segments is pulling away from the pack. Market segments that fall behind will suffer by contrast.
- **No sanctioned fix:** Official sanction of SOFR alternatives or variable credit adjustments to a SOFR base rate (SOFR-plus) are unnecessary and unlikely. Without delay, use your preferred lending rates in new loans.
- **Solutions are available:** SOFR's flaws for commercial lending can be mitigated using credit and interest rate hedges, modified SOFR rates, or alternative rates.
- **Avoid digging a deeper hole:** Continued LIBOR-based lending over the next 22 months increases the exposure banks want to avoid because conventional fallbacks will convert assets to SOFR.

Market participants will stumble as they take steps to implement new reference rates. Directional progress – not perfection – is the objective of such early steps. Learning from initial challenges on a small scale will lead to better outcomes post-2021, when results will affect entire portfolios rather than limited pilot programs.

Learning curve

The market's problem – with 22 months of LIBOR remaining – is inaction of segments that must learn their way through implementation and management of subsequent exposures. Pilot programs will help banks identify and hone new practices and troubleshoot challenges before full-scale transition is forced by LIBOR cessation.

A strained GPS analogy is an effective learning curve illustration. While idle, you turn on your phone's GPS and the positioning signals and software cannot discern which direction your car is pointing or slightly misplaces your position. As a result, GPS recommends the wrong maneuvers. How do you fix the flaw? Begin driving. Moving from position A to B clarifies the car's initial orientation and location. Then GPS recalibrates and corrects directions to get you where you want to go. This describes global money markets with respect to the -IBOR transition, and banks are not exempt. Implementation and execution must begin if there is to be data to allow course corrections.

It appears some constituents – rather than begin driving so GPS can find and fix its errors – prefer to sit and wait for guidance mechanisms to "figure it out" before they proceed. A SOFR phase-in is a generational adaptation of financial markets to new standards, practices, and protocols. It requires time and investment, and will not go smoothly if banks play hot potato with officials over SOFR's suitability.

Peer pressure

Markets can debate whether officials and the ARRC solicited enough involvement from all market sectors. By default or design, one thing ARRC's implementation strategy accomplished was to set in motion an adoption domino effect, forcing participants to fall in step with a transitioning market, or fall behind through 2021.

To select SOFR and drive its initial adoption, officials offered ARRC membership to institutions that play central roles in markets related to SOFR and risk-free rates. SOFR is now used by primary dealers and globally systemically important banks (G-SIBs), Central Counterparties (CCPs), Federal Home Loan Banks (FHLBs), agencies and some mortgage markets. CCPs have finalized plans to use SOFR for discounting and price alignment beginning in 2020,[2,3] FHLBs issue SOFR floating rate notes and hedge with SOFR derivatives,[4] and Fannie Mae and Freddie Mac announced they will cease to purchase LIBOR mortgages.[5]

Some of the next dominoes to fall are commercial lending and public debt issuance, but this will require banks to follow suit.

No sanctioned fix

Many banks are apprehensive to lend based on SOFR because the rate is "risk-free" (discussed below). A group of regional banks was reported to have voiced such concerns over adopting SOFR-based lending in a September 2019 note to select officials. The group cited potential negative impacts on regional and community banks and broad lending practices throughout the cycle.[6] As a fix, the group proposed formal consideration to add a "credit risk premium" to SOFR for commercial lending.

There is no official requirement for banks to lend based on specific reference rates, and it is important that onlookers not delay alternative rate implementation and adoption while they wait for official clarification. As the group itself described in its letter, it is common market practice

[2] https://www.cmegroup.com/education/articles-and-reports/sofr-price-alignment-and-discounting-proposal.html
[3] https://www.cftc.gov/media/3221/MRAC_LCH_SOFRDiscountingLetter121119/download
[4] https://www.fhlbny.com/financial-intelligence/libors-transition-to-sofr/
[5] https://www.wsj.com/articles/fannie-mae-freddie-mac-to-stop-accepting-libor-mortgages-11581015566
[6] See https://www.politico.com/f/?id=0000016d-d15d-d0d8-af6d-f77d6c5f0001 and https://www.politico.com/news/2019/10/15/banks-fret-over-life-after-libor-047474

for banks to lend based on heterogeneous rates.[7] Thus, banks that see fit to add a credit buffer to their lending rates should proceed without delay.

Solutions are available

SOFR is responsive to regulators' initial criteria for "best practice" among alternative reference rates, but at the moment, its direct relevance for commercial lending lags LIBOR in two key ways: 1) SOFR is an overnight rate in arrears and 2) SOFR is essentially risk-free.

Overnight & Arrears

An overnight reference rate neglects the commercial loan market's preference for term rates. Term rates promote medium term visibility and ease administration for segments that typically do not fund or invest in overnight markets. SOFR's arrears nature means yesterday's SOFR rate (based on yesterday's secured lending transactions) is published today - so interest cannot be calculated until after the period to which it applies. Simply put, SOFR requires today's published rate to calculate interest to be paid today for the use of money last night.

The ARRC has clarified that the ultimate goal for SOFR is to create a forward looking term rate as the "primary potential successor rate," however the committee is unprepared to sponsor publication of a term rate until the derivative markets achieve sufficient SOFR futures liquidity to support an IOSCO compliant reference rate.

Meantime, the ARRC encourages adoption of SOFR for cash products based on the overnight, compounded rate.[8]

Risk-free

Transactions underlying SOFR data are fully secured by U.S. Treasury securities, so the rate derived from these transactions is considered virtually risk-free. Notably, a dynamic credit risk component is absent. Hence, if banks base new loans on SOFR, but do not also modify the conventional approach to pricing for credit risk using fixed spreads, their assets and liabilities would be misaligned.[9][9] Their funding costs would reflect changes in credit market conditions,

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[7] To be clear, thoughts expressed in this section pertain to new loans rather than existing, such as would be created in an alternative rate pilot program. In this scenario, the slate is clean, and banks may choose to lend based on their choice of reference rate, with whatever adjustments they deem suitable. Existing loans will be subject to fallback provisions that determine the benchmark replacement rate.

[8] Next month, the Fed will begin to publish 30-day, 60-day, and 180-day compounded average SOFR. https://www.newyorkfed.org/markets/opolicy/operating_policy_200212

[9] Assumes funding uses unsecured borrowing markets rather than repurchase agreements. To be covered in a future article.

while their lending returns would not. Net interest margins would contract when credit market conditions worsen, and banks' credit spreads widen.

Historically, markets have used hedging to bridge gaps among objectives and preferences of all market participants. Hedging permits borrowers and lenders to have certainty of interest rates and credit spreads for the periods they choose. Preserving interest margins can be addressed through explicit credit hedging, adjustments to SOFR lending rates – such as SOFR-plus to reflect a varying credit component to mirror banks' funding costs – or both. Conventional risk management tools and practices would allow banks to overcome SOFR's drawbacks. Some call such strategies "complex," apparently encouraging banks to meet SOFR's challenge passively with a motto of "*don't just do something – stand there!*" However, a quite simple hedging approach would provide banks substantial directional protection of the basis risk between SOFR-lending and credit-sensitive funding cost.

Avoid digging a deeper hole

Despite the ARRC's encouragement for markets to promote SOFR-based cash instruments, LIBOR-based lending continues almost universally. Barring specific inclusion of a varying credit component in new syndicated loans or non-standard fallback provisions, most new LIBOR loans will fall back to SOFR (with no varying credit component) as soon as January 2022. If that happens, banks will incur the greatest possible exposure of net interest margin to changes in funding cost due to widening credit spreads.

Why do fallbacks favor SOFR? Many banks are using the ARRC's fallback language, which either hardwires the SOFR replacement rate, or promotes "amendment" for a rate that "need not be…," but still favors, SOFR adoption. Agreements that have no fallback provisions will likely be subject to legislative resolutions, which would favor SOFR. That leaves agreements where the Administrative Agent (AA) elects a rate. AA's might choose a non-SOFR rate that has a credit component. One potentially viable rate is Ameribor. But we can imagine supervisory, peer, and client pressure might swing in favor of SOFR.

Initiating non-LIBOR lending now will reduce banks' ultimate risk when its legacy portfolio converts to SOFR. By making new loans at, say, SOFR-plus - or Ameribor - there will be no need for a fallback provision to convert loans to risk-free SOFR, and interest received on new loans should vary in closer relation with the bank's credit-sensitive funding cost.

Summary

Alternative rate adoption continues in key market segments, and LIBOR's expected demise approaches. Time is running out for banks and others to acquire, adopt, and perfect practices to overcome non-LIBOR rate deficiencies. And the risk of SOFR fallbacks gets steeper as banks miss their chance to transition current lending away from LIBOR.

Derivative hedging markets exist to bridge between market practices and investor or borrower preferences, and they can help banks reduce unwanted exposure brought on by SOFR. Other solutions include adoption of non-SOFR alternative rates or a SOFR-plus approach that address preferences for credit components or term rates.

This LIBOR transition series will continue to address implementation and practice issues that impede markets.

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About the Author

Chuck Brobst advises financial institutions and commercial companies on financial risk management and markets. Chuck spent 15 years in global markets divisions of Bank of America Merrill Lynch and ABN-AMRO Bank, founded GFM Solutions, and most recently was the Managing Director of Analytics and Innovation Strategist at OANDA Corporation. He has also taught graduate courses on risk management and banking for the Department of Finance at DePaul University.

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