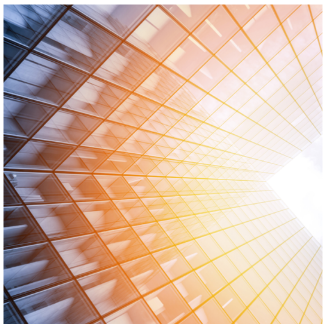
William Blair



SOFR Use Rises as LIBOR Sunsets

William Blair's Leveraged Finance group shares insight on the transition from LIBOR to SOFR, how the rates compare to each other, and where the leveraged finance market stands today.

Industry Commentary

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On July 27, 2017 the UK's Financial Conduct Authority (FCA) announced that financial market participants should not expect the London Interbank Offered Rate (LIBOR) to be available after 2021. This announcement came on the back of the so-called LIBOR Scandal of 2012, in which several U.S. and European banks colluded with each other to manipulate LIBOR rates. While many market participants welcomed the FCA's announcement, it nevertheless created a degree of uncertainty around which lending rate(s) would fill LIBOR's void. Stepping into the fray, the U.S. Federal Reserve and other financial institutions recommended that the Secured Overnight Financing Rate (SOFR) replace LIBOR and began publishing SOFR rates in April 2018.

Then on March 5, 2021, the ICE Benchmark Administration (IBA), the authorized administrator of LIBOR, confirmed its intention to cease publication of all euro, Swiss franc, yen, and Great British pound LIBOR tenors after December 31, 2021. In addition, the IBA indicated that it would cease publication of one-week and two-month US dollar LIBOR by the same date, as well as all other USD LIBOR tenors (e.g., overnight, one-month, three months, and six months) after June 30, 2023. Against this backdrop, LIBOR-based institutional loan volume decreased precipitously during the last three months of 2021, while SOFR-based loans dramatically increased.

LIBOR vs. SOFR: What's the Difference?

LIBOR is a short-term lending rate calculated by taking the average of what leading London-based banks estimate they would have to pay in order to borrow from other banks for various periods of time (e.g., 1-month LIBOR, 3-month LIBOR, etc.). The rate is forward-looking, so borrowers know the interest rate at the beginning of the period. LIBOR is unsecured, and the rate reflects a baked-in credit risk premium for the bank counterparty.

In contrast, SOFR is an overnight lending rate based on actual transaction costs in the overnight repo market, as calculated by the New York Federal Reserve. This makes SOFR a backward-looking rate. SOFR loans are collateralized by U.S. Treasuries, meaning they are secured and risk-free.

Comparing LIBOR vs. SOFR

LIBOR	SOFR
Bank-to-bank lending rate (includes bank credit risk)	Risk-free rate (no credit risk)
Unsecured	Secured by Treasuries
Forward looking	Overnight; backward-looking
Based on bank submissions and expert judgment	Transaction based
Based on roughly $1B of transactions per day	Based on roughly $1T of transactions per day

Since SOFR is a secured/risk-free rate, and LIBOR is unsecured, SOFR is inherently a lower rate than LIBOR. As a result, the majority of new loans tied to SOFR include a credit spread adjustment (CSA). Average margins on SOFR-denominated loans have fluctuated, but in March 2021, the Alternative Rates Committee (ARC) issued guidance on CSA structures of 11bps for one month, 26bps for three months, and 43bps for six months when converting existing LIBOR-based debt.

According to LCD, 31 out of 46 deals in January 2022 featured a CSA. Despite this trend, the CSA has quickly become another negotiating point. There has recently been an uptick in loans issued without a CSA, as well as the emergence of flat 10bps CSAs. Rate floors remain common in recent transactions as well. In fact, based on LCD data, all new transactions in January (excluding add-ons and loan re-pricings) tied to SOFR included a rate floor. Roughly 80% of January deals monitored by LCD, which generally reflect broadly syndicated deals, included a SOFR+CSA floor of 50 bps and the rest varied between 75 bps and 100 bps.

How do LIBOR and SOFR Rates Compare?

Data from IBA and the Federal Reserve Bank of New York indicate that LIBOR and SOFR generally trend together, except during significant market dislocations. Given this exception, a borrower's SOFR reset for a given period will not be based on a single SOFR print. Rather, it will be based on the average of the daily SOFR rate over a one-month term, which should significantly smooth out any daily volatility from market disruptions.

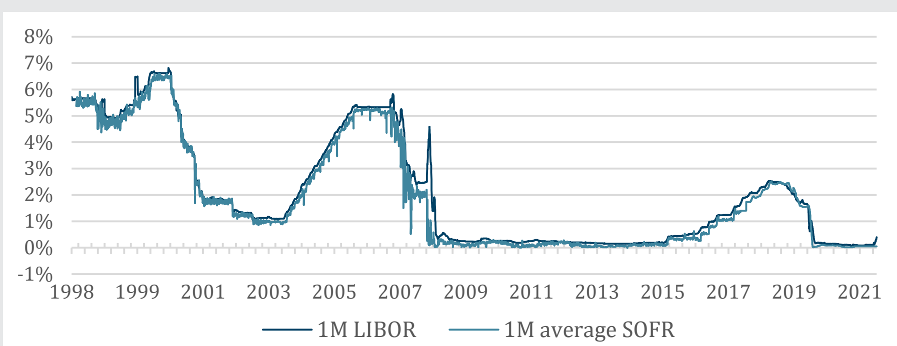
How are Credit Agreements Handling the LIBOR Phase-out?

Credit agreements have generally featured two options to address the LIBOR phase out. In the Amendment Approach, a lender and a borrower may amend an existing credit agreement to replace LIBOR with a benchmark replacement rate (which may be a SOFR-based rate) on the occurrence of a trigger event or an early opt-in election. In the Hardwired Approach, LIBOR is automatically replaced with a benchmark replacement rate after a trigger event or early opt-in election occurs.

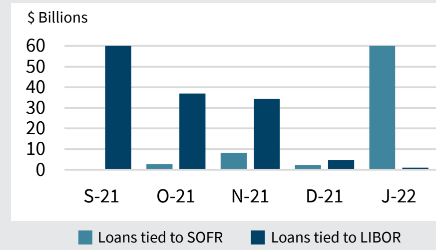
SOFR Rises in Institutional Volume

With the phase-out of LIBOR, SOFR has been gaining traction in the broadly syndicated loan market, with the middle market following suit. Data from LCD indicate that several large direct lenders also began issuing loans linked to SOFR at the start of the year, which further expedited the transition to the new benchmark.

LIBOR-SOFR Data[1]



New-issue institutional loan volume



S&P Leveraged Commentary & Data

Still, alternatives to SOFR remain viable. Some small and midmarket lenders are considering other benchmarks, such as the Bloomberg Short Term Bank Yield Index, known as BSBY, and the American Financial Exchange's Ameribor. Some market participants say these alternative rates better reflect lenders' funding costs and account for the risks of short-term lending. In their view, rates such as BSBY and Ameribor are more "plug and play" with LIBOR, and as such, make existing agreements easy to modify.

For more information on the LIBOR phase-out or to learn more about SOFR and its alternatives, please contact William Blair's Leveraged Finance Group.

1. ICE LIBOR 1-Month Rate Value from ICE Benchmark Administration via S&P CapIQ