In our first client alert about LIBOR’s passing, “LIBOR’s Long Good-Bye” (the First Alert), we suggested that borrowers of U.S. Dollars prepare themselves for the end of the London Interbank Offered-Rate (USD LIBOR), by understanding the replacement rates suggested by lenders. As we noted, it is almost certain that the daily Secured Overnight Financing Rate (SOFR) will have some place in the spectrum of replacement rates, but there are issues to be worked on prior to adopting SOFR.

SOFR (which has been recommended by the Alternate Reference Rates Committee (ARRC) since 2017) is a rate published daily by the Federal Reserve Bank of New York reflecting the cost of overnight borrowings secured by U.S. Treasury securities. Unlike USD LIBOR (which depends on submissions by lenders as to their costs of interbank borrowing), SOFR is a virtually risk-free rate and has impressive credibility – it (i) has an enormous underlying transaction value (averaging daily between $700 billion and $1 trillion), (ii) has a widely diverse range of direct and indirect market participants, (iii) is administered by the New York Federal Reserve Bank, and (iv) is subject to review by the New York Fed Oversight Committee.

If SOFR is such an impressively credentialed rate, how can there be any problems understanding conversions from USD LIBOR to SOFR borrowings? The answer lies in the technical differences between LIBOR and SOFR. For example:

- USD LIBOR is a term rate payable over an “interest period,” while SOFR is a rate that may change daily; and
• USD LIBOR is quoted “in advance” (at the beginning of an interest period), but, historically, SOFR has been quoted “in arrears” (which would require interest to be determined at the end of an interest period instead of the beginning (as is customary with USD LIBOR which is quote “in advance”)).

In other words, in addition to the “spread adjustment” discussed in the First Alert (required to address the “risk free” nature of SOFR as compared to USD LIBOR), some banking legerdemain is needed to make SOFR work in a world built on USD LIBOR, and Borrowers need to understand the effect of this sleight-of-hand unless they do not care about how much interest they are required to pay.

Averaging; In Advance or In Arrears; Compound or Simple, Hybrid?

AVERAGING

In its Guide to SOFR, the ARRC noted that “[f]inancial products either explicitly or implicitly use some kind of average of SOFR, not a single day’s reading of the rate in determining the floating-rate payments that are to be paid or received. An average of SOFR will accurately reflect movements in interest rates over a given period of time and smooth out any idiosyncratic, day-to-day fluctuations in market rates.”

In response to concerns about the viability of SOFR quoted “in advance” (i.e. prior to the beginning of an accrual interest period) as a replacement for USD LIBOR, on May 11, 2021, the ARRC released its “Guide to Published SOFR Averages” (the Guide to Averages). The Guide to Averages observes that the “averages” of SOFR can be quoted “in advance” in reliance on past averaging (or can be calculated on a “compounded” “in arrears” basis to take into account actual interest rates during an interest period). The ARRC points out in its February 2021 Updated User’s Guide (the Guide to SOFR) that “the amount of daily volatility in SOFR can change over time ..., but ... using an average overnight rate smooths out almost all of this type of volatility,” so that, in fact, “a three-month average of SOFR is less volatile than three-month USD LIBOR.”

In sum, it is likely that alternatives to LIBOR implemented by lenders will build on averaging SOFR over some period of time. However, interest calculated on any basis can be determined in differing ways with differing impacts.

IN ADVANCE OR IN ARREARS

For decades, USD LIBOR been quoted “in advance” for various specified interest periods (such as overnight, one-week, one, two, three, six, or 12-month “interest periods”) permitting both lenders and borrowers to know interest “in advance” of its accrual and payment, and the ARRC has expressed several times its goal of having a “forward-looking term rate” based on SOFR “in advance.” In fact on May 21, 2021, the ARRC announced that it has selected CME Group (CME) (which has published one, three, and six-month term SOFR rates beginning in April 2021) as the administrator for a forward looking SOFR term rate. Such a rate would closely mimic how USD LIBOR has worked and potentially be more feasible for lenders to adopt
than other types of interest rates. However, a robust forward-looking SOFR rate market has not yet fully developed.

According to the Guide to SOFR, average SOFR rates quoted both in advance and in arrears “will reflect the moves in monetary policy that are the primary driver of money-market rates, although an in advance structure will involve a one-period delay in the timing of when such moves are reflected.” In fact, the ARRC proposes that most business loan transactions avoid the one-period delay in timing imposed by the “in advance” convention and has adopted the “in arrears” convention in its term sheets for floating rate notes and syndicated and bilateral business loan. Lenders could be expected to embrace this “in arrears” approach to quoting average SOFR, since quoting SOFR “in advance” has no mechanism for predicting where interest rates will go (as USD LIBOR purported to do). (By contrast, the ARRC adopts the “in advance” convention for intercompany loans and consumer loan term sheets where the parties are believed to have more legitimate reasons for needing to know interest rate accruals in advance.)

Assuming that the ARRC’s lead is followed by most financial institutions, this would mean that, after the termination of USD LIBOR, most business loans will be quoted by lenders “in arrears” (unlike USD LIBOR). This change in how interest is quoted to borrowers is likely to be resisted by borrowers, because, as noted above, interest calculated “in arrears” would not be known until the end of an interest period (which would not be very helpful to borrowers who have come to rely on knowing their interest rates prior to their accrual).

That being said, depending on how repayment requirements are structured, there may be little difference between “in arrears” and “in advance” structures in the long run. The Guide to SOFR points out that any economic difference between “in arrears” and “in advance” conventions depends on “whether interest rates happen to be trending up or down over a given period … [and] “how frequently payments are made.” Although, in any given period, borrowers and lenders may either gain or lose from one structure relative to the other, any movement in rates not reflected in the current interest period in an “in advance” rate can be paid in the following period. “On average, any differences will therefore tend to net out over the life of a loan … if it lasts more than a few years.” In other words, the ARRC seems to tell both lenders and borrowers not to be too worried about the difference about “in arrears” and “in advance” interest calculations for anything except rather short-term borrowings. (Of course, that means that both borrowers and lenders may have grounds to worry about short-term borrowings.)

But the story about how USD LIBOR’s replacement will be calculated does not end with a decision as to averaging and calculation of interest in arrears or in advance. There is also a question whether interest should be calculated on a “compound,” “simple,” or “hybrid” basis.

**COMPOUND, SIMPLE, OR HYBRID**

The ARRC’s Guide to SOFR observes that simple interest conventions may seem easier but that compounded interest “would more accurately reflect the time value of money.” “Simple interest” is the daily amount of interest accrued on a principal
amount cumulatively determined at the end of an interest period. “Compound interest” is a convention whereby the interest accrued on each day during an interest period is added to principal (and bears interest on succeeding days at the stated interest rate). Either way, the ARRC notes that “the difference between the two concepts is typically quite small at lower interest rates and over short periods of time.”

The Guide to SOFR discusses how any differences in return to a lender from an “in advance” approach may be minimized by a “hybrid” approach. In an “interest rollover approach,” payments are set “in advance” but any amount by which interest is less than it would have been paid “in arrears” is payable at the end of the next interest period. In a “principal adjustment approach,” payments would be set “in advance” (but interest would accrue and be payable in arrears). The remaining principal on the loan would vary depending on the amount of interest that is payable. Both of these approaches can give borrowers advance notice of payment amounts that will be due (as would traditional USD LIBOR). Of course, neither of these “hybrid approaches” to “in advance” quotations of USD LIBOR would necessarily work easily for a borrower with embedded operational issues or for a borrower who has attempted to fully hedge its position with a swap or cap.

Any differences between a simple and compound interest rate can, according to the ARRC “be accounted for by adjusting the rate or margin.” At the end of the day, the choice between interest rate conventions to be applied “is a decision between counterparties and would entail investments to update systems in order to accommodate a compounded rate.” As “counterparties” to loans, of course, borrowers will want to know (i) whether their lenders are calculating interest as “simple interest,” on a “compound basis,” or on a “hybrid basis”; (ii) how the applicable conventions affect interest payable by the borrowers; and (iii) whether adjustments can be made by the lenders to accommodate their borrowers.

Where are we?

REMAINING ISSUES

As we noted above, whether interest is calculated on a compound, simple, in arrears, or in advance basis may have little effect on interest calculated over relatively short periods of time (particularly if rates are low), but that is not very helpful in making decisions as to longer term transactions in higher rate environments. In addition, there are legal issues lurking around the end of LIBOR that are starting to come into focus. All of this leaves us asking, exactly where are we now in our long good-bye to LIBOR?

Would credit sensitive rates (CSRs) help solve the in advance, in arrears, simple, and compounding interest issues raised above?

Upon review of publicly available agreements, the Loan Syndications and Trading Association (LSTA) said recently it believed that the loan markets have adopted a variety of alternative responses to LIBOR’s phase out, the most common structures being (i) SOFR compounded in advance (most often used in adjustable rate mortgages); (ii) SOFR simple or compound in arrears (most often used in floating rate
notes and interest rate derivatives; (iii) forward looking Term SOFR (which is trying to develop); and (iv) adoption of CSRs, not SOFR. The problems in creating a robust SOFR in advance (or “forward looking” SOFR) (items (i) and (iii) above) and borrowers’ anticipated resistance to SOFR in arrears (item (ii) above) mean that the first three alternative interest approaches identified by LSTA may not provide a lot of hope to borrowers, but the development of CSRs (item (iv) above) may provide some light at the end of the LIBOR tunnel.

Lenders have been looking for clearer answers all over the place, and perhaps CSRs will help. As of April 28, 2021, the LSTA published a form of rider for use with CSRs in replacement of LIBOR, and, thereafter, the LSTA observed that “[L]oan market participants … should be able to make educated decisions” using appropriate CSRs as alternatives to SOFR.

One example of a CSR is the Bloomberg Short-Term Bank Yield Index (BSBY). In April 2021, Bank of America, N.A. announced issuance of $1 billion in six-month floating rate bank notes referencing the one-month tenor of the BSBY saying that it adheres to the International Organization of Securities Commissions’ Principles for Financial Benchmarks and measures the average yields for U.S. Dollar unsecured funding of global banks. As such, the rate should be dependable, credit sensitive and reflect overnight funding costs for various interest periods. In May 2021, the CME Group announced the launch of interest rate futures based on BSBY, thus potentially paving the way for quotation of BSBY in advance.

Notwithstanding the fanfare preceding CSRs, there are substantial questions attending them. The ARRC initially selected SOFR to replace LIBOR due to the substantial credibility associated with SOFR (in terms of size, availability, and oversight). While CSRs may have significant market heft, it is unlikely to be close to that of SOFR, and, unless one or more CSRs is (are) endorsed by the ARRC, financial institutions can be expected to be heavily swayed by the ARRC’s approval of SOFR. The ARRC has not yet weighed in on CSRs, but Andrew Bailey, the Governor of the Bank of England, has said: “While these rates may offer convenience as a short-term substitution, they present a range of complex longer-term risks. And while they may remove the reliance on expert judgement, they veneer over the fundamental challenges of thin and incomplete markets through the extrapolation of data. The ability of such rates to maintain representativeness through periods of stress remains a challenge to which we have not seen adequate answers.”

In short, CSRs do not seem to provide easy answers to SOFR-related issues.

THE LEGAL FRAMEWORK

While the ARRC and financial institutions move inexorably towards the death of USD LIBOR, the legal framework within which USD LIBOR has lived has begun to adapt as well. In April 2021, New York State became the first state to adopt legislation (Article 18-C to the General Obligations Law of New York) addressing what are called “legacy LIBOR” contracts maturing after LIBOR terminates and lacking effective fallback provisions. Building on language developed by the ARRC, this new law says that selection of a recommended benchmark replacement constitutes a “commercially reasonable replacement” of LIBOR, and shall not be deemed to impair
or affect the right to payment or discharge or excuse performance of a contract. No one has any liability for selecting a recommended benchmark replacement or recommended conforming changes.

Similar federal and other state legislation may not be far behind. The Securities Industry and Financial Markets Association has articulated support for such legislation. However, regardless of the time and expense incurred in connection with adoption of well thought-out legislation, there is no way to rule out the incurrence of costs and expenses associated with legal issues unearthed in the process of terminating LIBOR.

The End

There is no question that LIBOR will end soon, and there are a lot of variables potentially affecting replacement interest rates that Borrowers need to understand and to which they should respond. We hope that Borrowers are using the time available to them to understand their particular situations, to talk to their lenders, and to adapt their operational systems to a new reality.

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