LIBOR in Focus

An AFS Newsletter about the LIBOR Transition

August 2021

In this issue:

This newsletter is meant to keep our client community informed, offer further insight into this critical and monumental market change, and help support your transition from LIBOR to Alternative Reference Rates.

For more information on how AFS is supporting our clients or for questions around Alternative Rate Choices or SOFR rates, calculations, and/or additional SOFR documentation, please contact your AFS Relationship Manager. Additionally, more information can be found on the AFS website.

Is Everyone Ready for LIBOR Cessation?

In less than six months, the credit markets will witness the cessation of one-week and two-month LIBOR followed by the last 18 months of LIBOR, hence ending its 40 plus years of usage. With the clock ticking towards LIBOR cessation and transition projects entering a critical point we ask, “Is everyone ready for LIBOR cessation?” Although 70% of our organizations are offering at least one alternative reference rate for new loans, AFS realizes that a number of organizations are still preparing their transition. The formal recommendation of Term SOFR is a much-anticipated addition to an organization’s SOFR offering. With the majority of the regional lending activity relying on known forward cash flows and payments, Term SOFR and some CSRs should now provide a less complicated path towards a world without LIBOR.

Numerous Rates to Replace LIBOR

Knowing which Alternative Rate to offer is a critical part to everyone’s LIBOR transition strategy. Therefore, having multiple rate types only makes this process even more challenging. AFS understands the market’s challenge of replacing one rate type (LIBOR) with the different Risk Free Rates (RFRs) choices of SOFR, or with the several alternative Credit Sensitive Rates (CSRs). Analyzing your rate choices becomes even more challenging as three of the SOFR rates: **Simple Daily in Arrears SOFR**, **Compounded Average in Advance SOFR**, and **Forward Term SOFR** are standard published rates, but the fourth SOFR rate **Compounded in Arrears** requires additional daily calculations. Compounded in Arrears also has two distinct methodologies, A) Compounding by Interest Rate or B) by Loan Balance, both supported by AFS. Being adequately prepared for customer queries will require each organization to have a proficient knowledge and access to the details of their system’s rate calculations.

AARC Formally Recommends Term SOFR

On July 29, 2021, the ARRC announced their formal recommendation for Term SOFR. This followed their July 26 completion of the inter-dealer broker market changing from U.S. dollar (USD) linear swap trading USD LIBOR to the Secured Overnight Financing Rate (SOFR). This development led the way for the ARRC's formal recommendation of Term SOFR for business loans, including syndicated loans. As mentioned in our previous LIBOR In Focus Newsletter, the ARRC recognized (May 21, 2021) the CME Group as the administrator for Term SOFR based on the increased usage and liquidity of the CME SOFR futures contracts (one, three, and six-month tenors launched in April 2021). This formal recommendation for Term SOFR will now provide greater borrowing certainty and longer fixed maturity rates, all good news for both lenders and borrowers. Possibly, before our next Newsletter, all market participants will be offering this much-anticipated rate to their LIBOR transition solution! The AFS SOFR team will continue researching how the market adopts Term SOFR, and will report their findings at the upcoming the **AFS Best Practices Leadership Webinar:** The Arrival of Alternative Rates! on **September 22 at 1 PM EDT**. We look forward to your attendance and participation!

Alternative Rate Choices

As banks plan to transition to reference rates backed by regulators (SOFR) or alternative Credit Sensitive Rates (CSRs), or a combination of both, it's worth highlighting two popular CSRs, 1) American Interbank Offered Rate (Ameribor) and 2) the Bloomberg Short Term Bank Index (BSBY). Both of these CSRs help provide a more accurate reflection of a lenders' funding cost. Although the Federal Reserve is backing SOFR, it has stated that they are open to other rate options in order to support all future lending sceneries. AFS understands the need to be prepared for all possible scenarios. This is why we have prepared our systems for all rate types, including all Credit Sensitive Rates.

Know your Alternative USD Rates

- SOFR – Secure Overnight Financing Rate
  - *Daily Simple SOFR*
  - *SOFR Averages*
  - *Term SOFR*
  - *Compounded SOFR in Arrears (by Rate & by Balance)*
- Fed Funds Rate
- Prime rate
- Ameribor
- Bloomberg Short Term Bank Yield (BSBY) Index
- ICE Bank Yield Index (BYI)
- Across-the-Curve Spread Index (AXI)

Know your Term SOFR and SOFR Averages Rate Conventions

- Business Day Convention: Modified following business day
- Rate Publication Calendar: SIFMA
- Lookback: Two U.S. Government Security business days prior to first day of interest period
- Borrowing Notice Period: Three U.S. Government Security business days prior to the borrowing date
- Rounding: Published to five decimal places; dollar amounts calculated to two decimal places, and parties may consider using their current rounding practices
- SOFR averages are compounded averages of SOFR over 30-, 90-, and 180-calendar day periods; published by the Federal Reserve Bank of New York
- CME Group currently publishes one-month, three-month, and six-month Term SOFR

Britain Considering Synthetic LIBOR

Early this year New York State signed into law a bill that will help with the transition of "tough legacy contracts" where a replacement of LIBOR might be difficult due to the upcoming December 31, 2021 cessation of one-week and two-month LIBOR tenors. The ICE Benchmark Administration (IBA) will continue to publish USD LIBOR rates for five tenors (overnight, one-month, three-month, six-month, and twelve-month) until June 30, 2023. Britain's Financial Conduct Authority (FCA) is also considering a Synthetic LIBOR to smooth over the transition. So what is Synthetic LIBOR? Proposed by FCA (under the Financial Services Act 2021) this temporary rate will result in a newly published screen rate for specific tenors where LIBOR tenors are no longer published (ex., one-week and two-month USD LIBOR). This new rate will actually not follow any existing LIBOR calculations, but would use the published Term SOFR rate and add the credit spread adjustment.

Managing LIBOR Exposure Risk

With LIBOR cessation dates coming ever closer, the market's "wait and see" strategy could soon be replaced with a "let's do this thing" approach. While the ARRC is warning that the end of LIBOR might pose financial stability risk to companies with LIBOR exposure the process of managing any possible risk is paramount. Organizations that stay focused on managing their transition risks, continually communicating with their customers, and validating their operational readiness will reduce their LIBOR transition risk. Market players should also continue to keep current on the latest LIBOR transition events, market developments, and regulatory announcements.

AFS continues to support the market by keeping our clients up-to-date with this Newsletter and our quarterly LIBOR Transition webinars. The quarterly webinars are an effective forum for keeping our clients informed on AFS system developments and readiness. Our next webinar [The Arrival of Alternative Rates!] will be on **September 22 at 1 PM EDT**. We look forward to your attendance and participation!

Cost of Carry

LIBOR is an unsecured market rate that has an embedded credit risk component, while SOFR is a risk-free rate backed by government bonds. This key distinction between the two rates has become a contention in the Cost of Funds/Lending conversations within the market, and has trickled down to the trading terms of the Cost of Carry fee concept, whereby the buyer owes a fee to the seller of a particular asset. AFS has been working closely with the LSTA and other industry participants to find a solution, which will ease any possible calculation changes. **What we know**: Today we sum one-month LIBOR rates and divide by the number of days of the delay period to derive our Average LIBOR Rate. **What we expect**: This methodology will not deviate far from what the industry is currently applying, but at the very least, will remain the same as current and only have an additional flat spread to the Reference Rate of choice, which we hope will be predominantly SOFR in the U.S. Dollar space. The conversations surrounding this issue are still ongoing. We anticipate a consensus by the fourth quarter of 2021.

For more information about how AFS is supporting our clients, please visit our website for FAQs, blogs, and webinars at [LIBOR Updates].

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