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Hello SOFR!
SOFR Loans are Here – What you need to know now!

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The first thing to know is that SOFR is pronounced like "gopher" and not "So Far", but since we kicked off 2022 and the first quarter is behind us, so Far, so Good!

The Background

The transition away from LIBOR has been a coordinated global effort, not just affecting USD LIBOR but most IBOR's around the world. In most jurisdictions, the regulatory body, such as a central bank or a committee appointed by the regulatory body, such as the US Federal Reserve's appointed Alternative Reference Rates Committee ("ARRC"), has recommended replacing the LIBOR benchmarks. Without diving into the weeds, the regulators concluded that the London Interbank Market, where banks borrow and lend to each other on an unsecured basis, is not deep and liquid enough to have trillions of dollars of financial instruments tied to a benchmark that fifteen-panel banks determine at their discretion and is subject to manipulation like we saw in the "LIBOR Scandal" in 2012.

For USD LIBOR, the ARRC has recommended the Secured Overnight Financing Rate ("SOFR") as LIBOR's replacement. SOFR measures the cost of overnight borrowing collateralized by US Treasuries in the overnight repo market. The repo market averages more than $800 billion of transactions per day and represents a vast body of participants not limited to banks. As a result, the repo market is far more robust than the London interbank market, and the SOFR rate is not subject to private sector manipulation.

Although the regulators have mandated no single benchmark, SOFR is preferred by most banks and institutional lenders. SOFR-based loans are not new to the market. The first SOFR loans were issued in 2018 primarily by government agencies and a handful of banks to test investor appetite and increase liquidity for the new index. There were very few SOFR-based corporate loan facilities in those early years (e.g., Royal Dutch Shell in 2019). Corporate volume finally picked up in the summer of 2021 following the regulators' Statement on the LIBOR Transition on November 30, 2020, and momentum increased after the ARRC formally recommended forward-looking Term

[1] Note this white paper was originally published in January 2022 by the Association of Financial Professionals (AFP) and has been updated to reflect the evolving market.

SOFR[2] rates on July 29, 2021. Since the summer of 2021, Riverside has directly advised on dozens of private market SOFR-based loans and has tracked public market issuers representing over $107 billion of SOFR-based debt.

The Dates You Need to Know

January 1, 2022 – The Federal Reserve, FDIC and OCC issued a joint statement in 2021 that banks should cease entering into new USD LIBOR contracts after December 31, 2021. New contracts include USD LIBOR debt and new derivative transactions, although LIBOR-based swaps will be allowed if they are hedging existing LIBOR-based exposures. Note that non-regulated alternative lenders, a large and growing source of corporate loans, may not be subject to the same restrictions.

June 30, 2023 - On March 5, 2021, the UK Financial Conduct Authority ("FCA"), which has oversight over LIBOR's administrator, ICE (i.e., the Intercontinental Exchange), made a formal announcement that LIBOR rates will no longer be representative after June 30, 2023. Additionally, the FCA will no longer compel banks to provide their LIBOR quotes after this date. Of course, ICE, which to most people's surprise, has a US trademark on the word "LIBOR," has every incentive to keep LIBOR going, so we'll see. I'm betting against it.

The Biggest Buzz - What are SOFR Spread Adjustments?

Since SOFR is a secured rate, it is typically lower than LIBOR, which is unsecured. Furthermore, LIBOR is a term rate (e.g., 30, 90, 180-day rate), while SOFR is an overnight rate. The market at large wanted to avoid value transfer between two parties when replacing LIBOR with SOFR in legacy financial instruments. To move LIBOR transition efforts forward and for trading book valuation purposes, a spread adjustment needed to be determined to approximate the economics of a LIBOR-based instrument to a SOFR-based one:

LIBOR + [Credit Spread] = SOFR + Spread Adjustment + [Credit Spread]

Upon broad market consultation by ISDA and the ARRC on an appropriate methodology, the spread adjustments to SOFR *for derivatives* were determined based on the five-year historical median difference between SOFR and the relevant term LIBOR rate. Following LIBOR's cessation[3], any term LIBOR rate (e.g., 3-month LIBOR in a swap or cap) will be replaced by daily compounded SOFR plus a spread adjustment. Accordingly, the ARRC's recommended spread adjustments for loans that incorporate the ARRC's Hardwire Fallback language mirrored ISDA's adjustments even though a term LIBOR rate in a loan facility may be replaced by a *term*, not daily, SOFR rate.

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[2] There are four different types of SOFR indices, all with different administrators, licensing requirements and calculations: Daily Simple SOFR, Daily Compounded SOFR, CME Term SOFR (forward looking), and SOFR Averages (backward looking).

[3] ISDA contracts executed after January 25, 2021 benefit from amended 2006 ISDA definitions which define specific benchmark replacement rates and spread adjustments. Contracts executed before this date will need to be amended through the ISDA Protocol process.

The FCA announced the following permanent spread adjustments on March 5, 2021. The announcement was determined to be a Benchmark Transition Event, a defined term in ISDA and the ARRC's recommended language for LIBOR fallback provisions in loan and derivative contracts.

- 1 month LIBOR = SOFR + 0.11448%
- 3 month LIBOR = SOFR + 0.26161%
- 6 month LIBOR = SOFR + 0.42826%

Are the Spread Adjustments in Loans Negotiable?

Yes and no! The spread adjustments were *only* contemplated for use in those loans or financial instruments that contractually incorporate the ARRC's recommended fallback language "*the spread adjustment selected or recommended by the Relevant Governmental Body for the replacement of the tenor of USD LIBOR with a SOFR-based rate having approximately the same length as the interest payment period*." The spread adjustments may be contractually set if your legacy loan contract incorporates ARRC Hardwired Approach language. If your contract contains ARRC's Amendment Approach, the administrative agent and borrower may take into consideration current market conventions for setting an adjustment. If your agreement does not include any of ARRC's transition recommendations, 100% lender consent will be required for any amendment. However, the issue is that upon LIBOR's demise, the Prime Rate is likely the fallback, so borrowers may not have too much negotiation leverage.

On a positive note, I can attest with first-hand experience that spread adjustments for ***new*** SOFR-based loans are, in fact, negotiable! Unfortunately, there is much misinformation about the intended use of the ARRC spread adjustments. Bankers often point to the basis swap market to confirm the validity of the ARRC spreads for new loan transactions, but that approach is flawed since it is circular logic. In its January 2020 Spread Adjustment Consultation letter, the ARRC made it clear:

"*The recommended spread adjustments would not and are not intended to apply to new contracts referencing SOFR.*"

I firmly believe that supply and demand and a competitive process between borrowers and lenders will dictate the spread adjustments to SOFR in the short run. Therefore, incorporating a spread adjustment to SOFR to achieve an all-in credit spread to the benchmark should be temporary in the market and for new loans, ideally ignored (i.e., there should be one credit spread, or applicable margin, to SOFR). We have already seen a clear market movement from the ISDA/ARRC adjustments for new deals and many transactions without spread adjustments.

SEC-filed documents revealed much when Ford Motor came to market in September 2021 with its much-anticipated broadly syndicated SOFR-based global multi-currency facility. Naturally, I was excited to flip through the broad details to see what the spread adjustments were. Sadly, they were redacted, but that answered my question early on and confirmed my own experience – Yes, the adjustments are negotiable (otherwise, why would they be censored?) Since then, many public loans have gravitated to spreads of .10%, .15%, and .25% for 1-, 3-, and 6-month interest periods, which approximately reflects the difference in today's spot markets.

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One additional point, for decades, borrowers always enjoyed the economic value of the "chooser" option in loan agreements applying the same credit spread, at its choice, to either one-, three- or six-month LIBOR. There is a loss of value to the borrower by differentiating the spread adjustments based on SOFR's tenor (and multi-currency facilities to take the concept one step further). Lenders should be indifferent to a flat spread versus the ARRC's recommended spreads for various interest periods since lenders cannot rely on ever getting the economics of a higher spread adjustment for longer interest periods to achieve higher returns.

Differentiating spread adjustments also add complexity to the Treasury team, who will have to remember the cost of each spread adjustment for each interest period, details buried deep in complex loan agreements. The new approach, which may not be so transparent, may result in unintentional material increased interest costs. We've already seen one client who made that costly mistake by choosing a six-month SOFR without realizing the spread adjustment of + .42%. The spread adjustment was not on the advice received from the administrative agent.

Recently, we have been observing a trend in public loan transactions moving towards a flat spread of 0.10% across tenors and a few spread adjustments of 0.07% for 1-, 3- and 6-month interest periods. In Q3 and Q4 2021, we observed only two public loans with a flat spread of 0.10 % across tenors; however, in Q1 2022 alone, 13 deals with a combined total of around $20 billion have been closed with a flat spread signaling a move in the markets towards flat spreads across various tenors. Riverside has experienced similar success in moving our clients to a flat spread, although the negotiations are not without challenges.

The Bottom Line

In conclusion, SOFR loans are here to stay and the spread adjustments, which should be temporary in the market, are negotiable. Effective negotiation includes referencing shortfalls in the methodology behind the loan spread adjustments, the current rate environment for LIBOR and SOFR, market comparables, value transfer, and other highly supportive commercial factors, including your bank relationship. Additionally, in the current rising rate environment, choosing the "right" SOFR benchmark, since there are four, may also impact borrowing and hedging costs, so being informed can save you time and money.

We are at the beginning of a new era in the financial markets, and although there will undoubtedly be hiccups, so far, so good.

Joyce Frost is Co-Founder of Riverside Risk Advisors, an independent derivatives advisory firm and leads Riverside's transition efforts on hedges and loans with its clients. She has given dozens of webcasts on the topic since 2018 and has been a featured panelist in numerous industry events, including ARRC's October 2021 SOFR Symposium. She is also very active within ARRC as a member ARRC's Bilateral Business Loan and Non-Financial Corporate Working Groups, the Accounting and Tax Working Group and Conforming Changes, Tax and Term SOFR sub-committees. Riverside is as also a member of ISDA and the LSTA.