Debtwire
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SRS ACQUIOM

LIFE AFTER LIBOR: Recommendations for an Orderly Transition

2021 Survey

Contents

Methodology

In Q2 2021, SRS Acquiom commissioned Debtwire to interview 100 executives in the US financial industry to learn about their institutions' preparations for transitioning away from LIBOR. The interviewees were split evenly among investment banks (25%), hedge funds (25%), distressed debt funds (25%), and direct lending funds (25%). The executives all personally had a role in syndicated lending. All the responses are anonymized, and the results are presented in aggregate.

Introduction

On June 30, 2023, the London Interbank Offered Rate (LIBOR) dollar daily rate will disappear.

Before that momentous day, companies must switch their old financial contracts to a different benchmark. For new contracts, US regulators have said they would like firms to stop initiating deals that use dollar LIBOR by the end of 2021. But many organizations have been slow to prepare for the transition, and regulators were compelled to postpone the original cutoff date for dollar LIBOR.

This reflects the lack of clarity about which replacement rate will become the new standard—it is hard for a firm's decision-makers to let go of one benchmark if they do not know which to employ instead. With that being said, US institutions must work quickly to resolve any remaining gaps in their preparations, in spite of the headaches it may entail.

In this report, we highlight the most effective transition strategies as the LIBOR deadline approaches, from the steps organizations have taken so far to the intricacies of navigating the switch to a new benchmark in existing loan portfolios, as well as what the predominant benchmark is likely to be.

For those that fail to make a timely transition from LIBOR, penalties could include significant lawyer fees, reduced access to wholesale financial markets, and reputational damage.

As Randal Quarles, the Federal Reserve vice-chair for supervision, asserted in March 2021, "There is no scenario in which a panel-based dollar LIBOR will continue past June 2023, and nobody should expect it to."[1]

The state of preparations

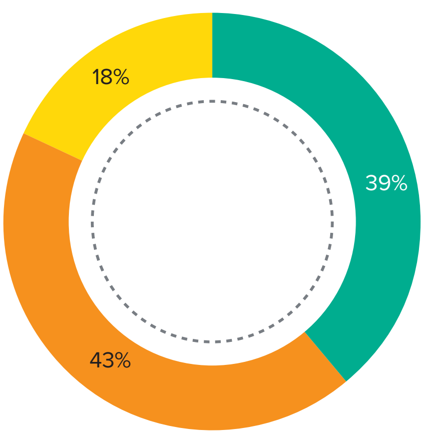
Firms have been under pressure to set out their post-LIBOR plans for some time. A large share of those we surveyed feel they are well-equipped for the transition, but others remain uncertain—many transition plans are still being discussed.

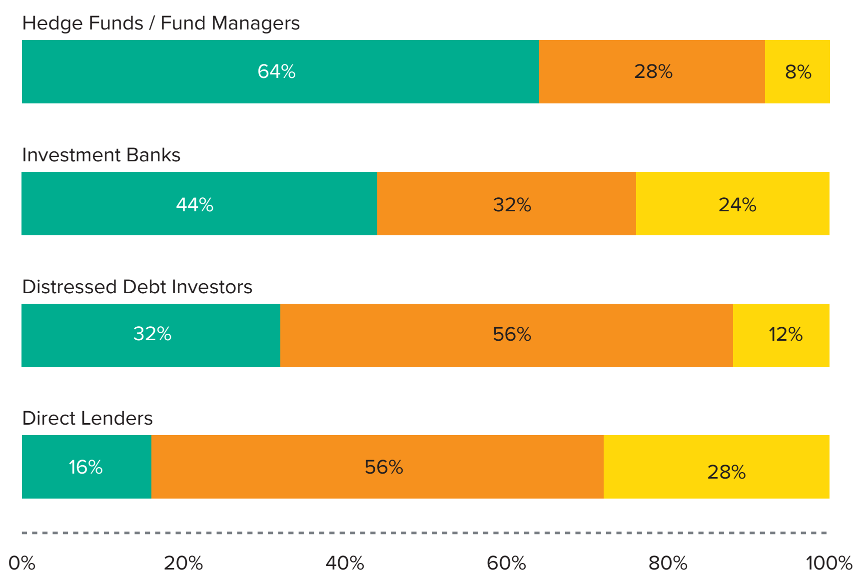
More than eight-in-ten firms say they are prepared for the transition away from LIBOR, including 39% who report that they are very prepared. In a survey we conducted in 2019, fewer than half as many respondents (19%) were as confident. This year, just 18% feel they are not well-prepared, versus 46% who felt that way in 2019.

But this masks wide differences between the various respondent groups. Almost two-thirds (64%) of hedge funds (specifically, fund managers) say they are very well-prepared for the transition away from LIBOR. This compares with only around one in six direct lenders—in fact, 28% of direct lenders say they are not at all prepared for the change.

"I think we are not prepared, despite having constant discussions about the options to replace LIBOR," says a managing director at one direct lender. "The market volatility and the recent disruptions have meant that we need to spend some more time evaluating the options."

1. Overall, how prepared is your organization for the transition away from LIBOR?





Very prepared
Somewhat prepared
Not prepared

Lingering LIBOR

More than half (57%) of all respondents say their institution or firm currently continues to reference LIBOR for new dollar loans. This is despite the fact that, although the dollar LIBOR rate will be published until June 2023, US regulators have issued guidance pressing banks to “cease entering into new contracts that use dollar LIBOR as a reference rate as soon as practicable and in any event by December 31, 2021.” However, this statistic is less worrying when one considers that only 3% say LIBOR is still their main rate.

More than three-quarters (77%) employ the Secured Overnight Financing Rate (SOFR), which uses actual transaction data from the highly liquid overnight Treasury repo market to calculate a daily rate, which has been published since April 2018.

SOFR’s popularity is unsurprising—the Federal Reserve has made clear that this is its preferred benchmark. In May 2021, John Williams, head of the New York Fed, insisted: “No other rate has the depth of transactions of the repo market that underlies SOFR, which proved to be resilient even during the market stress last spring.”[2]

The New York Fed calculates SOFR by looking at the cost of borrowing in the overnight repurchase market in US Treasuries. However, SOFR’s position as the future benchmark of choice is less dominant than our findings may suggest.

For example, 65% of respondents also say they use the Bloomberg Short-Term Bank Yield Index (BSBY). Some firms prefer it because it is based on global banks’ unsecured funding in dollars, so it includes the credit risk they want in their benchmark.[3] It also has the advantage of five tenors, running up to 12 months.

This is followed by Ameribor, the benchmark administered by the Chicago Board Options Exchange, which is heavily based on the transactions of smaller, regional US banks. This makes it popular with some heavily domestic firms. It also has a term rate (of one month), unlike SOFR.[4]

More than half (56%) of respondents in our survey set a fixed rate rather than relying on a benchmark. Fixed rates can appeal to businesses that are uncertain about how a benchmark will behave.

82%

Share of respondents who say they are prepared for the transition away from LIBOR

57%

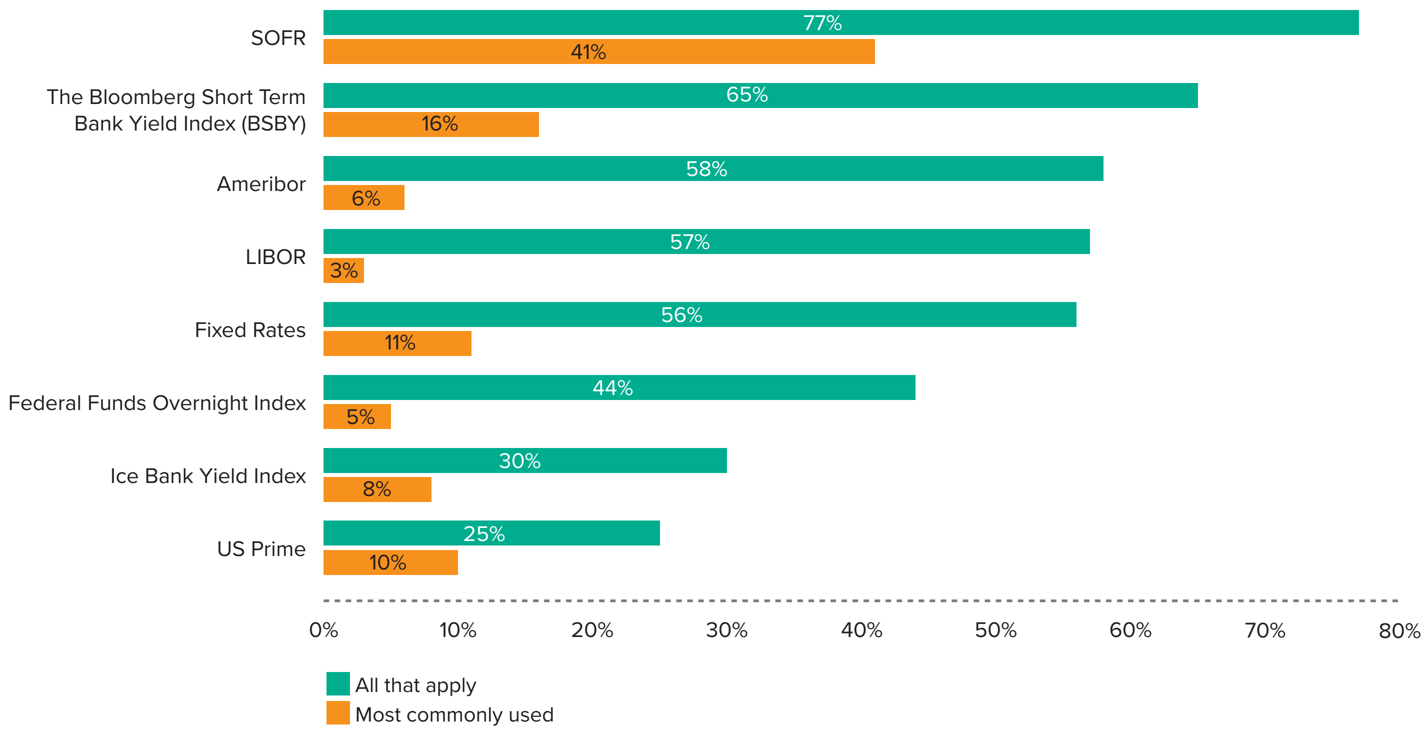
Share of respondents who report their institution continues to reference LIBOR for new dollar loans

These findings are very different from our 2019 LIBOR survey and reflect the general uncertainty still surrounding this debate. At the time, SOFR was only the fourth most popular alternative (by 55% of firms), behind the US Prime rate (85%), Ameribor (60%), and ICE Bank Yield Index (56%). In the intervening years, SOFR has clearly gained ground.

Another way of looking at what is likely to replace LIBOR in the US is to consider which alternative benchmark firms say they employ most often. Judged by this measure, SOFR has a strong position: 41% of firms favor it, and across each of the four groups surveyed—direct lenders, distressed debt investors, hedge funds and investments banks—the largest shares of respondents prefer it over other possible solutions.

The BSBY comes second at 16%, with fixed rates at 11% and the US Prime rate published by *The Wall Street Journal* at 10%. The Prime rate changes only occasionally, so most institutions may not regard it as sufficiently market-sensitive.

2. A&B) Which of the following actions is your organization currently undertaking or has it already performed to prepare for the change in the reference rate?



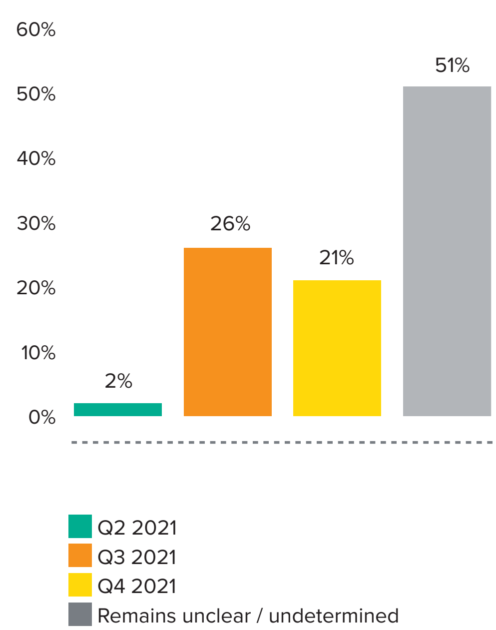
Lacking a LIBOR deadline

The use of LIBOR is certainly declining, but 51% of firms still lack a clear deadline for when they will stop applying it to new loans.

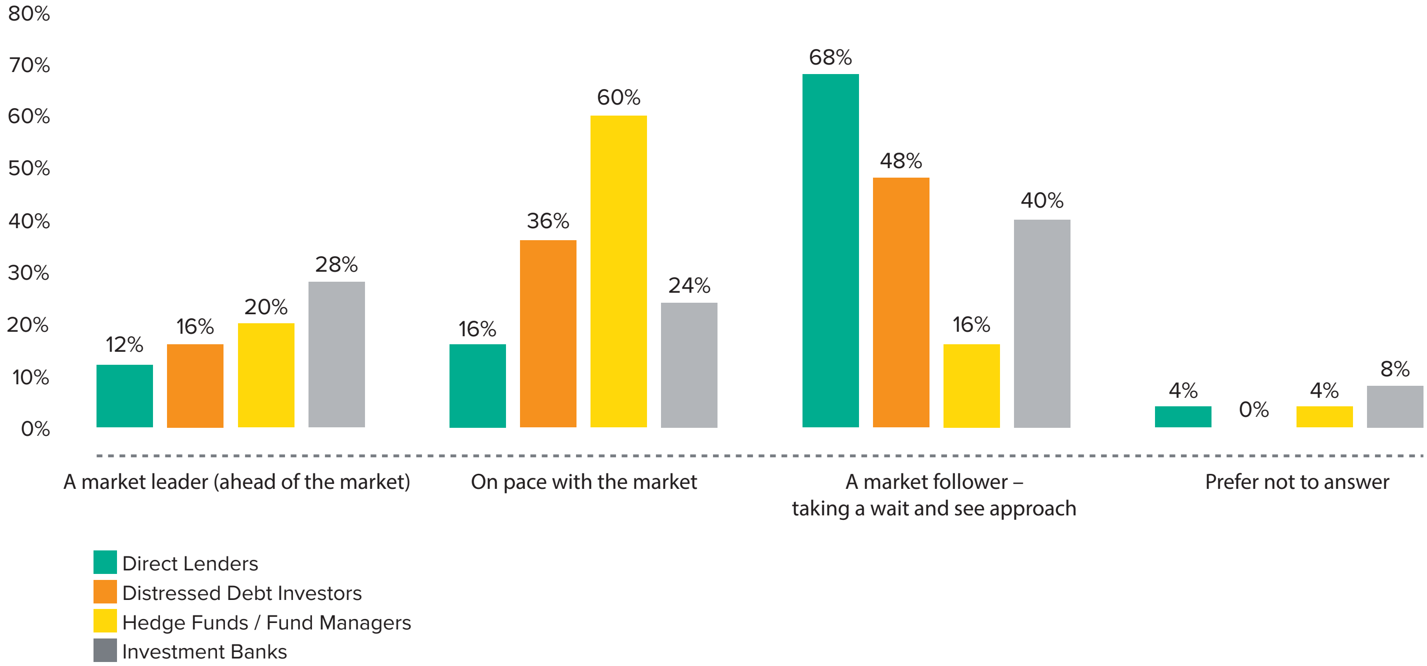
Firms like to believe they are market leaders but, for rate benchmarks, that approach can introduce risks. A company may pick a benchmark that ultimately proves less popular, or switch to a rate with low liquidity at the time of the switch.

When it comes to the transition away from LIBOR, 68% of direct lenders, almost half of distressed debt investors, and 40% of investment banks describe themselves as "market followers", taking a wait-and-see approach. These answers are subjective, but they provide a good gauge of the market's current mindset—for many, a cautious approach to the transition is still their preference.

4. When does your institution plan to stop using LIBOR for its newly issued loans?



3. With respect to the trainsitions away from the LIBOR reference rate, do you consider your organization to be:



No other rate has the depth of transactions of the repo market that underlies the Secured Overnight Financing Rate (SOFR), which proved to be resilient even during the market stress last spring.

John Williams, president and chief executive officer of the Federal Reserve Bank of New York, speaking in May 2021

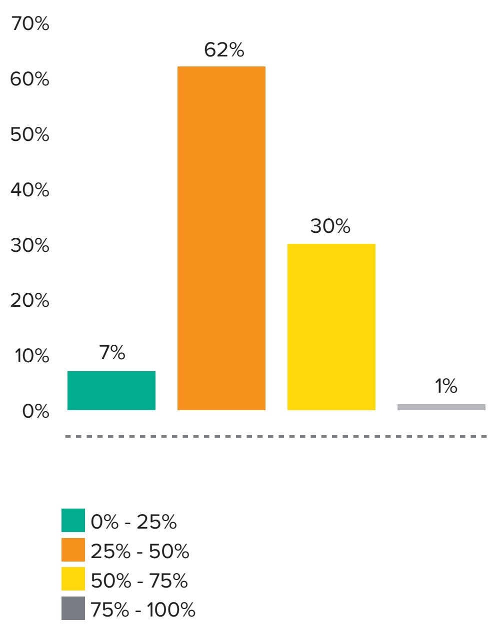
Making the switch

It is not surprising that some firms are having a hard time dealing with the transition away from LIBOR but, from technology solutions to fallback language, there are ways for firms to make the move less painful.

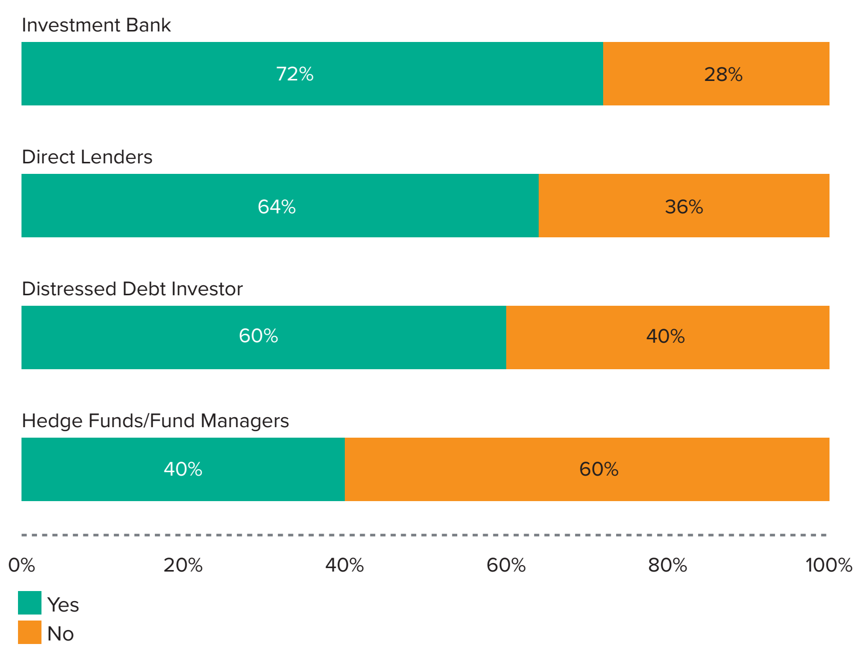
Most financial firms have a high proportion of loans that will mature after June 2023, when dollar LIBOR will stop being published. In 31% of cases, the majority of a firm's loans mature later than this. Few can afford to ignore the end of LIBOR, when it comes to existing contracts.

Investment banks lead the way in switching current contracts away from LIBOR: 72% have begun the transition. Direct lenders and distressed debt investors are not so far behind, at 64% and 60%, respectively. Hedge funds, however, are lagging behind the rest: 60% have yet to initiate the changeover.

4. What percentage of your institution's loan portfolio will mature after June 2023?



5. A) Have you already transitioned all or any part of your current deals from LIBOR to something else?



Where firms have moved away from LIBOR, 86% of respondents say they have used SOFR for at least some contracts, and 71% have used it more than any other rate.

This shows that SOFR is dominant in existing contracts where a switch is being made, rather than for new contracts. While lenders may see the virtues of competing benchmarks for new contracts, many firms are relying on the work done by the Alternative Reference Rates Committee (ARRC)—a group of private-sector market participants—on the issue of making a transition from LIBOR to SOFR fair to both parties in existing contracts.

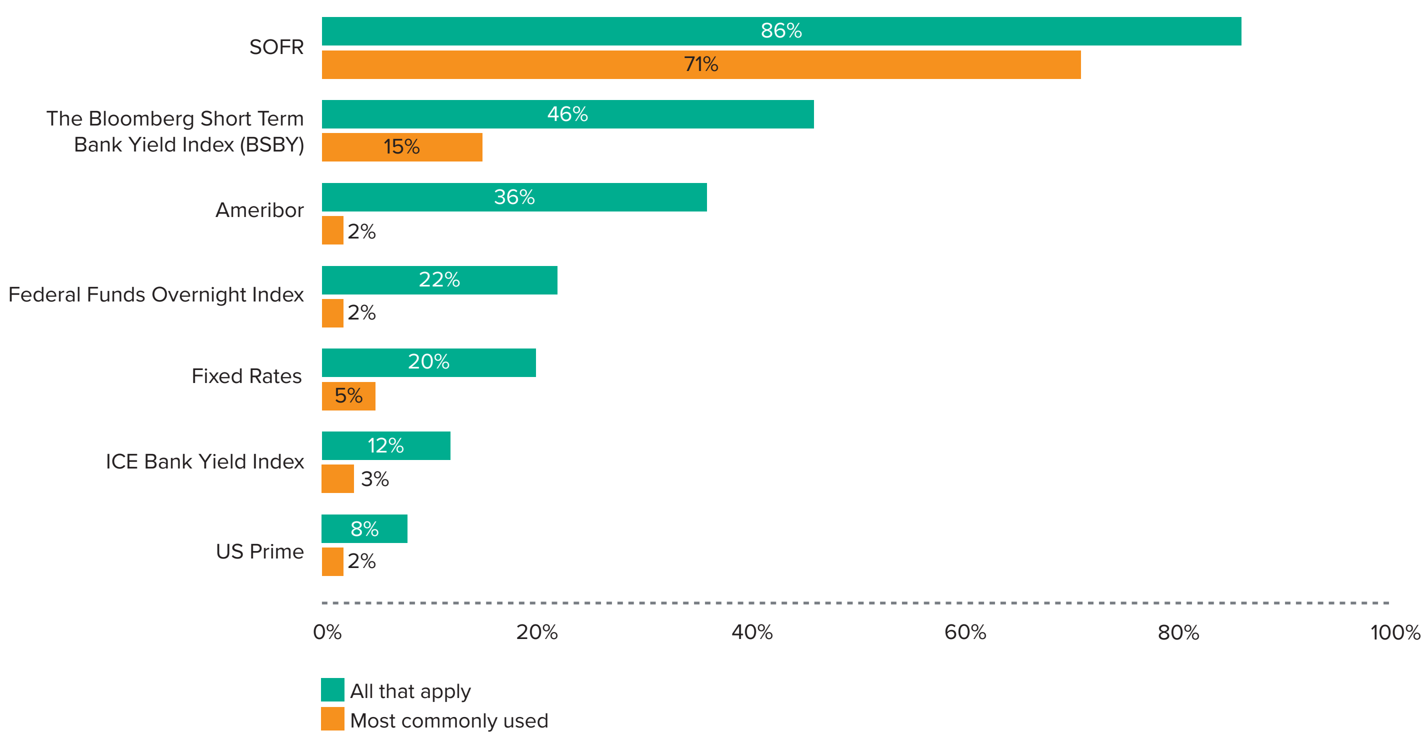
The rate most referenced on current contracts after SOFR is the BSBY. It is used for some contracts by 46% of firms and favored above all others by 15%.

"Our institution has decided to depend on the BSBY because the figures derived are close to the LIBOR measurements," explains a managing director at an investment bank. "Too many disparities from the current procedures would not be favorable."

Another says: "Since BSBY is a well-recognized version, we have selected this for our transition." This suggests that SOFR's proposed advantage as the de facto benchmark is not guaranteed.

Other replacement rates are favored by very small minorities where they suit their needs. As a partner at one direct lender explains, "Ameribor is highly reliable, as the time-stamped transactions are used for arriving at the rates. There would be fewer questions raised about whether the rates could have been manipulated."

5. B&D) If yes, what rates have you moved to?



Preparing systems

Choosing a new benchmark is an important task, but systems also need to be prepared for the end of dollar LIBOR.

In our 2019 survey, 42% admitted they were not close to a concrete project plan. Two years on, some specific measures are already in place. For example, 75% of respondents say they have updated their internal technology systems to make them compatible with rates other than LIBOR. Two-thirds have done the same for third-party technology and operations vendors.

Fallback language

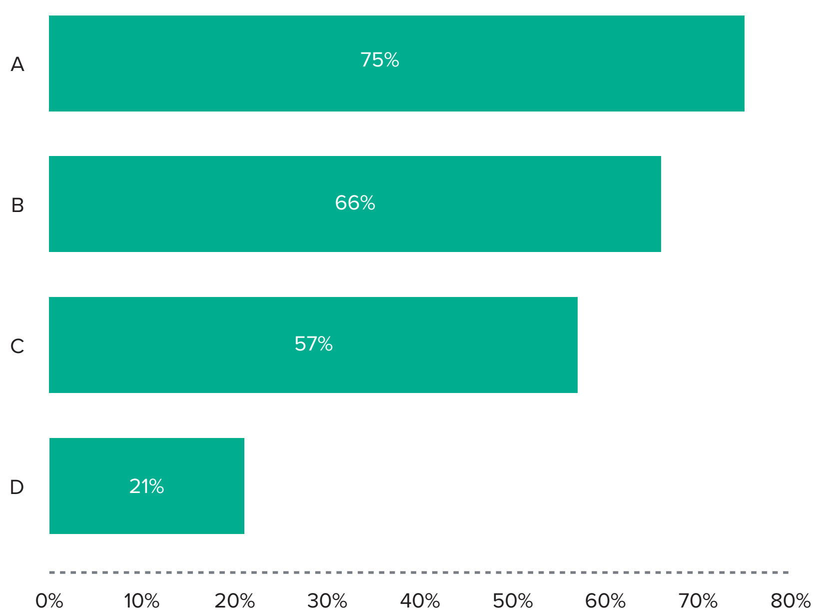
The biggest problem with switching existing contracts from dollar LIBOR to a new reference rate is that one counterparty will lose out, because the new rates will be different. Lenders will benefit if borrowers have to pay more than what would have been owed with a LIBOR-based loan, or borrowers will benefit if they have to pay less with the new reference rate.

This requires a "spread adjustment" in existing contracts to compensate for any losses the counterparty is likely to suffer. Regulators and trade bodies have made progress in devising spread adjustments—for example, the International Swaps and Derivatives Association set them for derivatives contracts in March 2021.[5]

Counterparties must, however, choose which adjustment to use. That may be one for LIBOR and SOFR. If using a different rate, such as Ameribor, it will need a spread adjustment for LIBOR and Ameribor. "Fallback language" that dictates how old dollar LIBOR-based contracts will be treated when LIBOR ends, including the spread adjustment and other issues, will be required.

The vast majority of respondents have made progress in adopting fallback language—only 5% say they have included it in less than a quarter of their old loans. At the same time, the process is largely incomplete for the bulk of firms: only 9% have agreed fallback language for three-quarters or more of their loans.

6. Which, if any, of the following do you currently have in place in preparation for the end of LIBOR? (Select all that apply)



A Updated internal technology systems to support use of alternative rates to LIBOR

B Confirmation that third-party technology and operations vendors can support the use of alternative rates

C Internal transition plan for LIBOR loans with maturity dates after the new LIBOR end dates

D A plan to outsource the transitioning of existing LIBOR based loans

Organizing fallback language is complicated. Some counterparties may prove difficult negotiating partners. Firms with many different business lines, such as investment banks, may have to negotiate with a significant number of parties across markets with differing choices for the most suitable benchmark.

Hardwiring versus amending

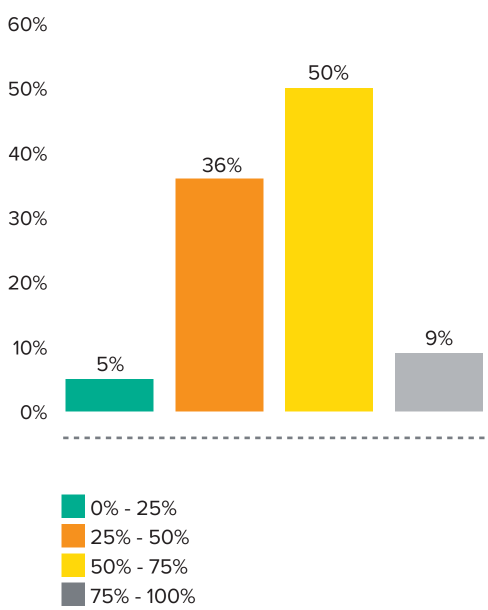
There are two options for fallback language. One is the "hardwired" approach, where the successor rate is explicitly identified in the contract. This offers certainty, but involves choosing a replacement rate before a clear successor to LIBOR has emerged.

The other is the "amendment" approach, where the lender (or the lenders' agent) agrees to set the benchmark at a later point, after negotiation with the borrower. This delays the decision on a replacement rate until both the borrower and lender have further information.

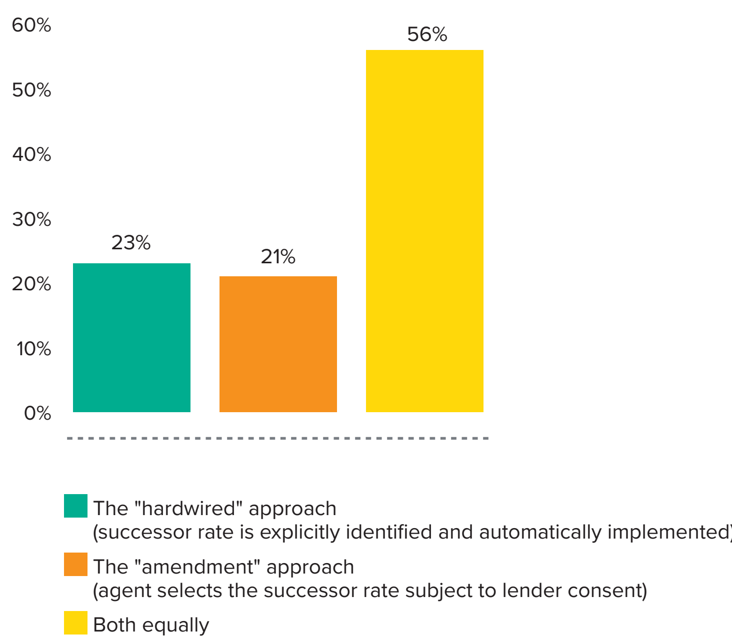
For example, the parties may agree that a particular benchmark is most suitable, but they may want to wait for deeper liquidity in a derivatives market based on that benchmark before committing. Some borrowers and lenders may dislike the uncertainty of the amendment approach, as they may worry that the two parties will be unable to agree on a benchmark in the future.

Our survey finds no clear favorite between the hardwired and amendment approaches—in fact, more than half (56%) of businesses use the two techniques equally.

7. What percentage of your portfolio agreements maturing after June 2023 contain fallback language to account for a change in the reference rate?



8. For your institution or client, what type of fallback language is most commonly used?



SOFR—The preferred alternative?

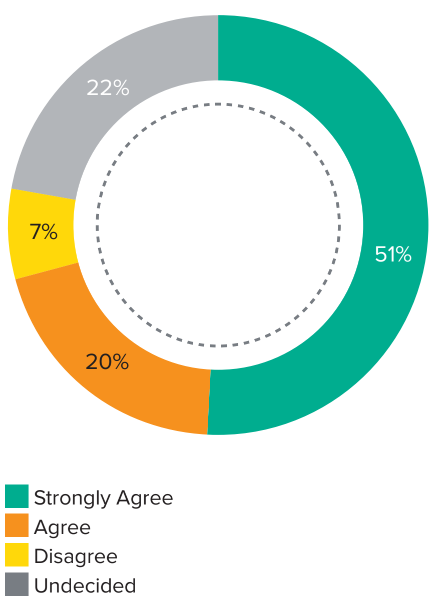
Though a handful of alternative benchmarks appear to be somewhat popular at the moment, SOFR seems likely to emerge as the post-LIBOR winner, as firms conduct their due diligence and scrutinize the rate's virtues and vices.

The ARRC devised SOFR as an alternative to LIBOR and has set out its advantages over rival benchmarks. These include its production by a trusted central bank and its transparency. The ARRC also cites its dependence on "an active and well-defined market with sufficient depth to make it extraordinarily difficult to ever manipulate or influence."[6] Almost three-quarters (71%) of firms in our survey agree that SOFR is the right rate for at least some contracts, including 51% of respondents who strongly agree.

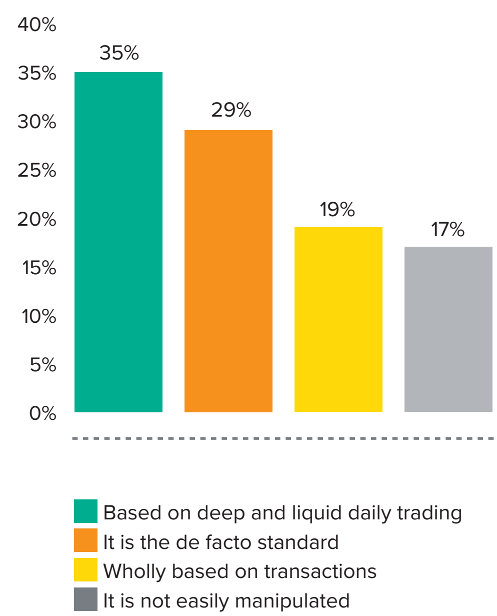
This support for SOFR is underpinned by clear advantages—35% of respondents say it offers deep and liquid daily trading of the underlying market, while 19% like the fact that it is wholly based on transactions. This is in contrast to LIBOR, which was based entirely on estimates made by a small panel of bankers. These factors make SOFR a hard rate to manipulate—a strength deemed the most important by a further 17% of firms.

A further 29% say they prefer SOFR because they believe it is the de facto standard. The New York Fed's involvement in SOFR gives it this status. These firms know that once a benchmark has become the widely agreed standard, liquidity deepens—which is one of the major selling points of a benchmark.

9. The Alternative Reference Rates Committee (ARRC) has identified SOFR as the preferred reference rate for certain USD contracts going forward. To what extent do you agree with the selection of this rate?



10. For your institution or firm, what is the main advantage of SOFR compared to LIBOR? (Select the most important)



SOFR's biggest risks

When asked their opinion on the single biggest risk of moving to SOFR, the largest share of respondents (25%) cite volatility. It is an overnight rate, which means it will always be more volatile than the longer-dated benchmark LIBOR rates. Some argue that when liquidity in longer-term SOFR derivatives contracts starts to emerge, firms can mitigate this problem by hedging against volatility. Liquidity in the SOFR derivatives contracts listed on the CME was slow to emerge but has begun to grow.

Next comes the difficulty in aligning cash products such as loans and the swaps contracts that offset their risk—selected as the most significant risk by 23% of respondents. The crux of the problem is that SOFR does not have credit risk built in, since it is based on secured borrowing against Treasuries.

Moreover, credit risk rises during turbulent times and falls during moments of calm. These are exactly when firms that have taken out derivatives contracts want them to be effective hedges—and these are exactly the times when they run the greatest risk of not being so. A further 9% of firms specifically say that the absence of credit risk in SOFR is the greatest hazard of moving to the benchmark.

The next two issues most likely to be selected by firms as the primary risk are that the method of calculating term rates is unclear, and that the switch of existing contracts from LIBOR may reduce margins.

It's noteworthy that the lack of clarity of term rates is the most widespread fear even though relatively few firms cite it as their number-one concern. Many market participants want the publication of term rates, which could substitute for the commonly used LIBOR rates of one, three and six months. These have, however, been slow to get off the ground for SOFR.

The ARRC has said for some time that the market was not ready for this, citing illiquidity in the derivatives and cash markets. It also postponed initial plans to publish a term rate in June 2021, though in May 2021 it insisted that the necessary conditions for launching a term rate "can realistically be met soon."[7]

Concerns over term rates will likely ease once the calculations involved are confirmed, as pointed out by the managing director at a distressed debt investor: "We are unclear about the method used for calculating term rates. Once these are available in a systematic format, the risks of using SOFR will reduce. We can then be more confident with our choice."

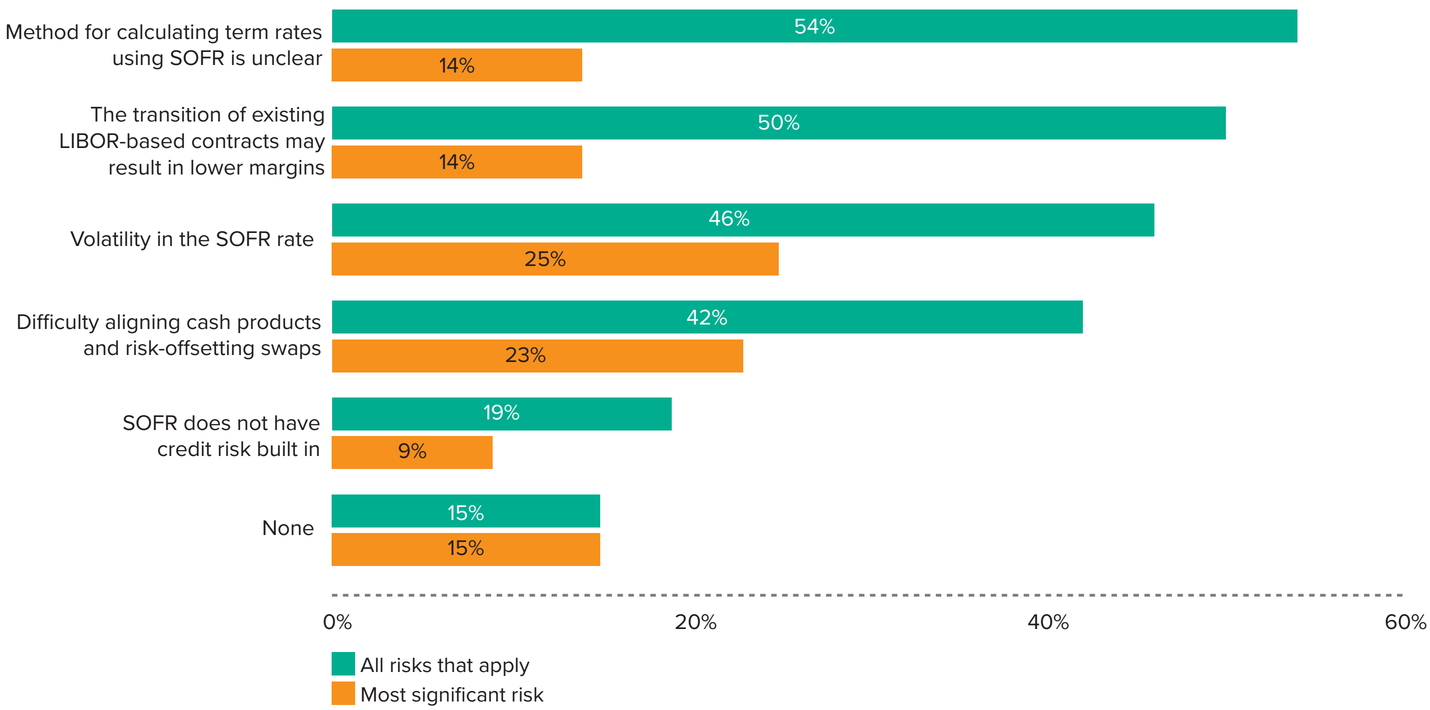
The fear of lower margins due to the transition from LIBOR to SOFR reflects the fact that SOFR will, on most days, be lower than LIBOR. This highlights the already discussed absence of a credit risk premium for SOFR. That, for example, lowers the interest payable on loans.

However, differences between the LIBOR and SOFR rates will be bridged by spread adjustments. Fear over this issue should gradually dissipate, given recent progress in working out spread adjustments.

51%

Share of respondents who strongly agree with the ARRC's appraisal of SOFR as the preferred reference rate for future dollar contracts

11. If your institution is moving to SOFR, what, if any, are the main risks?



A breakdown by respondent group shows that investment banks are particularly worried about volatility—36% say it is their top concern. It is also the leading source of anxiety for hedge funds (equal with "difficulty of aligning cash products and risk-offsetting swaps"), with direct lenders not far behind.

25%

Share of respondents who identify volatility as SOFR's single most significant risk

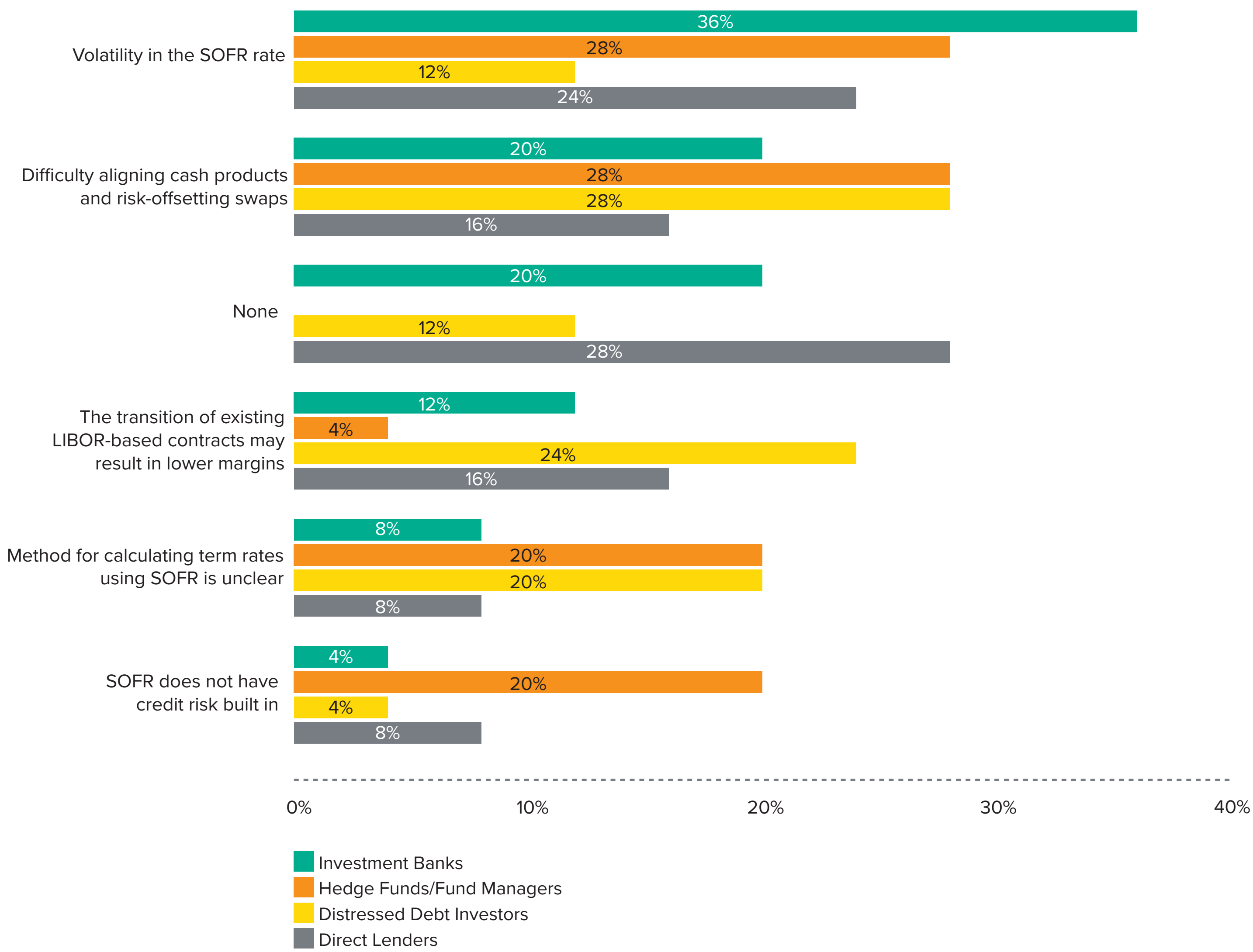
"Volatility in SOFR can lead to financial losses if the firm is not careful," says the managing director at a hedge fund. "There are concerns that the long-term risks of SOFR might outweigh the immediate positives." Only distressed debt lenders seem largely unconcerned about it.

A revealing bellwether is the proportion of different types of firms that do not select any issue as their top concern. More than a quarter of direct lenders do not list one—more than any other group. Looking at particular issues that trouble them less than other firms, they are more relaxed about the mismatch between cash products and swaps. Direct lenders are also relatively untroubled about problems with term rates. At the other extreme, no hedge fund or fund manager failed to think of a top risk.

There are concerns that the long-term risks of SOFR might outweigh the immediate positives.

Hedge Fund Managing Director

12. If your institution is moving to SOFR, which is the most significant risk of a move to SOFR? (Select most important)



Term rates

Although some market players are frustrated at the absence of a term rate, only a minority feel they need it. When asked what they would prefer loan documents to reference in the future, only 38% want SOFR compounded in advance (in other words, a term rate), rather than in arrears. The partner and managing director of a distressed debt investor is in this camp, saying: “The use of ‘advance’ SOFR would be of greater advantage, leaving out any ambiguity.”

More than six-in-ten businesses say the development and publication of spread adjustments would “to a great extent” make them more likely to adopt SOFR. Progress made in devising spread adjustments should therefore help instill confidence in SOFR.

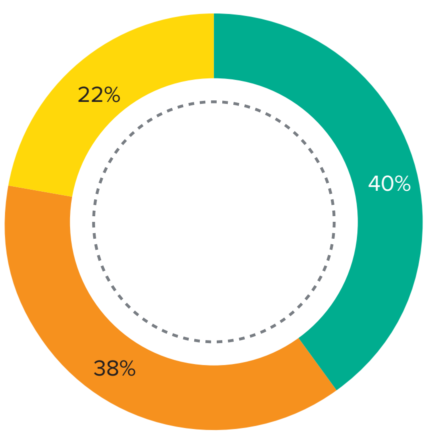
SOFR has another reason to emerge as the primary benchmark: the LIBOR transition legislation passed in New York state. The new law stipulates that contracts that lack fallback language or that fall back to LIBOR shall instead fall back to “the recommended benchmark replacement,” which is “a recommended benchmark based on SOFR.”

The vast majority of firms are familiar with the legislation and deem it a positive development that will help ensure a smooth transition. Almost seven-in-ten support the idea of nationwide legislation along these lines, including 44% who would strongly support it.

69%

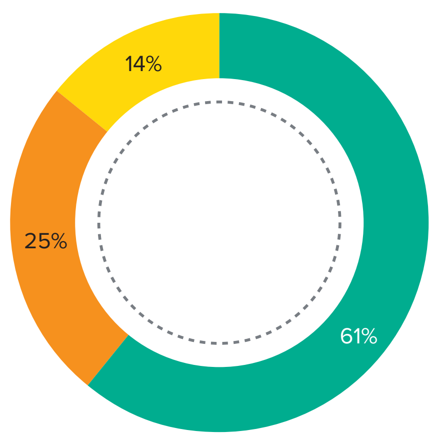
Share of respondents who would support nationwide legislation akin to the LIBOR transition legislation passed in New York State

13. While there is currently no SOFR term rate, which of the following would you prefer loan documents to reference in the future?



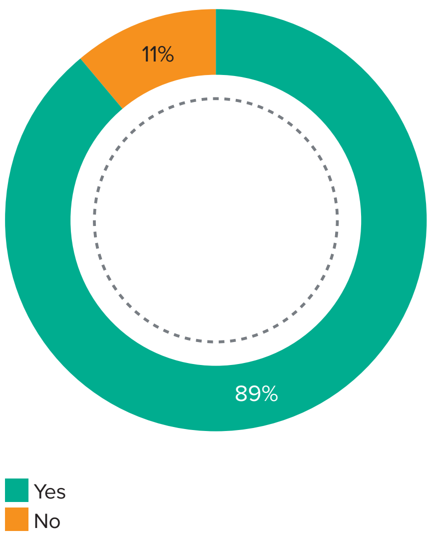
SOFR compounded in arrears
SOFR compounded in advance
Simple daily SOFR in arrears

14. Does the development and publication of credit adjustments make you more likely to adopt SOFR?

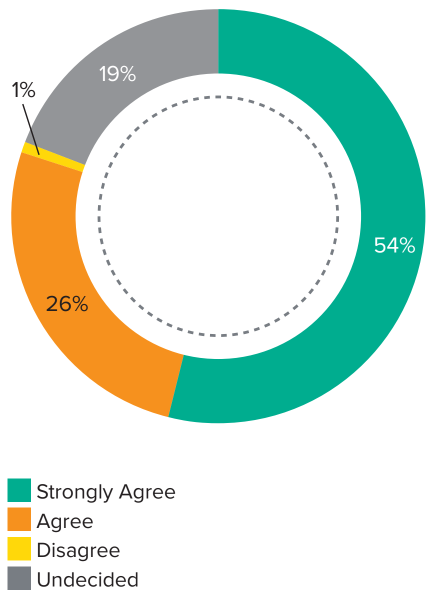


To a great extent
Somewhat
Very little

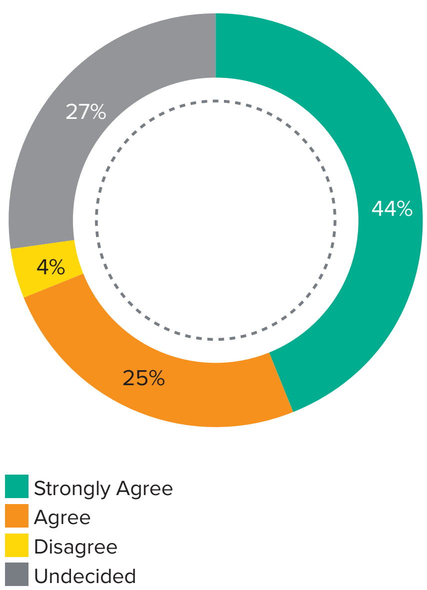
15. A) Are you familiar with the LIBOR transition legislation?



15. B) To what extent do you agree or disagree with this statement: “The LIBOR transition legislation passed in New York State is a positive development in ensuring a smooth transition.”



15. C) Do you support the passing of similar legislation on a nationwide basis



Conclusion and Recommendations

This study confirms that considerable progress has already been made in the US financial industry over the past two years in preparing for the end of LIBOR, but there is still much to be done. After analyzing the results, we recommend that institutions consider taking the following actions, if they have not already done so:

Set a date for a full transition. More than half of institutions have no clear date for this. Specifying a deadline, and then working backwards from it, makes it easier for firms to set a series of other intermediate deadlines as staging posts.

Keep up with market developments—but don't wait for them. Many firms would prefer to see how cash and derivatives markets develop before favoring one replacement for LIBOR over another. But there is a danger in waiting—particularly because complete information will not be available until the old system has ended.

Check if your network of contractors and clients is prepared. For example, two-thirds of financial markets firms have confirmed that their third-party technology and operations vendors can support the use of alternative rates—but that leaves one-third that have not yet done so.

Set fallback language for contracts, even if it is not clear what the dominant benchmark rate will be. Failure to devise fallback language could trigger long and expensive legal disputes with counterparties—particularly if there is no nationwide legislation to deal with the absence of fallback language.

Research all possible alternatives. Institutions are considering many different rates, even if regulation and legislation has given SOFR an advantage. Different rates offer different advantages for different users, and it is important to understand all of the various forces at play.

Endnotes

[1] https://www.federalreserve.gov/newsevents/speech/quarles20210322a.htm

[2] Remarks at SOFR Symposium: The Final Year (Part II), May 11 2021

[3] https://www.natlawreview.com/article/libor-meets-sofr

[4] https://www.ft.com/content/e5f1ebbb-2e7b-46cc-88ce-b0a1c48ea1ee

[5] https://www.isda.org/2021/03/05/libor-cessation-and-the-impact-on-fallbacks/

[6] Alternative Reference Rates Committee, "An Updated User's Guide to SOFR," February 2021

[7] Alternative Reference Rates Committee, "ARRC Identifies Market Indicators to Support a Recommendation of a Forward-Looking SOFR Term Rate," May 6 2021

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