FUND FINANCE FRIDAY

SOFR: More Answers Make for More Questions

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The market has received a lot of answers about benchmark replacement this year. We know for sure that LIBOR is going away. We also know that no new USD LIBOR loans should be originated after December 31st of this year. More recently, we now have more confidence in our LIBOR replacement as the Alternative Reference Rates Committee ("ARRC") formally recommended forward-looking Secured Overnight Financing Rate (SOFR) term rates for syndicated and bilateral business loans and a number of other products.

Following this recommendation from the ARRC, the loan market has been off to the races to prepare for a SOFR-first world ... but not *that* fast: most players in the market are still originating LIBOR-based loans with a hardwired fallback.

In any case, shortly after the ARRC's recommendation at the end of July, the Loan Syndications and Trading Association ("LSTA") issued a SOFR Concept Credit Agreement. This form document is a term loan facility with Term SOFR as its benchmark rate of interest. This document is a wealth of information and guidance and even provides options for market participants to consider when crafting their own agreement.

One might think, "We have a benchmark and we have a form, so we must be ready to go all SOFR all the time," but we are not quite there yet. First, the LSTA has been clear that this is a concept document and does not represent or set market practice. Instead, it is a tool for market participants to use in their transition planning. Moreover, efforts to draft a Term SOFR-based credit agreement have brought into sharp focus the differences between LIBOR and SOFR and have brought to the fore the question of how to originate new SOFR loans that are economically comparable to LIBOR-based loans. While SOFR is going to replace LIBOR, it is not completely comparable – SOFR is a risk-free rate while LIBOR includes a measure of bank credit risk. This being the case, SOFR tends to be lower than LIBOR as a general matter. In periods of market disruption, the difference is generally more pronounced.

The fact that the rates are not comparable isn't news. The ARRC has recommended that credit agreements that fall back from LIBOR to SOFR include a spread adjustment to account for the

fact that SOFR is generally lower than LIBOR. The ARRC-recommended spread adjustment was set on March 5, 2021, and it is the five-year historical median difference between LIBOR and SOFR. You can review all those changes **here**.

The LSTA has explained that, ironically, the suggested spread adjustment – which is intended to be helpful and maintain the economics for parties switching from LIBOR to SOFR – might actually be causing some consternation. This has to do with the fact that we are in a historically low interest rate environment, and with interest rates hovering around zero, it makes the actual spot spread difference between LIBOR and SOFR significantly lower than the historical medians. For example, this month, the LIBOR-SOFR spread differential is around 9 basis points for 3-month LIBOR as compared with 3-month SOFR. The ARRC-recommended spread adjustment for 3-month SOFR loans is 26 basis points. Simply put, no borrower is going to be happy paying more than the actual market spread for its SOFR loans just because the recommended spread-adjustment is thought to be a historically accurate and fair rate.

According to the LSTA, there are several ways to bridge this gap and avoid a "cliff-effect," which is where the rate that a borrower pays changes dramatically at benchmark transition. You can read all about it here in this thoughtful analysis by the **LSTA**. Essentially, the first is a bit of a "do-nothing" approach and the expectation that general market forces will handle the issue because we are unlikely to stay in a zero interest rate environment indefinitely. As interest rates rise, the difference between LIBOR and SOFR is expected to widen, which would increase the spot spread adjustment. Another theory on the point where we could reach equilibrium is when LIBOR ceases to be available at the end of June 2023. At that point, billions of dollars' worth of LIBOR-based loans (and trillions of dollars of assets, if you consider other financial products) with hardwired fallback language become SOFR-based deals and the spread adjustment baked into the fallback language will go along with it. It will mean that anything that doesn't contemplate the relevant spread adjustment for a particular tenor will be "off market." Another option would be to include step-up adjustments in a loan agreement that apply every time the rate resets – for example, at every quarterly reset. A set of spread step-ups would be an easy-to-incorporate provision and prevent the cliff-effect. There is a good deal of precedent in the market for this.

Bottom line: lots is coming together in the transition to SOFR, and the spread adjustment is the latest piece of the puzzle that market experts are working to put into place. Understanding that there is an economic difference between SOFR and LIBOR will set up market participants to address this issue head-on in their loan docs, with the understanding that further guidance is in the works.