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FUND FINANCE FRIDAY

SOFR Breakage Costs: Breaking Up Is (Still) Hard to Do

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Our topic today is breakage costs (also called “break funding” costs) in your new SOFR credit agreements. Someone in the market recently asked:

> “I have a friend (OK, it’s me) who’s negotiating a credit agreement. We received comments regarding the old LIBOR break funding provisions. How do I explain what’s relevant in our new SOFR-only world?”

The short answer to your friend is that both Term SOFR and Daily Simple SOFR may have breakage costs (although the breakage costs for an overnight rate like Daily Simple SOFR would likely be less than the breakage costs for Term SOFR, which is a tenored rate). The reasons for breakage cost protection remain unchanged from the days of LIBOR. The bank must still conduct asset-liability management (ALM) across all its facilities and operations − whether such assets and liabilities are denominated in LIBOR or SOFR is irrelevant from the bank’s ALM perspective.

First, what is a breakage cost? A breakage cost occurs if the borrower prepays (1) for Daily Simple SOFR, on a day other than a payment date or (2) for Term SOFR, on a day that is earlier than the last day of the interest period. A breakage cost can also occur if a borrower refuses to accept a loan that it had previously requested or does not prepay a loan on a date for which it previously gave notice of prepayment. The breakage occurs when the bank’s expectations as to its assets and liabilities change because of these actions (or inactions) by the borrower.

It is fundamental to the existence of any bank to manage its assets and liabilities, and ALM is a career and discipline in itself. It is therefore not a business preference but a requirement of bank policy that breakage costs be covered by an indemnification in the credit agreement (most commonly a section labeled “Funding Losses”). These ALM policies go to the core of bank risk management and, indeed, such policies are represented to bank regulators as part of a bank’s prudential standards. Banks get regulatory examinations on such policies; forms and agreements get scrutinized.

Not all banks take the same view, and bank policies on risk management differ in scope and intensity. Some banks, for instance, are comfortable forgoing Daily Simple SOFR from the section indemnifying against breakage costs, whereas other banks must have this coverage to remain within the scope of risk policies. All banks would at least want Term SOFR covered. The key takeaway is that the scope of coverage is not a business call but a policy requirement, which may vary from bank to bank.

Second, we can also say what breakage costs are not, and here we come to some historical confusion on this topic. We were all brought up with LIBOR, and many times breakage costs were explained with a simple example of the bank having to "re-deploy capital" from a LIBOR-bearing account in order to match liabilities with assets in the event of a breakage. People also tried to sound cool on calls with phrases like "putting funds to work." This starts to sound like lost profits or lost opportunities, which is a fundamentally different concept than ALM. The breakage issue isn't what the bank would have otherwise earned in absence of the prepayment, but whether the bank's expectations concerning its assets and liabilities have changed. It would also, therefore, be a mistake to call breakage cost protection a "prepayment penalty."

There is also a more fundamental misconception, which is that the reason for breakage cost protection comes from the bank's need to literally match assets and liabilities. While some lenders (*e.g.*, insurance company general accounts) are truly match-funded (dollars in, dollars out), most banks are not. For banks, assets exceed liabilities, which creates shareholder equity. They're also not match-funded in duration: banks run a carry trade that funds longer-term (therefore higher-yielding) assets with shorter-term, lower-cost liabilities. It would therefore be a mistake to discuss breakage cost protection for banks solely in the context of matching assets and liabilities. The correct conceptual approach is to analyze breakage costs as part of the bank's broader ALM.

Third, why do we care? ALM is central to how a bank creates shareholder equity value. In the main, ALM encompasses how the bank is (1) managing liquidity to meet its near-term obligations, (2) managing interest rate risk, using a host of tools (including using derivatives to fine tune the duration of assets and liabilities) and (3) responding to changing market conditions. ALM must respond to these dynamic market conditions, including funding sources and pricing constantly changing, the mix of available assets changing and the costs of hedging constantly increasing or decreasing. Management and shareholder priorities also change as the market context changes. Preferences for deposit sensitivity and interest-rate sensitivity will change based on where the market is perceived to be going. All of these ALM functions are done within a prescribed regulatory framework. If a borrower voluntarily prepays a loan because its interest rate benchmark preference has changed, it's fair that the bank be compensated for the unanticipated change and to discourage opportunistic breakages that impede the bank's ability to manage assets and liabilities effectively.

So where does that leave us with SOFR? Some in the market might ask whether the bank couldn't just enter the overnight SOFR market to manage its liabilities. Seems like this could be true for Daily Simple SOFR, but if a bank got paid on a date other than an expected payment date, it may or may not be able to fund in the overnight market at the same cost. It could work out, or it could not, but the bank's risk should be covered by the credit agreement. The case is even clearer for Term SOFR, a synthetic term rate based on the futures market for the

overnight rate for certain tenors. It’s a near certainty that the overnight rate on any given day would differ from the one-, three- and six-month tenors for Term SOFR we have been recently providing in our credit agreements.

In conclusion, banks carefully manage their balance sheets, which is a well-developed discipline and career field in itself. While many of us learned LIBOR breakage costs with some confusing examples that sounded economic in nature or were based on an incorrect assumption of literal match funding, the key issue isn’t lost profits or opportunities but the change in the bank’s expectations with respect to the flow between assets and liabilities. With SOFR, as with LIBOR, breakage costs go to the fundamental risk management policies of the bank and its ability to create positive equity value. Finally, when it comes to credit agreement drafting, while conceptually SOFR should be covered for the same reasons LIBOR was covered, some banks will differ in scope (that is, whether to include Daily Simple SOFR), which is a bank policy issue and not a business preference. So cheers! Enjoy your new SOFR credit agreements, but breaking up is still hard to do.