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All you should know about the LIBOR to SOFR transition

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Agenda

- What is the LIBOR transition?
- What is SOFR?
- How are you impacted?
- What is the timeline?

What is the LIBOR transition?

- Interest rate benchmarks are used in millions of contracts…
  - InterBank Offered Rates (IBORs) like LIBOR (in USD, GBP, CHF, JPY) were derived from quotes, sourced from panel banks, providing an indication of the average interest rate at which they can borrow in the interbank market (on an unsecured basis), from overnight to 12 months, in a given currency
  - IBORs have been widely used in floating-rate loans, bonds and in derivatives contracts
- Yet, IBORs' reliability and robustness have been questioned…
  - Significantly lower volumes of interbank unsecured term borrowing / Decrease in number of panel banks contributing to the quotes of the IBORs / Increasing reliance on expert judgment to set the IBORs → This has questioned the relevance and representativeness of quote-based IBORs
  - Several scandals related to the manipulation of interest rate benchmarks

What is the LIBOR transition?

- … calling for a reform, pushed by regulators worldwide
  - G20 gave a mandate to the Financial Stability Board (FSB) to reform IBORs
  - Working groups have been set up in different countries, involving market participants and industry associations (e.g., LMA, ISDA, ICMA)
- In practice, alternative benchmarks have been developed in different currencies and are gradually replacing LIBOR…
  - Those new benchmarks aim to be nearly risk-free ("risk-free rates" or RFRs) and to provide robust alternatives for IBORs
  - Those have been defined in most currencies (SOFR in USD, €STR in EUR, …)

What is SOFR?

- Secured Overnight Financing Rate (SOFR)
- New overnight risk-free rate in USD, based on actual deals
  - Secured: SOFR is computed based on repo transactions collateralized by US Treasuries → this contrasts with LIBOR, which is an *unsecured* interbank rate → SOFR is less risky
  - Overnight: In contrast to LIBOR, SOFR has an overnight maturity, meaning that a term adjustment is needed for longer time horizons (e.g. 3 months) to replace USD LIBOR (3M) – see next slides
  - Actual deals: SOFR is not “quote-based” (like LIBOR) but “transaction-based”, meaning that the published rates really reflect actual transactions. SOFR is calculated as a volume-weighted median of transaction-level tri-party repo data collected from relevant sources

How are you impacted?

1 Interest rate conventions are changing…

– Two (new) types of approaches are emerging, which may very well co-exist
  - Approach 1: Backward-looking methodologies* (see next slide)
  - Approach 2: Forward-looking methodologies* (see next slide)

2 … and **the way new loans are priced (or existing loans are repriced) should evolve accordingly**

– As RFRs are "risk-free", while "IBORs" reflect the risk of banks, when one moves to RFRs, an additional "spread adjustment" should be agreed to compensate for this.

– In other words, USD LIBOR = SOFR (adjusted for the time horizon) + spread adjustment

3 **Robust fall-back provisions** are required

– Previous fall-back language not robust

How are you impacted?

- In a “**backward-looking**” methodology, the interest rate due over a certain term (e.g., 3 months) is derived from the average of realised daily observations of the SOFR rate over that term.
- This average could either be a simple mean or a daily compounded interest rate over the period.
- The interest rate due is only known at the end of the term (“backward-looking” at realised rates)

- In a “**forward-looking**” methodology, a “term rate” (e.g., for 3 months) is derived from the average of expected daily observations of the SOFR rate over that term → “**term SOFR**”
  - https://www.cmegroup.com/market-data/cme-group-benchmark-administration/term-sofr.html
- This allows the rate to be fixed at the beginning of a given interest period, unlike rates set using the backward-looking methodology, but like LIBORs currently.
- How can such term rates be derived?
  - From SOFR derivatives

How are you impacted?

DATE	CME TERM SOFR (%)				SOFR*		SOFR AVERAGES*		
	1 MONTH	3 MONTH	6 MONTH	12 MONTH	OVERNIGHT	INDEX	30-DAY AVG (%)	90-DAY AVG (%)	180-DAY AVG (%)
17 Jun 2022	1.50684	1.93428	2.51372	3.16594	-	1.04388177	0.79224	0.52756	0.29126
16 Jun 2022	1.50914	1.9436	2.52905	3.20864	1.45	1.04383972	0.77056	0.51477	0.28347
15 Jun 2022	1.47739	1.88594	2.45756	3.18484	0.7	1.04381943	0.7739	0.51032	0.27986
14 Jun 2022	1.33382	1.67598	2.19657	2.94698	0.69	1.04379942	0.77723	0.5032	0.2763
13 Jun 2022	1.27865	1.59718	2.05421	2.70909	0.73	1.04377825	0.77924	0.49563	0.27251

What is the timeline?

- Since January 2022, no more NEW loan contracts referencing USD LIBOR → new signatures to refer to SOFR
- At the end of June 2023, USD LIBOR will be discontinued
- Until then, discussions to amend EXISTING contracts to replace references to USD LIBOR in the contract will take place

Thank you

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