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SOFR, the New LIBOR? A Critique of SOFR and the USD LIBOR Replacement Process

Ronald Scheinberg*

The secured overnight financing rate—commonly known as SOFR—has been designated by the U.S. Federal Reserve as the benchmark rate to replace U.S. dollar LIBOR. This article explores issues concerning the SOFR and the processes for incorporating it in legal documentation, and offers some observations on, if not suggestions to address, these issues.

The London interbank offered rate—commonly known as LIBOR, the iconic interest rate benchmark ubiquitously used in bank and other lending transactions—will no longer be an available interest rate at the beginning of calendar year 2022. The resulting *sturm und drang* in anticipation of the loss of this benchmark rate has generated proposals to deal with replacements for it and processes for their adoption and adaptation. The secured overnight financing rate—commonly known as SOFR—has been designated by the U.S. Federal Reserve (the "Fed") as the benchmark rate to replace U.S. dollar LIBOR.[1] The SOFR rate is based on the U.S. Treasury repurchase ("repo") market, being the rate charged for financing Treasury securities on an overnight basis.

The choice of SOFR by the Fed was driven by a number of factors, but none of these factors considered the need to find a good proxy for bank funding costs (which LIBOR has, by default, become). Further, in order for the SOFR rate to be a viable pricing option, there needs to be established definitive methodologies and conventions for utilizing SOFR in lending transactions, but these methodologies and conventions remain very much in flux. As well, the process for incorporating into legal lending documentation an interest rate serving as the LIBOR benchmark replacement is rather complicated given the uncertainties surrounding SOFR.

This article explores these and other related issues concerning SOFR and the processes for incorporating it in legal documentation, and offers some observations on, if not suggestions to address, these issues.

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[1] Press Release by ARRC/Alternative Reference Rates Committee, "The ARRC Selects a Broad Repo Rate as its Preferred Alternative Reference Rate," June 22, 2017.

BACKGROUND

LIBOR is reportedly used in $350 *trillion* of financial contracts worldwide. LIBOR rates are short-term fixed rates quoted for interest periods of, typically, one, two, three, and six months; overnight and 12-month interest periods are also available. Insofar as these rates are set for discrete periods of time, they are good for the duration of those periods and are reset at the end of those periods to the then available rates reflecting market conditions. These rates, quoted as annualized interest rates, provide an indication of the average rate at which a LIBOR contributor bank can obtain unsecured financing in the London interbank market for a given period. Individual LIBOR rates are the end-product of a calculation based upon submissions from LIBOR contributor banks. LIBOR rates are made available by their being posted as publicly-available "Screen Rates" by Reuters and others. The determination of LIBOR is managed by the Intercontinental Exchange ("ICE"), which is the parent company of the New York Stock Exchange and a number of other exchanges and markets around the world.

ICE Benchmark Administration, an affiliate of ICE, is the body that oversees the rate setting processes. This organization maintains a reference panel of between 17 contributor banks for U.S. dollar LIBOR. Each contributor bank is asked to base its ICE LIBOR submissions on the following question: "At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers in a reasonable market size just prior to 11 am London time?" Therefore, submissions are based upon the lowest perceived rate at which a bank could obtain funding of U.S. dollars in the London interbank money market, for a given maturity assuming a reasonable market size. U.S. dollar LIBOR rates for each maturity are calculated using a trimmed arithmetic mean. Once each submission is received, they are ranked in descending order and then the highest and lowest 25 percent of submissions are excluded. This trimming of the top and bottom quartiles allows for the exclusion of outliers from the final calculation. The remaining contributions are then arithmetically averaged, and the result is rounded to five decimal places to create a LIBOR rate.

LIBOR pricing carries with it particular payment conventions:

- Interest is calculated on the basis of a year of 360 days and actual number of days elapsed;
- The rate is set at 11:00 a.m. (London time) two London business days prior to the first day of the interest period;
- Payments are made using, and interest period end dates are adjusted

based on, the "modified following business day" convention;[2]

- Payments are made in arrears on the last day of the interest period;
- Interest periods are calculated by reference to calendar months (not number of days);
- Business days include London, England; and
- Interest accruals for the then applicable interest period are adjusted for changes in period end dates.

ICE took over administration of LIBOR from the British Bankers Association ("BBA") in early 2014, following rate-fixing scandals involving LIBOR interest rates under the auspices of the BBA. In addition, among the consequences of the collapse of the financial markets in 2008 in the wake of the *Lehman* debacle was a near drying up of the short-term London interbank lending market (resulting from, among other reasons, the unwillingness of banks to make loans to one another due to concerns about counterparty credit). The resulting lack of trades at LIBOR required rate quotes to be based on estimated—rather than actual—values. Not only might this situation lead to market manipulation (which did happen, and a number of bankers/traders are spending time in the Big House as a result), but it calls into question the integrity of the benchmark and may create systemic risks for financial markets, especially if liquidity in LIBOR falls further. As a consequence of these market risks, regulators in the United States and other countries have come around to a view that LIBOR needs to be replaced. Taking the lead on finding a replacement for U.S. dollar LIBOR is the U.S. Federal Reserve.

The Fed established an Alternative Reference Rates Committee ("ARRC") for the purpose of developing a new benchmark. On June 22, 2017, the ARRC voted to adopt as an alternative to the use of LIBOR an interest rate benchmark based on the U.S. Treasuries-backed repo market. This rate, being the SOFR rate mentioned above, was selected over the Overnight Bank Funding Rate ("OBFR"), an unsecured bank lending rate based on transactions in the federal funds and Eurodollar markets. The ARRC said that the SOFR rate was considered the most appropriate rate after considering the depth and robustness of the market as well as other factors including regulatory principles. "I am confident the new reference rate chosen today [SOFR] by the Alternative Reference Rates Committee is based on a deep and actively traded market and will be highly robust," U.S. Federal Reserve Board Governor Jerome Powell said

[2] This convention provides that if a payment falls due on a non-business day, payment is to be made on the next succeeding business day unless the payment would fall in the next following month, in which case payment is made on the preceding business day.

in a statement. "With this choice, the ARRC has taken another step in addressing the risks involved with LIBOR," Powell said.[3]

SOFR is calculated as a volume-weighted median of transaction-level data on the cost of borrowing cash overnight collateralized by Treasury securities. The SOFR rate for any business day is published by the U.S. Federal Reserve on the following business day at approximately 8:00 a.m. (New York time). The Fed has the ability to correct and republish that rate until 2:30 p.m. (New York time) so that the SOFR rate for any day is not definitively known until about 3:00 p.m. (New York time) on the next business day.

Against this backdrop of a LIBOR sunset in 2022 and a likely move to SOFR as a replacement for LIBOR, the ARRC[4] has considered the need to develop contract language for inclusion in loan documentation utilizing LIBOR that is being newly entered into and that will persist past the end of 2021 (or that can be used to amend LIBOR benchmark-based transactions with maturities beyond 2021). ARRC has drafted two alternative sets of language for this purpose—language that they call (1) "Hardwired Approach" Fallback Language and (2) "Amendment Approach" Fallback Language. The Hardwired Approach Fallback Language hardwires SOFR as the fallback interest rate benchmark. This language runs for some five (single space) pages of rather turgid legalese that is necessitated by the large number of unknowns on how the SOFR rate might be calculated. The Amendment Approach Fallback Language is a simpler approach insofar as it does not identify any particular fallback benchmark but rather allows the transaction's administrative agent and borrower to select any alternate benchmark that is either selected or recommended by the Fed or is an evolving or then prevailing market convention.

THE SOFR RATE—COST OF FUNDS PROXY

The LIBOR rate is, and the SOFR rate in its stead must be, a proxy for the cost of funds for a bank. An underpinning theory of bank lending is that banks obtain funds at or based on a benchmark rate, which is a proxy for its cost of funds, and lend those funds to its borrowers at that benchmark rate (to cover its cost of funds) plus a margin to compensate the bank for taking the borrowers' credit risk and provide its profit.

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[3] *See* Reuters "Bank Committee Selects Repo as LIBOR Alternative for Swaps," June 22, 2017.

[4] In addition to ARRC, the London-based Loan Market Association ("LMA") (acting together with The Working Group on Sterling Risk-Free Reference Rates) has developed procedures to adopt a sterling-based LIBOR replacement (SONIA).

The first observation to note in this regard is that the Fed, in selecting a rate to serve as the benchmark, focused almost exclusively on the robustness of the rate to be selected. In selecting the SOFR rate, the Fed identified the following factors that made the SOFR rate their optimal selection:

1) It is a rate provided by the Federal Reserve Bank for the public good;
2) It is derived from an active and well-defined market with sufficient depth to make it extraordinarily difficult to ever manipulate or influence;
3) It is produced in a transparent, direct manner and is based on observable transactions, rather than being dependent on estimates, like LIBOR, or derived through models; and
4) It is derived from a market that was able to weather the global financial crisis and that the ARRC credibly believes will remain active enough in order that it can reliably be produced in a wide range of market conditions.[5]

Importantly, none of these criterion considered whether the SOFR rate is a good proxy for bank cost of funds. Failure to consider bank cost of funds for this purpose seems to be a glaring omission given the role that a benchmark serves.

The second observation to note in this regard is that the SOFR rate, in contrast to the LIBOR rate, is a secured rate. The security in this instance being U.S. government Treasuries, thereby offering no credit risk to the repo lender (for our purposes deeming U.S. government risk as "risk free"). Thus the existing LIBOR benchmark rate, being an unsecured rate that includes the price of bank credit risk, will be higher than the SOFR rate. Also, SOFR is a daily rate in contrast to LIBOR rates which are for discrete monthly or multi-month interest periods (which, given a normal yield curve, would price longer term rates higher than shorter term rates).[6] In order, then, to make the SOFR rate the equivalent of a short term unsecured rate, the SOFR rate needs to be adjusted upward.[7] The need for an adjustment is recognized by the ARRC, as their model language includes a "Benchmark Replacement Adjustment" which is a spread adjustment (or a method for calculating or determining such spread adjustment) to the benchmark rate. Interestingly, the ARRC language and

[5] The Alternative Reference Rates Committee, "A User's Guide to SOFR," April 2019, p. 2.

[6] It is also worth noting that LIBOR is a forward-looking rate, while SOFR is backwards looking.

[7] Assuming, for the purposes of adjusting for the longer term, a standard yield curve.

commentary do not specify what the adjustment is designed to achieve (such as making SOFR the credit-equivalent of bank cost of funds)[8] but rather the ARRC hardwired language simply punts to a Fed-advised adjustment with a fallback to an ISDA[9]-generated adjustment.

In order for the SOFR rate to act as a proxy for bank funding costs, then, even on an adjusted basis, there must be some correlation between SOFR and such funding costs. There is some correlation, but that correlation is not uniform and is very choppy. Thus, simply adding X basis points to the SOFR rate (as the appropriate adjustment factor) will not yield a proxy for cost of funds given the imprecise correlation—some other adjustment(s) will need to be made. Further exacerbating the lack of a tight correlation is the fact that the SOFR rate is based on the U.S. Treasury rate, which itself is subject to the particular vagaries of the U.S. Treasury market and the Federal Open Market Committee. During times of economic and political stress, there is often a "flight to quality," which drives U.S. Treasury yields downward. Such reduction in yield at such times would likewise reduce the SOFR rate, but not necessarily drive down bank funding costs. Without some adjustment to deal with this failed correlation, banks would likely pull back from lending—this at a time when bank lending may be most desired. Perhaps adding a floor interest rate benchmark to the SOFR rate, such as an adjusted Federal Funds rate or the Adjusted Base Rate referred to below, would be in order to mitigate this risk as well as the choppiness of the SOFR rate.

THE SOFR RATE—INTERNATIONAL RATE

One of the great successes of the LIBOR rate is that it is a benchmark rate utilized internationally for U.S. dollar-denominated transactions. Facilitating this international utilization is that banks without a U.S. dollar deposit base can source dollars in the interbank lending market, largely based in London.

The fact that the transaction pricing utilizes LIBOR as a benchmark, then, provides perfect match funding pricing for these banks; their funding costs are at LIBOR, and their loan pricing is benchmarked to LIBOR. Moving away from LIBOR as the benchmark, then, has the potential to disconnect the banks' borrowing/cost-of-funds basis from the pricing at which they lend funds to their customers. Unless these banks' treasury departments can be convinced that

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[8] Other than an oblique reference "to encompass all credit, term and other adjustments that may be appropriate for a given tenor of the benchmark rate."

[9] International Swaps and Derivatives Association.

SOFR-based pricing is equivalent to their cost of funds, these banks may not be comfortable using the SOFR benchmark (unless they can raise U.S. dollars on a Treasury-repo basis).

LIBOR REPLACEMENT—CURRENT TECHNOLOGY

The perceived need to find a replacement for LIBOR, and the concomitant requirement to document a procedure for adopting and adapting the new rate, seems to ignore the robust legal technology already in a great many credit agreements and related Loan Syndication and Trading Association ("LSTA") and LMA forms of loan documentation. Endemic in a broad range of loan agreements are provisions relating to market disruption. Market disruption provisions provide that if either (x) *the LIBOR Screen rate is no longer available* or (y) the LIBOR Screen rate does not adequately cover banks' cost of funds, then the LIBOR benchmark rate shall no longer be applicable. In lieu of LIBOR, the replacement rate is (for U.S. transactions, generally) the "Adjusted Base Rate" or (for non-U.S. transactions, generally), the banks' cost of funds (with a 30-to-90-day period to agree on a different benchmark). "Adjusted Base Rate" is typically defined as the higher of (A) the U.S. Prime lending rate and (B) the Federal Funds rate plus 50 basis points (with a downward adjustment applicable to both (A) and (B) to the lending margin of 100 basis points). Insofar as the clause (x) above provides a trigger for a LIBOR cessation event, the protocols currently in place already address the cessation issue and provide a fallback. It is puzzling that the ARRC and LMA draftsmen have all but ignored this existing fallback methodology.

A key feature in the ARRC—and LMA—suggested language for incorporating a LIBOR fallback pertains to bank voting dynamics. Whereas any changes to transaction economics, including any changes to interest rates/margins, etc., normally require unanimous lender approval, the suggested language for incorporating the replacement benchmark rate only requires approval of a majority of lenders. Indeed, the drafters of the LMA provisions have stated that "[t]he *main purpose* of the clause is to provide the Parties with greater flexibility to make amendments with a lower consent level than would otherwise be required" (emphasis supplied).[10] Whether this will be acceptable in the general bank market remains to be seen, since this could result in an abdication of control by a bank of its loan pricing—a core matter in any lending transaction.

[10] "Syndicated loan replacement of screen rate clause," The Working Group on Sterling Risk-Free Reference Rates copying The Recommended Revised Form of Replacement Screen Rate Clause and Users Guide of the Loan Market Association, October 16, 2018, Section 2.2.

THE SOFR RATE—NOT YET READY FOR PRIME TIME

The ARRC's attempt to provide a hard-wired documentation approach to allow a shift to a SOFR rate at such point as LIBOR ceases to be available (or for other specified trigger events) may be a commendable effort to provide certainty, but falls far short of that goal. If the idea is to have a provision which will work under any scenario, even if one were to concede that the various SOFR pricing alternative fallbacks encompass all possible outcomes, the remaining details that will still need to be specified are voluminous. There will be no getting around the need to further document the actual pricing provisions to be utilized. Documentation amending a loan agreement will need to specify the rate to be utilized and the related adjustment factor, whether averaging will be used, whether simple or compound averaging is to be incorporated, whether a "term" SOFR is applicable and the applicable tenor thereof, whether an advance or arrears structure will be applicable, what procedures will be adopted for paying interest where the rate might only be known on the due date, etc. As well, payment conventions such as actual/360, following business day, etc., will need to be specified and properly incorporated. It is worth noting that not only are there no market conventions currently in place for the utilization of SOFR in the loan markets, but the first SOFR pricing alternative in the hard-wired approach—"Term SOFR"[11]—is a fiction insofar as a forward-looking term rate is a product that has yet to be developed. In short, putting in the Hard Wired language as a fail-safe is not a guarantee of any certainty of outcome.

EXISTING TRANSACTIONS

LIBOR is a pricing metric currently utilized in billion of dollars of financing contracts that are scheduled to remain outstanding past 2021. These contracts include publicly traded securities, home mortgages, and bank credit agreements. While sophisticated parties—such as corporate borrowers and their banks—may be able to amend their interest rate provisions to take into account any newly developed and accepted pricing standard (like a Term SOFR), the loss of LIBOR may create high levels of uncertainties where other types of parties are involved or mechanisms do not exist for fallback provisions. How the loss of this pricing metric will play out is rather difficult to say, but one thing is for

[11] Term SOFR would be a product whereby interest periods would be available for discrete periods (30/60/90 days, or 1/2/3 months [which?]), much as they are for LIBOR. The Term SOFR rate would be established at the beginning of the interest period [when?], one would expect based on forward Treasury rates.

sure, litigation will likely ensue.[12] To mitigate the consequences of a loss of LIBOR, it would be useful to continue some form of quoted LIBOR rate beyond 2021.

CONCLUSION

The uncertainties surrounding SOFR—whether concerning the actual rate to be used/calculated, finding and devising an appropriate adjustment factor, the payment conventions, etc.—leave bankers and their lawyers scratching their heads as to just what it is they will be signing themselves up for. If SOFR is to be the rate to replace LIBOR, pricing protocols for SOFR should be developed, and conventions for SOFR should be adopted, *in the near term*. The ARRC should prevail upon the Fed to make these decisions now, or it should at least delineate a timeline for when they will be made. Borrowers and lenders alike have an interest in creating a single product to be used in the bank market in which all pricing inputs and conventions are known and agreed so that transactions can be compared and bid-on on an apple-to-apple basis. Having the market diverge with multiple variants of SOFR (or any other benchmark rate) will create uncertainty and confusion.

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[12] *See, for example*, Speech by Michael Held, Executive Vice President and General Counsel of the Federal Reserve Bank of New York, "SOFR and the Transition from LIBOR," Remarks at the SIFMA C&L Society February Luncheon, New York City, February 26, 2019. Mr. Held "blame[s] the lawyers" for not properly considering in transaction documents the likelihood of LIBOR "simply disappearing." I daresay that that criticism is a tad rich; lawyers are surely not tasked to imagine every conceivable possibility in transaction documents which are already long enough.