Moving from LIBOR to SOFR

A resource to help clients understand the worldwide transition to a new lending benchmark.
How we got here

It starts with LIBOR, which stands for the London Interbank Offered Rate. Created in 1986, LIBOR quickly emerged as an unregulated proxy for borrowing rates. It’s calculated daily by ICE Benchmark Administration, based upon the anticipated borrowing for certain global banks on an unsecured basis.

The rate is established through a submission process by contributor banks based upon actual inter-bank lending data, but it’s modified by the judgment of those banks when sufficient data is not available.

The final rate is used as a benchmark for pricing roughly $350 trillion of U.S. commercial loans, derivatives, student loans, mortgages and many other types of credit.

The problem with LIBOR

Following several scandals that involved manipulated and/or coordinated LIBOR rate submissions, the U.K. Financial Conduct Authority (FCA) began regulating member bank rate submissions in 2013 and took steps to increase reliance on actual inter-bank lending data.

In the summer of 2017, the FCA announced that after 2021 it would no longer compel member banks to submit LIBOR rates. After then, it would be up to each member bank to decide whether to continue submitting LIBOR rates.

LIBOR may continue to exist past 2021, but could be discontinued as a benchmark rate.

The advent of SOFR

November 2014 marks the first step in the search for an alternative to LIBOR. That’s when the Alternative Reference Rates Committee (ARRC), a group sponsored by the Federal Reserve, first gathered to identify an alternate set of reference rates—that were based more firmly on market transactions.

After considering a number of alternatives, on June 22, 2017, the ARRC named the Secured Overnight Financing Rate (SOFR) as its recommended alternative to the USD LIBOR. SOFR is based on the overnight repo markets with ~ $1 trillion of transactions per day. Publication of the SOFR rate began in April 2018. While trading and clearing of SOFR-based swaps and futures began in May 2018, they are still not widely available to market participants.

A broad benchmark with built-in flexibility

According to the ARRC, SOFR “has the widest coverage of any Treasury repo rate available.” SOFR can be used across a wide range of financial products, including derivatives (listed, cleared and bilateral-OTC) and variable-rate cash products. And because it’s comprised of the widest market average available, SOFR has the ability to evolve with the market.

Outstanding SOFR-linked notional across all products has grown from less than $100 billion in May 2018 to over $9 trillion as of April 2019.
What’s next

It’s anticipated that SOFR can be used for cash products before 2021 ends. In the meantime, SOFR is expected to co-exist with LIBOR, as long as LIBOR is published. Because LIBOR has been used so widely, many will be impacted by this transition, including:

- Retail customers
- Corporations
- Issuers
- Investors
- Asset managers
- Financial products service providers
- Large financial institutions

While a number of variables will affect the actual transition to SOFR, the current coordination of a broad range of market participants and commitments from the private sector should help ensure that the availability, adoption and transition to SOFR will take place in a smooth and time-efficient manner.

Fifth Third has established an enterprise-wide program to prepare for the changes that will result from the replacement of LIBOR in your credit documents, including identifying floating rate alternatives, and determining systems/processes requiring changes to begin offering other floating rate alternatives like SOFR.

Fifth Third wants you to know that when the appropriate time comes, we intend to follow the market, which we believe means that we will ultimately transition your LIBOR-based product to an alternative rate such as SOFR, and adjust the applicable spread as appropriate under prevailing market standards. It is important to note, however, that although ARRC has selected SOFR as the preferred alternative reference rate to LIBOR, there is no guarantee that, as the market matures, SOFR will perform like LIBOR.
LIBOR FAQs

Why is a new benchmark rate needed?

LIBOR is based on quotes submitted by banks. Its reputation as the market standard was tainted due to various scandals that emerged post crisis thus signaling an inefficiency of the 50-year-old benchmark. Globally, officials wanted to gravitate towards a rate that was not dependent upon submissions but rather based upon interest rate transactions which are transparent and provide insight into market liquidity.

What might replace USD LIBOR?

After considering a number of alternatives, on June 22, 2017, the Alternative Reference Rates Committee (ARRC) named the Secured Overnight Financing Rate (SOFR) as its recommended alternative to the USD LIBOR. 1

SOFR is considered a “good representation of general funding conditions in the overnight Treasury repo market.” 1

What is SOFR and who administers it?

Published daily by the Federal Reserve Bank of New York, “SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities.” 1 With transaction volumes that are far larger than LIBOR or any other U.S. money market, “it has the widest coverage of any Treasury repo rate available.” 1

Will SOFR price like LIBOR?

SOFR will not price like LIBOR. LIBOR prices based upon participant banks providing historical rates from overnight up to 1 year, to a repository that calculates a trimmed mean. SOFR prices based upon trading of instruments that facilitate the borrowing of cash in the overnight market, on a forward-looking daily basis.

Who will be affected by the transition to SOFR?

Due to the extensive use of USD LIBOR, many will be impacted, including: retail customers, corporations, issuers, investors, asset managers, financial products service providers and large financial institutions.

What sort of financial products should reference SOFR?

SOFR can be used as a reference across a broad range of financial products, including—but not limited to—derivatives (listed, cleared and bilateral-OTC) and many variable-rate cash products that have used LIBOR as their reference rate in the past.

What about contracts that use LIBOR as the underlying reference rate?

It’s recommended that market participants “understand their contractual fallback arrangements.” 1 Fallback language refers to the legal provisions in a contract that go into effect if the underlying referenced rate is discontinued or no longer available.

For cash products, market participants are recommended to “include more robust fallback language in LIBOR-based non-derivatives contracts, including loans, bonds, securitizations, consumer mortgages, etc. (collectively, ‘cash products’).” 1

Is SOFR here to stay?

Because SOFR is comprised of the widest market coverage available, it is enabled to evolve with the market. With the coordination of a broad range of market participants, as well as commitments from the private sector, the availability, adoption and transition to SOFR can take place in a smooth and time-efficient manner.

When will the benchmark rate transfer from LIBOR to SOFR?

The ARRC has implemented a paced transition plan. Over time, the plan calls for establishing “a baseline level of liquidity for derivatives contracts referencing SOFR”. 1

In the meantime, SOFR is expected to co-exist with LIBOR, as long as LIBOR is published.


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