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Competing Benchmarks in the Transition from LIBOR

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"The key thing is we're going to be in a multi-rate environment. We've seen it. We've expected it. And it's not a tragedy".

Meredith Coffey,
Executive Vice President of Research and Public Policy, Loan Syndications and Trading Association

As has been widely communicated, on July 27, 2017, the United Kingdom's Financial Conduct Authority (the "FCA"), announced that the London Interbank Offered Rate ("LIBOR") would be phased out by 2021. Subsequently, on March 5, 2021, the FCA extended this time period for certain LIBOR tenors, announcing that 1-week and 2-month LIBOR would still cease after December 31, 2021, but all other LIBOR tenors for all other currencies would be published until June 30, 2023.

In the aftermath of the FCA announcements, the loan market has been scrambling to build consensus around a prevailing alternative rate to replace LIBOR and to agree the requisite spread adjustments and related mechanics necessary to operationalize such rate.

While significant momentum has built over the last few years around the Secured Overnight Funding Rate ("SOFR"), we have seen other alternative interest rates gain traction in recent months, especially as the initial December 31, 2021 deadline draws nearer.

In this update, we provide an overview of SOFR and compare it to some of the other competitor LIBOR alternatives that have emerged in recent months.

SOFR

SOFR, which is published by the Federal Reserve Bank of New York, is an overnight reference rate that measures costs of borrowing cash collateralized by U.S. treasuries in the repurchase (repo) market and is based on approximately $1 trillion of such overnight transactions. The Alternative Reference Rates Committee ("AARC") has endorsed SOFR as its benchmark alternative of choice to replace LIBOR, in large part, because it is based on actual transactions and, therefore, insulated from the potential manipulation that plagued LIBOR. The Loan Syndication and Trading Association ("LSTA") has also released model language that includes mechanics for hardwiring SOFR as an alternative rate in credit agreements, which has become a common documentary approach in the loan market in recent months.

Because SOFR is an overnight rate, it differs from LIBOR in that it is backward-looking rather than forward-looking and it does not include a credit-sensitive component since it is a risk-free rate that is secured by treasuries. Further, in March 2021, the AARC announced that it would not be able to guarantee a forward-looking SOFR rate by the end of 2021 due to insufficient liquidity. This announcement, coupled with the loan market's desire for a forward-looking and credit-sensitive rate more closely approximating LIBOR, has further paved the way for other benchmarks, like BSBY, to compete for market share.

BSBY

The Bloomberg Short Term Bank Yield index ("BSBY") was launched in January 2021 by Bloomberg Index Services Limited, a subsidiary of Bloomberg LP, as one of various contenders to replace LIBOR. BSBY is forward-looking and uses aggregate transactions of commercial paper, certificates of deposit, U.S. dollar bank deposits and short-term bank bond trades to build a reference rate that contains a bank credit component.

Recently, at least 3 deals have launched in 2021 using BSBY as an alternative pricing reference, including a corporate syndicated loan for Duluth Holdings Inc., two swap trades entered into by JPMorgan Chase Bank and Bank of America and a floating-rate note issued by Bank of America.

AMERIBOR

AMERIBOR, overseen by the American Financial Exchange ("AFX"), is another alternate interest rate which, like LIBOR, is based upon the credit weighted average of the unsecured loans of more than 1,000 small to mid-size banks in the U.S. As pointed out by Federal Reserve Chairman Jerome Powell in February 2020, while AMERIBOR may be an appropriate benchmark rate for banks that fund themselves through AFX or for whom AMERIBOR reflects their cost of funding, it may not be a "natural fit" for all market participants.

Bank Yield Index

Although not yet launched, the ICE Benchmark Administration – the same administrator that oversees LIBOR – is expected to launch its Bank Yield Index rate in the near term. The Bank Yield Index is expected to be a forward-looking rate, measuring average yields at which investors are willing to invest U.S. dollar funds on a senior, unsecured basis and based on actual transaction data. Unlike LIBOR, there will be no requirement for data contributors to use expert judgement when providing input data.

Post-LIBOR World

It remains to be seen whether SOFR will win the race as the dominant LIBOR alternative in the loan market and to what extent the post-LIBOR world will instead be a multi-rate environment, with the ability for borrowers to choose from various rates depending on their capital needs. Much of this may depend on how long it takes the AARC to come forward with the forward-looking term SOFR rate that the market has been anxiously waiting for.

While the market evolves on this topic, private equity sponsors and borrowers should ensure that their loan documents include LIBOR successor provisions that provide sufficient flexibility. The LSTA, too, has acknowledged the need for flexibility by publishing a "credit-sensitive rate rider" to its form LIBOR replacement language on April 8, 2021, which allows market participants to transition to one of four alternatives ahead of, in lieu of, or after, adjusted term SOFR.

Your Weil Finance Team is Available to Assist

Given the changes to LIBOR outlined above, we encourage our private equity clients to reach out to the Weil finance team with any questions regarding the cessation of LIBOR and implications for your existing and future credit facilities and other financing transactions.

For further information on this topic, see also the following previous Weil Alerts:

The Transition from LIBOR and the Syndicated Loan Market's Initial Reaction

Leveraged Finance Market Updates – LIBOR and Leveraged Lending Regulatory Guidelines

For Syndicated Loan Market, NY Fed Anticipates Publication of "Term Structure" SOFR in 2Q 2018 and Implementation in 2021

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