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Regulator Joint Statement Highlights Need to Move on from LIBOR (But For Some, Not Necessarily to SOFR) - McGuireWoods

On November 6, 2020, Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency ("OCC"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies") issued a joint "Statement on Reference Rates for Loans" (the "Joint Statement").

The Takeaway: You don't have to go to SOFR, but you can't stay here. The Agencies expect banks to include fallback language in existing LIBOR loan contracts and "begin transitioning loans away from LIBOR without delay," but recognize that the "use of SOFR is voluntary" and that a more credit sensitive alternative may be more appropriate for some banks. Although the Agencies have recognized the desire by some banks for a more credit-sensitive alternative to SOFR as a replacement for LIBOR, they have also been clear that they won't be recommending any particular credit sensitive alternative, in contrast to the ARRC's recommendation of SOFR. The Agencies note that "[b]anks should assess the appropriateness of alternative reference rates in light of their funding costs and their customers' needs." So while money center banks and syndications markets continue to trend towards SOFR, the Agencies have made clear that banks in other market segments have regulatory leeway to continue to evaluate other options and alternatives.

But why might SOFR not fit all shapes and sizes?

Stress Test:

The Joint Statement foregrounds an ongoing undercurrent of discussions by some banks focused on potential issues with SOFR as an index rate in times of economic stress. In a September 23, 2019 letter to the Agencies, a group of banks highlighted the squeeze that many banks would feel during times of economic stress with a portfolio of SOFR indexed loans:

- LIBOR is an unsecured credit sensitive rate, so that in times of economic distress, as the cost of funds for banks rise, the yield on banks' portfolio of LIBOR indexed loans also rises; thus, with LIBOR indexed loans, bank lending and borrowing rates tend to move in concert; HOWEVER
- SOFR is a secured nearly "risk free rate" (overnight rate for borrowing secured by U.S. Treasury securities), and as such during times of economic distress, "SOFR (unlike LIBOR) will likely decrease disproportionately relative to other market rates as investors seek the safe haven of U.S. Treasury securities."

With a portfolio of SOFR based loans, banks will bear the risk that in times of economic distress, their cost of funds will go up but interest income will go down, squeezing banks' net interest income. The tendency of borrowers to draw down credit lines and hoard cash during economic crisis amplifies the potential problem.

Credit Sensitivity Group:

The Agencies responded to that letter by organizing a Credit Sensitivity Group ("CSG"), which conducted four workshops over the summer (June 4, 2020, July 22, 2020, August 12, 2020 and August 27, 2020) to vet and discuss the issue, summaries of which can be found here. Additional working sessions are scheduled for November 18, 2020 and a TBD December date to continue discussions around developing a credit sensitive component to help address the disconnect between SOFR and bank cost of funds under conditions of economic distress. However, in a public letter from the Agencies on October 21, 2020 and in advance of the next CSG working sessions, the Agencies made clear that "the official sector does not plan to convene a group to recommend a specific credit-sensitive supplement or rate for use in commercial lending products."

Challenges to Credit Sensitivity / "Dynamic" Spreads:

Constructing a "dynamic" adjustment to SOFR to account for ongoing changes in credit quality was weighed by the ARRC early on, but discarded in favor of the currently recommended "static" spread adjustment added to SOFR to approximate LIBOR (i.e., a spread determined and fixed at the point in time that LIBOR is discontinued). In electing to go with a static spread adjustment, the ARRC recognized that dynamic spread adjustment formulations suffer many of the same IOSCO compliance problems as LIBOR itself: (a) limited transactions in normal times that could be used to calculate the spread adjustments, (b) even more limited transactions in periods of stress and (c) an unstable sample of firms that borrow in unsecured wholesale markets, resulting in borrower-based variability. Nevertheless, market participants continue to explore ways mitigate the risks posed by SOFR movement during economic stress.

As the clock winds down on LIBOR, ISDA rolls out its IBOR Benchmark Fallback Protocols for swaps and the syndicated loan market moves toward hardwired fallbacks to SOFR, the demand by some banks for a more credit-sensitive alternative to LIBOR continues to generate both discussion and recognition by the Agencies.

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