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Banks Press Ahead with Term SOFR Preparation; Credit Sensitive Rates Under Scrutiny: McGuireWoods

Where we left off: In our Mid-Year Check-In blogpost, we noted that progress in the development and readiness of some credit sensitive interest rate indices (e.g., Bloomberg's BSBY, IBA's Bank Yield Index and American Financial Exchange's AMERIBOR) seemed to spark some urgency in the development of SOFR's forward-looking term rate in Q2, including the ARRC's selection of CME Group as administrator for Term SOFR, and the CFTC's SOFR First Initiative to encourage primary market swaps dealers to quote USD swaps at SOFR. Those efforts culminated in the ARRC's formal recommendation of Term SOFR for use in the bank loan market on July 29, 2021.

The LSTA followed up by releasing a Concept Credit Agreement for Day-One Term SOFR, and now many bank clients have developed day-one Term SOFR language in their own form documents in anticipation of issuing new loans at Term SOFR in Q4.

SOFR Deals Debuting. Both Daily Simple SOFR and Term SOFR have started to see actual use cases in the market in Q3:

- Some term sheets in the market include provisions to toggle over to day one Daily Simple SOFR or Term SOFR if they close after a certain date (e.g., December 31, 2021 or in some cases earlier).
- Two of Ford Motor Company's credit facilities led by JP Morgan Chase Bank, N.A. transitioned to daily simple SOFR on September 29,[1] providing the market with a look at how that variety of SOFR operationalizes in real time.
- Several sources (Covenant Review; Bloomberg; LSTA) reported seeing the first Term SOFR term sheet, a loan for the acquisition of Sanderson Farm.
- Bloomberg and the LSTA have noted a JPMorgan Chase Bank, N.A. led deal for Walker & Dunlop with a TLB priced at SOFR.

One issue to watch in the development of day one SOFR deals: whether the rate is constructed as a three part calculation (SOFR + spread adjustment (used to approximate LIBOR) + applicable margin) or a two part calculation (SOFR + applicable margin, loading any implied spread to LIBOR into the applicable margin). The spread adjustments fixed by the ARRC at the end of Q1 used the average delta between SORF and LIBOR over the prior 5 years – the LIBOR spread over SOFR is now much lower in our current environment of historically low interest rates. As a result, lenders have been watching to see whether the spread adjustment becomes a hotly negotiated point in a three part construct, or subsumed into the negotiation of the applicable margin in a two part construct. Banks may need to operationalize a dual tracking system if both approaches remain in the market.

Do you have a license for that? LIBOR became so ubiquitous in the bank loan market that its status as a licensed product faded into the background, but LIBOR is a rate administered and licensed for use by the ICE Benchmark Administration (IBA), and financial institutions using LIBOR are required to enter into a license agreement with the IBA for its use. CME Group is licensing its publication of Term SOFR on largely the same basis, and market participants are now familiarizing

themselves with CME Group's license categories and use restrictions in anticipation of booking loans at Term SOFR in Q4. A summary of CME Group's license tiers can be found at cmegroup.com. At a high level, it seems clear that an administrative agent running a syndicated lending transaction needs a license, as does each member of the syndicate using the published Term SOFR rates to make its own interest calculations; the "end-user" borrower would not, unless the borrower is independently using the CME Group's published rates to run its own models and analytics. The takeaway: if you plan to use Term SOFR as an agent or to run your own models, you'll need one; if you're unsure, check in with CME Group.

What about those Credit Sensitive Rates? The rapid progress of Term SOFR over the summer hasn't stopped loan market participants from preparing to offer credit sensitive rates as an alternative, and in both their systems and loan document forms, despite the comments of SEC Chair Gary Gensler at the June 2021 FSOC Meeting.

The official sector, however, continues to preach caution on the robustness of credit sensitive alternatives:

- The International Organization of Securities Commissions ("IOSCO"), which previously established Principles on Financial Benchmarks for evaluating LIBOR alternatives, on September 8 issued a statement specifically calling for greater attention to its Principle 6 (relative size of the underlying market in relation to the volume of trading) and Principle 7 (data sufficiency in a benchmark's design to accurately and reliably represent the underlying market) in evaluating credit sensitive rates.
- SEC Chair Gensler led off the Fifth SOFR Symposium on September 20 by restating and amplifying his FSOC meeting concerns about the thin (or in times of economic stress, likely non-existent) market in unsecured term bank-to-bank lending underlying BSBY and other credit sensitive rates.
- In comments at a Structured Finance Association conference in Las Vegas on October 5, Vice-Chair of the Federal Reserve Randal Quarles again focused on the need for banks to move quickly away from new LIBOR loans by the end of 2021, and emphasized that regulators will be paying close attention.

Many banks have established October or November internal deadlines for "no new LIBOR" to provide cushion for the very clear regulatory December 31 cutoff, so we expect to see rapid progress in market adoption of, and adaptation to, both SOFR-based and credit sensitive rates throughout Q4. We'll be watching and advising on how it evolves for our financial institution clients.

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[1] https://www.sec.gov/Archives/edgar/data/37996/000003799621000079/exhibit101toseptember29202.htm; https://www.sec.gov/Archives/edgar/data/37996/000003799621000079/exhibit102tosep

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LIBOR Transition Blog

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