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What Happens To My Rate Upon Conversion?

March 2021

Transition Update

Before it was mid-2023, now it's a date. Two weeks ago, the FCA confirmed that LIBOR will cease to be provided or no longer be representative as of 6/30/2023. It's always possible that this date gets pushed back, but we wouldn't bank on it.

What does this mean? A few things:

1. We now have a hard date for when LIBOR will go away and SOFR will come into play. While the FCA does not expect any rates to become unrepresentative before that date, LIBOR will not be available after it.

2. The announcement represented an "Index Cessation Event" meaning that the spread adjustments for the SOFR fallback rates have been locked in (they were previously fluctuating).

3. Regulators are upping pressure on banks to begin moving away from LIBOR. Now that there's a hard date, it's time to start planning for the transition if you haven't already.

One common question we get is what happens to my rate once LIBOR is discontinued? Assuming the loan and hedge fall back to the same index (SOFR), the answer should be "not much."

If your loan switched to SOFR today, the rate would increase ~3 bps, but things wouldn't feel much different otherwise.

We explore this a little deeper on the following pages.

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ISDA Replacement for LIBOR

On the hedge side, ISDA will be using SOFR + spread adjustment as the LIBOR replacement for contracts entered on or after 1/25/2021. The same fallback also applies to contracts entered prior to 1/25/2021 where both counterparties have adhered to the 2020 IBOR Fallbacks Protocol. For more on this, check out our whitepaper **here**.

Below we drill down on the pieces of the fallback being used by ISDA.

ISDA SOFR
There are several different ways SOFR is calculated, but ISDA is using SOFR which is compounded in arrears. Bloomberg calculates and publishes the exact rate for ISDA, but it closely approximates what the NY Fed publishes **here**.

Keep in mind – since the rate is set in arrears, the actual rate and payment won't be known until near the end of the period. In lieu of the rate being determined two business days prior to the *beginning* of the interest period, it is known two business days prior to the *end* of the period.

Spread Adjustment
These were previously fluctuating based on the five-year median difference between LIBOR and SOFR, but they were locked in following the 3/5/2021 announcement. Below we've outlined the spread adjustments, which ISDA will be using for the most common two LIBOR tenors. All other tenors can be found **here**.

1ML	0.11448%
3ML	0.26161%

LIBOR vs Fallback SOFR – A Quick Comparison

Let's say accruals, payments, and resets for a LIBOR cap all roll on the 15th. On 2/15 the rate resets and the cap provider would look back two London business days (2/11) and determine the LIBOR rate.

1-month LIBOR	0.11225%

Since Fallback SOFR is set in arrears, it's determined two business days prior to the *end* of the period. Therefore, the rate Bloomberg published on 3/11 is used.

30D SOFR	0.02964%
Spread	0.11448%
Fallback 30D SOFR	0.14412%

The delta between the two indices is ~3 bps.

How Will My Contracts Behave?

Loan

Many loans with hedges will follow what ISDA does on the hedge side or give due consideration to the replacement index used on the hedge when selecting a fallback index. This is the ideal scenario.

In that case the loan index would become SOFR + spread in lieu of LIBOR, and as we established, your rate should only change +/- a few bps.

Cap

Not a lot of changes – the cap strike you purchased remains the same. However, instead of comparing LIBOR to the strike to determine how much the cap will pay out, the bank will compare SOFR + spread to the strike.

From the example above, if 0.14412% exceeded the strike, the cap would pay out.

Swap

Once again, not a lot of changes. You continue to pay fixed and the swap desk returns SOFR + spread, which you pass through to meet the obligations on the loan.

Conclusion

Since day one, regulators have worked to ensure the transition is as smooth as possible, which includes ensuring all parties are "economically indifferent". If the hedge and loan both fallback to the same SOFR index, your rate may change a few bps, but otherwise you shouldn't really notice a difference.

For situations where the loan and hedge don't align, we have a basis calculator **here** which can help quantify the risk.

There's a lot of moving pieces and not every loan aligns perfectly with the hedge. If you have any questions or would like assistance walking through considerations, we're here to help.

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