LIBOR Transition Update: US Regulators Give In to Widespread SOFR Opposition

The other momentous news in November (in addition to the US elections) is that US Banking Regulators (FDIC, Federal Reserve and the OCC) finally gave in to banking community opposition to the use of SOFR as the official LIBOR successor. The regulators released a joint statement[1] on November 6th that stated, in part (Advocate comments afterwards in italics):

1. The three regulators "are not endorsing a specific replacement rate for LIBOR for loans". *They sure could have fooled us*.
2. "The use of SOFR is voluntary". *Ditto*
3. "The agencies recognize that banks' funding models differ and that in structuring their lending activities it is appropriate for banks to select suitable replacement rates for LIBOR that are most appropriate given their specific circumstances. This may include using credit-sensitive alternatives to LIBOR". *Recognition a few years earlier would have been more helpful*.
4. "Examiners will not criticize banks solely for using a reference rate, including a credit sensitive rate, other than SOFR for loans". *Let's get ready to rumble!*

We draw three significant implications from the regulators' statement:

Implication 1: Regulators' Preferred LIBOR Successor Turns out to be Badly Suited for… Banks!

"Some banks have noted that SOFR is a near-risk-free rate and does not reflect banks' underlying funding costs. These banks have advocated for the development of a credit-sensitive rate or a credit-sensitive spread that could be added to SOFR to better reflect banks' funding costs". This is an astonishing admission from regulators that despite their attempt to replace LIBOR, the London Inter-***Bank*** Offered Rate, with SOFR, it turns out that SOFR is not well-suited for… ***Banks***!

Banks have a strong preference for a LIBOR-replacement that has a built-in credit component because it automatically resets periodically to account for varying credit risks that they face and therefore need to charge to their clients. To replace LIBOR with SOFR (based on a one-time adjustment) removes a much-needed shock absorber from the banking system.

Implication 2: Get Ready for a Brave New Multi-Rate World

The regulators' belated concession that banks are free to use non-LIBOR and non-SOFR indexes in their floating rate banking products should have been made at the dawn of the LIBOR replacement process. It frees the banking and financial world to experiment with different floating rate indexes and eventually to gravitate around one or a few. Just as LIBOR did not become the world's preferred rate by fiat, the market should be the one to decide (after a period of experimentation) on the appropriate rate(s). We include an updated list of possible US floating rate indexes from Advocate's Q2 letter and identify the RFRs that contain a bank credit component.

[1] *Statement on Reference Rates for Loans*. Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, November 6, 2020

FIGURE 1. SOME ALTERNATIVE US "RISK FREE RATES" (RFRS)

Alternative RFRs	Available Maturities	Has Bank Credit Spread?	RFR Liquidity	Comment
Fed Funds	O/N	Y	Excellent	Daily trading volume between $30-$80Bn. Highest liquidity basis swap instrument in the market today.
Prime	O/N	Y	Good	Primarily used by middle-market corporations. Historically FF+300bps, now 300-325bps given FF target range.
OBFR (Overnight Bank Funding Rate)	O/N	Y	Excellent	High daily transactions ($100-200Bn).
T-Bill	4-, 8-, 13- , 26-wk, 1yr	N	Excellent	Excellent liquidity and transparency due to frequent and highly transparent auctions overseen by the US Treasury Department. Lower secondary trading volume and liquidity.
Ameribor	O/N, 30-day, 90-day	Y	Very Good	Banking funding rate based on daily volume-weighted US bank funding transactions (not poll).
COFI (Cost of Funds Index, Various Districts)	1m (in arrears)	Y	Low	
Commercial Paper (Top Tier)	1-, 7-, 15-30-, 60- and 90-day	Y	Excellent	Index publication and methodology has been overseen by the Fed since the 1990's.
CMT (Constant Maturity Treasury)	2y, 3y, 5y, 7y, 10y, 20y, 30y	N	Excellent	Treasuries notes and bonds are the very definition of market liquidity.

Sources: Bloomberg, Federal Reserve, US Treasury Department, Advocate

Implication 3. Craft A Coherent Floating Rate Strategy To Navigate This Brave New World

"All institutions should have risk management processes in place to identify and mitigate their LIBOR transition risks that are commensurate with the size and complexity of their exposures" [1]

In light of the above regulators' statement, it is even more important that borrowers work with their finance staff and external advisors to craft a well-considered approach to the end of LIBOR that fits their unique profiles. Now that usage of non-SOFR RFRs has effectively been given the official regulatory green light, a coherent funding-mix strategy that allows for a diverse and customized set of floating rates in conjunction with the prudent use of derivative hedges will be critical to meeting the challenges arising from the end-of-LIBOR.

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