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From LIBOR to SOFR: Why the Upcoming Shift Matters to Everyone

As the world shifts away from LIBOR, companies of all sizes will feel the impact. Is your business ready?

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For more than 40 years, the London Interbank Offered Rate (LIBOR) has been the benchmark interest rate for the global financial services industry and companies that rely on it. No longer.

After LIBOR's stability began to erode in the wake of the 2008 financial crisis, with investigations uncovering rate manipulation, the industry began looking for alternative rate-setting mechanisms. As a result, the United States, the United Kingdom, and other markets will be phasing out LIBOR in 2021 in favor of an Alternative Reference Rate (ARR) as determined by each country. In the U.S., the recommended ARR is the dollar-denominated Secured Overnight Financing Rate (SOFR).

For what has been called the "world's most important number" affecting contracts worth more than $240 trillion, this shift is anything but trivial. Indeed, anyone who is involved in the financial borrowings of their entity knows they are exposed in some way to LIBOR. That's regardless of whether you're a multinational corporation or a small- or medium-size business. Not since the ubiquitous effect of Y2K more than 20 years ago has the corporate world undergone a challenge that carried with it such widespread implications—ones that could impact contracts, systems, finances, and forecasting.

At Bank of the West, we are working to keep our clients informed of market developments as we are currently enabling the shift to SOFR. At our bank, and many other financial institutions, legacy loans will continue to be based on LIBOR through either the maturity of the loan or to June 30, 2023, at the latest. After that date, all LIBOR-based loans will have moved to SOFR. For newly originated loans, LIBOR will cease to be used as the reference rate beginning January 1, 2022. Those are hard deadlines, which bring with them an array of cascading challenges for both lenders and corporate borrowers.

Companies globally need to determine where LIBOR lives in their systems, which lending or financing agreements are affected, how the potential repercussions will play out, and what adjustments or solutions need to be devised for its replacement.

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Whether it's reviewing existing agreements to determine LIBOR exposure, recalibrating funding costs to mitigate risks, or evaluating accounting and ERP systems to modify how interests are calculated, companies of all sizes must work to understand the potential impact of the transition, establishing new measures and procedures for adjusting to the change.

Know the Difference Between LIBOR and SOFR

LIBOR has been in use since the mid-1980s with rates established daily through estimates and projections from global banks. Based on expectations of anticipated rates, they are forward-looking calculations that set the lending rate banks pay for unsecured loans from other institutions.

To remove the potential risk embedded in the previous rate-setting process, SOFR incorporates actual transactions involving repurchase agreements, or repos, in the U.S. Treasury markets. As collateralized transactions – and therefore secured – they do not carry the same credit risk premium as LIBOR rates. Because SOFR is backward-looking and relies on actual transactions, there is also less room for potential manipulation—an inherent flaw in LIBOR, which led to its downfall.

While SOFR will be used in dollar-denominated credit facilities, other countries either have adopted or are expected to adopt other replacement Risk-Free Rates (RFRs). For example, the Euro Short Term Rate (€STR) is slated to replace the Euro OverNight Index Average (EONIA), and the Sterling Overnight Index Average (SONIA) has replaced GBP LIBOR.

Review, Assess, and Plan for the Future

As companies either prepare or continue to work through their LIBOR-SOFR transition, it is recommended that they keep three key steps in mind:

1. **Launch an Extensive Review of Lending Agreements**

In preparation of the SOFR transition, every company—of any size—should consider reviewing its lending agreements with an eye toward impact. It is vital that companies obtain a clear view on all contractual terms, especially regarding fallback provisions, which can determine their LIBOR exposure. Determine whether LIBOR has been used as a rate-setting mechanism with lenders or suppliers. There is no doubt that the impact is widespread. The New York Fed estimated that even retail mortgage contracts referencing USD LIBOR are valued at $1.2 trillion, while non-syndicated business loans amount to $800 billion.

In many cases, there might be terms that specify a replacement rate for LIBOR. If so, determine the likely impact of the change and which party has the right to call the rate. Perform this review carefully and understand the implications on the funding terms and its potential impact when LIBOR goes away.

2. **Conduct a Review and Assessment of Reporting Systems**

As part of an audit, a complete review of various internal programs and processes should be conducted to determine potential LIBOR impact. As LIBOR and SOFR have different characteristics, IT systems might need to be modified to manage financial products, such as loans, that might reference interest that is compounded in arrears.

Additionally, assess your infrastructure to determine the potential impact on software systems, engaging with hardware and software vendors, if necessary, to facilitate your transition. These overall operational and IT impacts should also be incorporated into other projects that are underway as linkages can often exist. Keep in mind that these interdependencies might require ongoing and active management.

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For example, if your company is currently inputting LIBOR plus the spread into your accounting software, you will want to ensure it can accommodate SOFR once the transition is made. Similarly, a company may use LIBOR as the basis for intracompany loans; the company will need to update its internal processes. Additionally, be prepared to incorporate SOFR into any future forecasting models your company might currently be using.

3. **Determine and Plan for the Transition**

To prepare for the overall transition to SOFR and potentially other RFRs, establish a framework to ensure key stakeholders are informed of the overall impact, the game plan to address the required changes, and the progress to date. Clearly delineating the internal processes that need to be addressed to a company's board of directors and senior leadership is a critical component in preparing for the overall transition and appropriate governance.

Given the transition from LIBOR to SOFR, estimating the total financial impact can be challenging. Existing loans, especially those predating SOFR discussions, may lack fallback language if LIBOR is phased out. For those that do stipulate a fallback—perhaps a prime or base rate—the impact is more clearly defined.

Plan Now with Your Trusted Partners

Each of these steps remains critical in preparing for the future. Much of this shift remains undetermined—SOFR is not yet even commonly cited as a benchmark rate in contracts—but now is the time to plan for the impact.

As such, reach out to your trusted advisors for input and assistance, whether these might be your banking partner, auditor, lawyer, or mergers and acquisition advisors. For many businesses, working with the relationship manager at your financial institution can be key to determining the potential implications for your company.

Success will not come by chance. A deliberate, strategic approach to the transition will be necessary to limit disruptions and ensure expectations are met. SOFR is coming, and now is the time to prepare.

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