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Interest Rates Watch: Examining USD LIBOR-SOFR Spreads

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Welcome back to our *Interest Rates Watch* series, developed to provide timely updates and practical advice on developments related to interest rates and benchmarks on a regular basis. As always, we are here to help.

As noted in our previous article on this topic, the Alternative Reference Rates Committee (the ARRC), the working group backed by the United States Federal Reserve and tasked with recommending a replacement for US dollar (USD) LIBOR, formally recommended the CME Group's forward-looking Secured Overnight Financing Rate (SOFR) term rates (SOFR Term Rates) for one-, three- and six-month tenors. As we near the end of USD LIBOR, many are beginning to take a closer look at how the cessation of LIBOR, and recommendation of SOFR Term Rates, will impact credit facilities and other arrangements which are tied to USD LIBOR.

One variable which is coming into focus is the spread adjustment. For contracts that have incorporated the ARRC hardwired fallback language, once the applicable USD LIBOR replacement date occurs USD LIBOR will be replaced by the applicable SOFR Term Rate (if the relevant SOFR Term Rate tenor exists) plus the applicable ARRC-recommended spread adjustment. On the other hand, contracts that have incorporated the amendment approach fallback language previously recommended by the ARRC, and contracts that have not incorporated any fallback language, will need to be amended to select a replacement rate and spread adjustment. Will the ARRC-recommended spread adjustments result in rates that are economically equivalent to USD LIBOR loans? And, if not, how can rates be adjusted to move replacement rates closer to USD LIBOR?

In setting the recommended spread adjustments, the five-year historical median difference between USD LIBOR and SOFR was used. The ARRC-recommended spread adjustments were set on March 5, 2021 and are 0.11448% (11.448 bps) for a one-month tenor, 0.26161% (26.161 bps) for a three-month tenor and 0.42826% (42.826 bps) for a six-month tenor.[1]

Although the ARRC-recommended spread adjustments are expected to result in a SOFR Term Rate close to USD LIBOR loans in "normal" times, as a result of near-zero interest rates the current spread differentials between USD LIBOR and SOFR are less than the ARRC-recommended spread adjustments (as seen in the table below). The result of this is that, currently, utilizing the ARRC-recommended spread adjustments (which are used in the ARRC hardwired fallback language) yields a replacement rate that is higher than it would be if the real-time USD LIBOR-SOFR spot differentials were used.

	1-month			**3-months**			**6-**
	USD LIBOR	Term SOFR	Differential (vs. ARRC-recommended 0.11448%)	USD LIBOR	Term SOFR	Differential (vs. ARRC-recommended 0.26161%)	U
Sept. 17	0.08350%	0.05693%	0.02657%	0.12388%	0.05982%	0.06406%	0.
Sept. 16	0.08738%	0.05466%	0.03272%	0.12200%	0.05705%	0.06495%	0.
Sept. 15	0.08413%	0.05245%	0.03168%	0.12000%	0.05254%	0.06746%	0.
Sept. 14	0.08463%	0.05170%	0.03293%	0.11800%	0.05182%	0.06618%	0.
Sept. 13	0.08375%	0.05228%	0.03147%	0.11600%	0.05249%	0.06351%	0.

Sources: https://www.cmegroup.com/market-data/cme-group-benchmark-administration/term-sofr.html and https://www.wsj.com/market-data/bonds

Experts and market participants expect that the USD LIBOR-SOFR spot differentials will move closer to the ARRC-recommended spread adjustments in the long-term. However, that may not be enough comfort for borrowers today, who may be faced with a spread adjustment that is higher than the USD LIBOR-SOFR spot differential.

As an alternative to using the ARRC-recommended spread adjustment, parties to USD LIBOR contracts may consider one of the following:

1. Incorporate a transition period (e.g. one year) to gradually move to the ARRC-recommended spread adjustments.
2. Use a different spread adjustment entirely.
3. Replace USD LIBOR with Term SOFR, with no adjustment.

Each of these alternatives has associated pros and cons. For example, option one (transition period) should result in a replacement rate that is closer to USD LIBOR. However, this approach would be more burdensome from an administrative perspective. Option two can be used to reflect the commercial agreement between the parties (if the parties can agree on a different spread adjustment), but agreeing on a different spread adjustment may be difficult and may not be consistent with market convention. Finally, option three (replacing USD LIBOR with Term SOFR, with no adjustment) is simpler from an administrative/operational perspective and, in some instances, would result in a replacement rate closer to the current USD LIBOR-SOFR spot differentials. However, given that experts expect the USD LIBOR-SOFR spot differentials to level out to something more consistent with the ARRC-recommended spread adjustments, creditors will likely be hesitant to adopt this approach long-term.

Parties should consider whether an alternative approach to spread adjustments makes sense from a commercial perspective and should ensure that documentation is amended to provide for the desired fallback rate prior to the cessation of USD LIBOR.

We will be issuing further articles relating to interest rates. Find other articles in our Interest Rates Watch Series here.

[1] https://assets.bbhub.io/professional/sites/10/IBOR-Fallbacks-LIBOR-Cessation_Announcement_20210305.pdf

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