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Point of View Paper

Preparing for LIBOR's Sunset

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The expected phaseout of the London Interbank Offered Rate (LIBOR) as a benchmark for loan interest rates is prompting financial institutions to examine their portfolios, assess their exposure and create migration plans for the various loans in those portfolios.

LIBOR has been a widely used index rate for lending since the mid-1980s and is one of the primary benchmarks for short-term interest rates worldwide, including many variable rates that apply to consumer and commercial loans. But that's about to change. While the LIBOR index rate is expected to be discontinued at the end of June 2023, banks are encouraged by the Alternative Reference Rates Committee (ARRC) to stop issuing new LIBOR loans after December 2021. Implications for financial institutions' core accounting processes and balance sheet considerations are substantial.

Why LIBOR Is Going Away and What Comes Next

LIBOR is being abandoned because it no longer reflects actual interbank funding costs and relies heavily on expert judgment for rate setting, according to a 2014 Financial Stability Board report. The transactions on which the rate is based are too few and not representative of the massively larger set of transactions to which it has been applied. That unreliability poses a potential threat to the financial system in general, according to the report.

Recognizing the unreliability of LIBOR, working groups in various jurisdictions around the globe have formed to recommend alternatives to LIBOR for their respective currencies. In the U.S., the ARRC was convened by the Federal Reserve Board and the Federal Reserve Bank of New York in 2014 to recommend a replacement for the LIBOR index rate and to ensure a smooth transition.

In 2017, the ARRC chose the Secured Overnight Financing Rate (SOFR) as the preferred benchmark interest rate to replace LIBOR. Based on overnight U.S. Treasury-backed repurchase transactions, SOFR is more attractive as an index because it is secured, risk free and based on actual transactions occurring in a market with daily volumes in excess of $1 trillion of market trading. It offers a more reliable indication of the actual cost of borrowing cash.

More Than a New Index Rate

SOFR is not simply a new index rate. The new benchmark offers several methodologies and configurations for accruing interest on loans. SOFR accrual methods include simple and compounding, which will work in conjunction with different index and billing options.

Configuration options control index spread adjustments, lookback days and payment delays. Financial institutions that use LIBOR will face significant changes that go beyond just instituting a new reference rate.

SOFR Accrual Methods

Methodology	Details
Forward-Looking Term SOFR	This option is similar to how LIBOR works today and is the preferred replacement for LIBOR. However, a Forward-Looking Term SOFR rate is not yet available.
Compounded SOFR in Advance	This option uses one of the published backward-looking compounded SOFR averages (30-, 90- or 180-day average) and, as with a LIBOR loan, the rate is set in advance for a fixed period of time.
Simple Daily SOFR in Arrears	This option uses the daily SOFR and behaves like a daily floating rate loan.
Compounded SOFR in Arrears	This option uses the daily SOFR and compounds the rate (or the balance). The rate or balance is compounded for the duration of the interest period.

SOFR Configuration Options

Option	Details	Methodologies
Spread Adjustment	This applies to each converted loan to minimize the difference between LIBOR and SOFR on the day the loan is converted.	All methodologies
Payment Delay	The due date will be after the end of the interest period, so billing can be done at the end of the interest period.	Simple Daily and Compounded SOFR in Arrears
Lookback	This determines the dates used when looking up the SOFR index to enable billing in advance of the end of the interest period.	Simple Daily and Compounded SOFR in Arrears
Business Day (Due Date)	Payments due on a nonbusiness day will be adjusted to the next succeeding business day, unless that business day falls in the next succeeding calendar month. If that happens, the interest payment date will be the preceding business day.	All Methodologies

Preparing for the Move to SOFR

As a technology provider to financial institutions that may be affected by the sunset of LIBOR, Fiserv has been monitoring the evolution of SOFR and planning for the impact it will have on our clients that are most likely to be affected. In addition to participating in ARRC calls and updates, we are tracking current and evolving SOFR requirements and hosting an ongoing client focus group. Our priority is to ensure a smooth SOFR implementation for our clients that adopt SOFR.

Financial institutions will want to review relevant information and guidelines provided by the ARRC, as well as government-sponsored enterprises such as Freddie Mac and Fannie Mae, the Consumer Financial Protection Bureau, and the Loan Syndications and Trading Association (see Recommended Resources).

Recommended Resources

Alternative Reference Rates Committee

Freddie Mac LIBOR Transition Playbook

Freddie Mac LIBOR Transition FAQs

Fannie Mae LIBOR Playbook

Fannie Mae LIBOR FAQs

Consumer Financial Protection Bureau LIBOR Transition FAQs

Resources assembled by the Loan Syndications and Trading Association

The demise of LIBOR affects not only new loans but also existing loans. Financial institutions will need to review their loan portfolios for variable rate loans tied to LIBOR, including purchased participations.

For those that determine they will be affected by the planned LIBOR sunset, the following LIBOR-to-SOFR Migration Checklist outlines some steps that a financial institution may follow, in conjunction with consultation with advisors.

LIBOR-to-SOFR Migration Checklist

- Determine the types of loans affected by LIBOR cessation
- Review fallback language – The ARRC has made recommendations regarding fallback language, which is used to lay out the process for replacing a reference rate such as LIBOR if it becomes unavailable
- For the following loan types, determine an approach to SOFR:
  - Consumer and Retail Loans
  - Bilateral Commercial Loans
  - Adjustable-Rate Mortgage (ARM) Loans
  - Student Loans
  - Securities-Based Lending (SBL) Loans
  - Syndications (Midmarket)
  - Club Deals
- Prepare a plan to map LIBOR to a new reference rate
- Determine the SOFR methodologies you plan to use for new loans
- Determine SOFR methodologies for new loan originations
  - Create a timeline for offering SOFR products
  - Determine SOFR configurations
- Review credit documents and participation agreements for loans you participate in to understand the rate fallback language and how the lead bank intends to proceed at LIBOR cessation
- Consider borrower notices for LIBOR-to-SOFR transitions
  - Rate and Payment Notices
  - New Index Notices

Mapping Accrual Methodologies, Features and Configurations to Loan Types

Drawing on the recommendations of the ARRC and input from financial institutions that have participated in monthly working groups hosted by Fiserv, the following tables provide suggestions for employing the SOFR accrual methodologies, features and configurations within your organization.

SOFR Accrual Methodologies

Loan Types	Term SOFR	SOFR in Advance	Simple Daily SOFR	Compounded SOFR
Consumer	x	x		
ARM Loans		x		
Student Loans	x	x		
SBL Loans	x	x	x	x
Commercial (Bilateral)	x		x	x
Syndications	x		x	x
Club Deals	x		x	x

SOFR Features and Configurations

Loan Types	Spread Adjustment	Lookback	Business Day (Due Date)
Consumer	x		
ARM Loans	x		
Student Loans	x		
SBL Loans	x	x	x
Commercial (Bilateral)	x	x	x
Syndications	x	x	x
Club Deals	x	x	x

Staying Informed Can Lead to Smooth Transition

While LIBOR is going away, financial institutions have some leeway in how they approach its replacement. Those who are moving to SOFR will want to remain informed about the new reference rate and develop a workable plan for the transition.

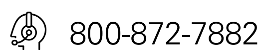
The key to a successful transition will be understanding how changing the index affects core account processing and collaborating with technology providers to successfully implement the required changes.

About the Author

Ken Katz joined Fiserv in July 2019. He heads up product management for account processing solutions within the up-market and commercial segment. Ken has over 30 years of experience building banking software and leading software development and product management teams that design commercial banking solutions for financial institutions around the world.

Connect With Us

For more information about making the move to SOFR: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