afs Market Insights

Alternatives to LIBOR Growing Rapidly as Key Milestone Approaches

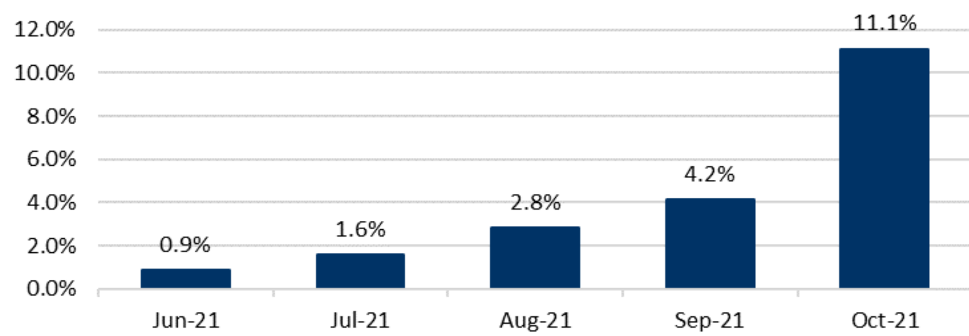
December 2021

Recently, the federal banking agencies issued another joint statement on managing the US LIBOR transition[1]. While these pronouncements have collectively addressed a wide range of topics pertaining to LIBOR cessation, in this edition of Market Insights we focus on two points in particular. One, that institutions have been directed to not enter into new contracts that use US LIBOR as a reference rate as soon as practical but no later than December 31, 2021. And two, the UK Financial Conduct Authority's decision to continue the publication of some, but not all, US LIBOR settings through June 30, 2023. So, given the significance of these statements – and the first deadline rapidly approaching – how is the commercial banking industry doing, and how much work lies ahead?

After a sluggish start, the volume of new or renewed commercial loans tied to SOFR has begun to increase rapidly (see Figure 1). In fact, in October alone the percentage of the monthly activity referencing SOFR as a base rate more than doubled from the prior month. With the year-end deadline looming, we expect this trend to accelerate even further.

Figure 1

Percentage of New or Renewed Commercial Loans indexed to SOFR

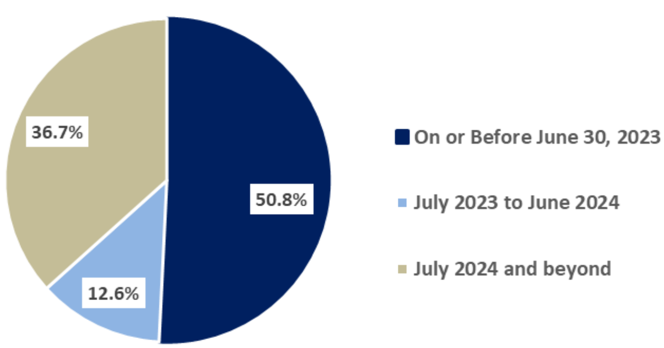


Source: AFS Business Intelligence

Despite this progress, the expansive market for business loans has a long way to go. As noted, the publication of one-month LIBOR – by far the most popular tenor in use today – will continue through June 30, 2023. The plan here was to buy additional time for market participants to wind down or renegotiate existing contracts that reference certain LIBOR settings. But as we can see in Figure 2, only about 50% of the remaining LIBOR-based population in our database has a maturity date on or before June 2023. So for a large number of loans tied to LIBOR, the adoption of fallback language or some other type of resolution will be necessary.

Figure 2

Maturity Date of Remaining Libor-Based Commercial Loans



Source: AFS Business Intelligence

So far, the vast majority of the SOFR-based business loans made in 2021 have been tied to either Daily Simple SOFR or SOFR compounded in Advance (SOFR averages). This is not surprising, given SOFR's head start and recommendation by the Alternative Reference Rates Committee (ARRC). Furthermore, the ARRC's July 2021 endorsement of CME Term SOFR rates may well serve as a key turning point, as a forward-looking term structure has been lacking up until now and is the preferred fallback rate. But as of this writing, the United States' diverse group of lending participants, both borrowers and lenders, have not coalesced around any particular replacement rate just yet. Many industry participants think credit-sensitive rates (SOFR is a risk-free rate) will also have a place in the final mix, particularly in the middle market where it is viewed as more closely matching a smaller bank's cost of funds. Watch for future issues of AFS Market Insights as we track continuing developments in the LIBOR transition.

[1]https://www.federalreserve.gov/supervisionreg/srletters/SR2117a1.pdf

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