WELLS FARGO
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From LIBOR to SOFR — 500 days and counting

What will happen?

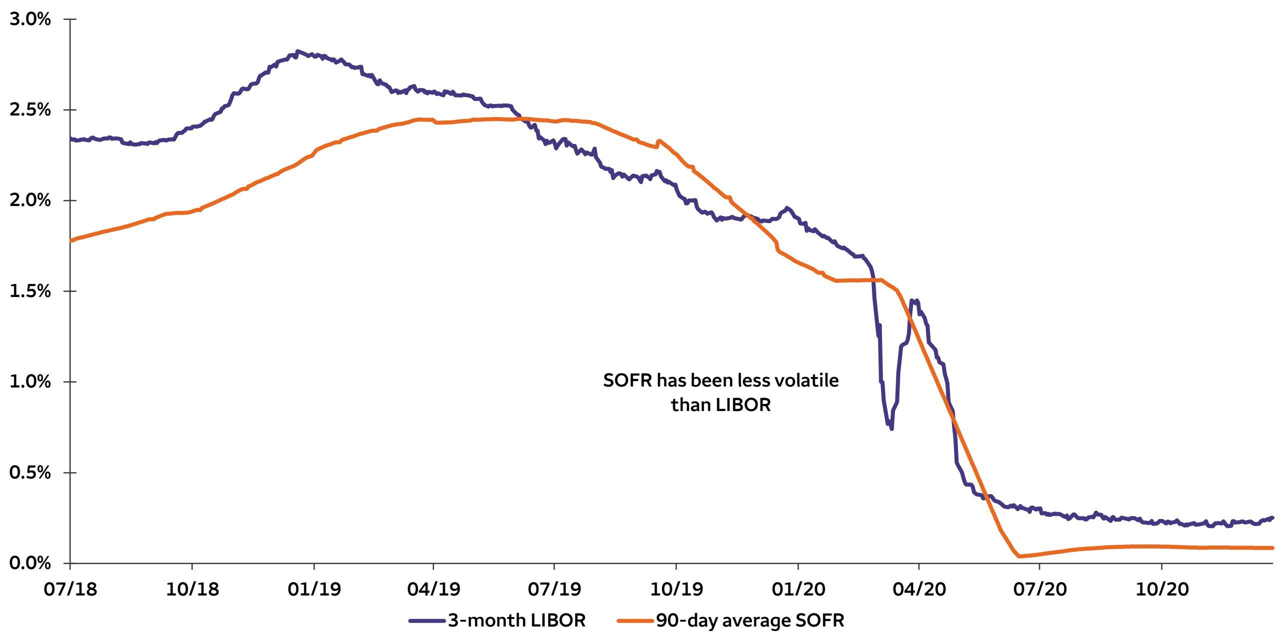
- It was originally thought that by the end of 2021, London Interbank Offered Rate (LIBOR) panels at participating banks likely were going to cease publishing LIBOR, a widely used reference interest rate. However, on November 30, 2020, U.S. and UK regulators and LIBOR's administrator announced that the expectation now is for no new LIBOR contracts to be issued after the end of 2021.[1] They will continue publishing U.S. LIBOR on a representative basis until June 30, 2023 to allow most legacy U.S. LIBOR contracts to mature.[2]
- LIBOR is a critical component of the financial system, hardwired not only in global derivatives but also in business loans, securitizations, floating-rate notes, adjustable-rate mortgages, and student loans. Given the sensitivity of this change, a group of market participants backed by the Federal Reserve (Fed) convened to create the Alternative Reference Rate Committee (ARRC) and tasked that committee with orchestrating a smooth transition from LIBOR in an effort to mitigate risks.
- SOFR is the replacement benchmark rate selected by the ARRC. The Federal Reserve Bank of New York has been administering the publication of this rate on a daily basis since April 2018. The market underlying SOFR has a daily trading volume that often exceeds roughly $1 trillion, and it has demonstrated consistent volume for several years. LIBOR, on the other hand, has few actual trades underpinning the rate itself (close to $500 million or 0.1% of SOFR's volume per day).
- SOFR is a representation of general funding conditions in the overnight Treasury repurchase agreement (repo) market. As such, it reflects actual costs of lending and borrowing relevant to the wide array of participants that are active in the market, including broker-dealers, money market fund managers, asset managers, insurance companies, securities lenders, and pension funds. The key difference is that SOFR is a secured, overnight borrowing rate, and therefore, it does not reflect either the interbank unsecured credit component or a forward-looking term structure that has been inherent in LIBOR.

[1] January 2022: GBP, CHF, EUR, JPY LIBOR expected to cease publication for all tenors; 1-week and 2-month USD LIBOR expected to cease publication.
[2] July 2023: USD LIBOR expected to cease publication for the remaining tenors (overnight, 1-month, 3-month, 6-month and 12-month).

What should investors do?

As a transition to SOFR continues, it will be important for fixed-income and credit-market participants to monitor the related changes and respond to them. We believe that individual investors and households with debt linked to LIBOR should seek to continue understanding the new alternative reference rates (such as SOFR) — and how these changes may impact new and existing LIBOR-linked agreements and contracts that they may have. Of course, this is also important for businesses and other institutions. Our goal is to ensure that Wells Fargo clients and other stakeholders are informed with the appropriate information and equipped to make educated decisions.

Chart 1. Preparing for LIBOR's sunset and SOFR's sunrise



Sources: Wells Fargo Investment Institute, Federal Reserve Bank of New York, Bloomberg; as of December 23, 2020.

Setting the stage

For more than 30 years, LIBOR has been one of the most widely used benchmark interest rates in the world. While LIBOR has been used for short-term interbank loans and as a benchmark interest rate, its importance has grown in recent decades as derivative markets have expanded. Currently, U.S.-dollar LIBOR is used as a reference rate for more than $200 trillion in financial contracts in the cash alternatives and derivatives markets; hence, it has been an important rate throughout the global financial system.[3]

Since its inception, LIBOR has been used as an interest rate for short-term, unsecured, interbank loans. It also serves as an index for longer-term rates on many consumer loans, such as credit cards, auto loans, and adjustable-rate mortgages — and for loans to businesses and institutions. The LIBOR market involves five primary currencies, including the U.S. dollar, the euro, and the British pound.[4] In the LIBOR market, Intercontinental Exchange (ICE) administers LIBOR by surveying participating banks to determine the rate at which they would lend to other banks — and then ICE calculates an average rate each day. After the 2008 financial crisis, unsecured lending between

[3] "Alternative Reference Rates Committee (ARRC): Frequently Asked Questions (FAQs)", July 16, 2020. Amount shown ($200 trillion) is the notional amount of financial contracts.

[4] In addition to LIBOR, other interbank offered rates include: the Hong Kong Interbank Offered Rate (HIBOR) — the rate offered in the Hong Kong interbank market; the Tokyo Interbank Offered Rate (TIBOR) — the rate offered in the Japanese interbank market; EURIBOR — the rate offered in the European Union interbank market; and the Swiss Interbank Offered Rate (CHF LIBOR) — the rate offered in the Swiss interbank market.

global banks declined (in part, due to regulations). As transactions dwindled, the establishment of LIBOR became more of an "expert judgment" submission by large banks, and it became more susceptible to potential conflicts of interest. After several LIBOR manipulation scandals made headlines, the way in which this interest rate was constructed began to create concern. Despite improvements made to the LIBOR submission process after the financial crisis, the lack of volume of supporting transactions prompted regulators and market participants around the world to call for a market transition to more robust and transparent reference rate.

Selection of SOFR

In the U.S., the Fed tasked the ARRC with finding a benchmark interest rate that was more firmly based on transactions from a robust underlying market. The ARRC also was tasked with ensuring a successful transition from USD LIBOR to SOFR. The ARRC has released several recommendations and best practices related to transition related activities, including related to robust financial contract design to help ensure resiliency of contracts upon a LIBOR cessation.[5]

On June 22, 2017, the ARRC identified SOFR as its recommended alternative to U.S.-dollar LIBOR. As noted, SOFR is a broad measure of the cost of borrowing cash on an overnight basis (and collateralized by U.S. Treasury securities). It is determined by actual transaction data compiled by the Federal Reserve Bank of New York. The volumes underlying SOFR are far larger than the transactions in other U.S. money markets today — and they dwarf the volumes underlying the LIBOR market. As mentioned previously, LIBOR has an inherent unsecured risk component — and SOFR does not (it is pricing based on secured loans). This difference in rates, among other characteristics, results in different yields for LIBOR and SOFR, with SOFR generally lower than LIBOR. The implication for the market is that the margin for a SOFR-based loan will be higher than the margin for a LIBOR-based loan (e.g., a loan priced at LIBOR plus 200 basis points may need to evolve to a SOFR plus 210 basis points loan to account for a market risk premium).[6]

Work remains ahead

The ARRC has established objectives for itself and best practices for market participants as the transition continues. Below, we highlight some of the next steps in the transition timeline:[7]

December 2020

- Floating rate notes should be issued using alternative reference rates. No new LIBOR floating-rate notes (FRNs) should be issued.

March 2021

- Dealers will change the market convention for quoting U.S.-dollar-based derivatives from LIBOR to SOFR.

June 2021

- All floating rate products (except for collateralized loan obligations, or CLOs which are targeted for September 2021) should be issued using alternative reference rates. No new LIBOR contracts should be issued.
- ARRC will seek to recommend a forward-looking SOFR term reference rate. (Compounding conventions may have been used in advance.)

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[5] "Alternative Reference Rates Committee (ARRC): Frequently Asked Questions (FAQs)", July 16, 2020. Amount shown ($200 trillion) is the notional amount of financial contracts.

[6] One hundred basis points equal 1.00%.

[7] ARRC, September 9, 2020.

September 2021

- There will be no new LIBOR CLOs.

January 2022

- No new LIBOR contracts are expected to be issued.
- GBP, CHF, EUR, JPY LIBOR expected to cease publication for all tenors; 1-week and 2-month USD LIBOR expected to cease publication.

July 2023

- USD LIBOR expected to cease publication for the remaining tenors (overnight, 1-month, 3-month, 6-month and 12-month).

Our stance

Wells Fargo Investment Institute believes that the ARRC continues to move in the right direction toward an orderly transition from LIBOR to SOFR. The ARRC has published the Paced Transition Plan, which outlines the key milestones to reach during the months leading up to year-end 2021. We believe that the ARRC has outlined a clear path to lead this transition successfully. We will continue to monitor developments for the important LIBOR-to-SOFR transition, which will influence global money markets and many credit (and fixed-income) markets.

We believe that individual investors and households with debt linked to LIBOR should seek to understand the new alternative reference rates (such as SOFR) — and how these changes may impact new and existing LIBOR-linked agreements and contracts that they may have. Individuals impacted by this change also should consider reviewing existing contracts to ensure that they contain robust language that sets forth the steps to be taken or the interest rate to be applied, should LIBOR be discontinued during the term of a contract. If there is LIBOR-based loan with an associated derivatives contract (for example, swap, cap, or collar), then both the loan and the derivatives contract may need to be amended. Of course, these steps are also important for businesses and other institutions.

Our goal is to ensure that Wells Fargo clients and other stakeholders are informed with the appropriate information and equipped to make educated decisions. For additional information, please contact your Wells Fargo relationship manager or financial advisor.

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