Published on *The National Law Review* https://natlawreview.com

LIBOR to SOFR – Five Things Every Financial Services Provider Should Know

Article By:

B. Taber Cathcart

Patrick T. Strubbe

1. What is LIBOR and why is it going away?

The London Interbank Offered Rate, or "LIBOR," is a reference rate commonly used in a broad range of financial contracts. In fact, it serves as a reference rate for tens of millions of contracts worth about $200 trillion in the US alone[1]. LIBOR is hardwired into bilateral loans, syndicated loans, securitizations, adjustable-rate mortgages, derivatives and more. In short, it's embedded into the global financial market in a systemic way.

But to understand why it's going away, you should understand what it actually is. LIBOR is the forward-looking average rate, computed daily, at which a contributor bank (of which there are 17 for USD LIBOR) can obtain unsecured financing in the London interbank market, in a process overseen by the ICE Benchmark Administration, or IBA. It is produced for the US Dollar, British Pound, Euro, Swiss Franc, and Japanese Yen, and plays a large role in international financial markets. But ever since the financial crisis of 2008, the volume of interbank lending has decreased, creating an increasingly thin market of interbank loans underlying the rate. In addition, in the years following the financial crisis, several governmental investigations revealed widespread manipulation and rate-fixing by some contributor banks, leading to $9 billion in fines levied on banks in the US and UK. Since 2014, groups in the US, UK, Eurozone, Switzerland and Japan have been working to transition from interbank rates to alternative reference rates in light of the obvious failings of LIBOR, and in 2017, the UK's Financial Conduct Authority announced that it would no longer compel panel banks to submit quotes for LIBOR beyond 2021, a clear indication that LIBOR is on its way out.[2]

2. SOFR is the identified replacement rate of choice in the US.

Anticipating the eventual cessation of LIBOR, in November 2014 the Federal Reserve convened the Alternative Reference Rates Committee ("ARRC") to determine alternatives to LIBOR as a benchmark rate in the US. In June 2017, ARRC identified SOFR as the preferred replacement rate in its consensus view.[3] But what is SOFR?

SOFR, or Secured Overnight Financing Rate, is a measure of the cost of borrowing cash overnight

against Treasury securities, and it has been published by the Federal Reserve Bank of New York since 2018. Unlike LIBOR, which has been increasingly based on estimates in the wake of the financial downturn, SOFR is a secured, daily overnight rate based on an observable market with a daily trading volume of more than $1 trillion.[4] Due to the higher liquidity in overnight markets, the Financial Stability Board has encouraged all market participants to use overnight rates rather than forward-looking term rates; however, ARRC expects to recommend a forward-looking term rate in the near future.[5] In the meantime, to counteract the volatility inherent in an overnight rate, the Federal Reserve began publishing 30, 90 and 180-day SOFR averages, or “compounded SOFR,” and a SOFR index on March 2, 2020[6]. It is unclear if and when the Federal Reserve will develop a forward-looking “term SOFR,” similar to the 1-month, 3-month and 6-month LIBOR term rates that are currently used, but it would be beneficial for the syndicated loan market in the long run to develop one[7]. In the derivatives market, a recent consultation conducted by the International Swaps and Derivatives Association (“ISDA”) indicated that market participants overwhelmingly prefer a forward-looking “compounded in arrears” rate for risk-free rates like SOFR, as opposed to a backward-looking “compounded in advance” rate.[8]

3. The transition away from LIBOR will require significant remediation of existing contracts.

Given how intertwined LIBOR is with financial products around the world, moving to another reference rate will require enormous efforts from all market participants. For existing contracts that mature after 2021, that means significant overhauls from both a business and legal standpoint. Most financial contracts include fallback language in the event LIBOR becomes temporarily unavailable, but existing fallback language is not sufficient to deal with the permanent cessation of LIBOR.

Many firms and banks have already begun using tools, such as artificial intelligence, to digitize and analyze the millions of LIBOR-based contracts currently active. After the identification and analysis of these agreements is complete, parties will need to decide the best path forward, including possible renegotiation and amendment of existing deals. This decision is highly sensitive to the type of agreement and the financial realities involved, making the entire process very time-consuming. For this reason, ARRC has urged all market participants to actively engage with the issue to ensure as smooth a transition as possible. As of now, deal parties might consider replacing current fallback language with the more robust language recommended by ARRC, and in the near future it may become advisable to move completely to SOFR or another alternative rate.

4. Until LIBOR goes away, new contracts will need to contain more robust fallback language.

Going forward, ARRC recommends that market participants begin drafting new agreements with the permanent discontinuation of LIBOR in mind. ARRC has proposed unique sets of fallback language for floating rate notes, bilateral loans, syndicated loans, securitizations and residential adjustable-rate mortgages. For example, for syndicated loans, ARRC has proposed “hardwired” and “amendment” approaches. Under the hardwired approach, a waterfall of potential replacement rates is used, including term SOFR, compounded SOFR, or another alternate rate agreed upon by the agent and the borrower. Under the amendment approach, similar to the existing fallback language in many contracts, the agent and the borrower shall agree on a replacement rate, but with specificity regarding trigger events and spread adjustments not found in existing fallback language.[9] Similarly, ISDA has engaged in consultations on fallback language for derivative products.

Also included in the fallback language proposed by ARRC and ISDA are spread adjustments to minimize the difference between LIBOR and SOFR. Because SOFR is a secured risk-free rate and does not incorporate a risk premium like unsecured interbank rates do, a spread adjustment mechanism will need to be added in the event a deal “falls back” from LIBOR to SOFR. Both ISDA and ARRC have decided to use static spread adjustments that are calculated once at the discontinuation of LIBOR, but ARRC has indicated a possible one-year transition period, during which the spread adjustment would be calculated based on the difference between the two rates at the cessation date and the difference in the long run.[10]

5. Market participants should remain active and flexible, as uncertainty still surrounds the transition.

While strides have been made, considerable uncertainty still surrounds the transition away from LIBOR. Despite the apparent consensus that SOFR will succeed LIBOR, it may not be the only alternative rate available. Many US companies have been advised to use several short-term benchmark rates in place of LIBOR, and Federal Reserve Chairman Jerome Powell has indicated the Federal Reserve’s openness to exploring a separate, credit-sensitive reference rate.[11] As Powell acknowledged, many small and midsize banks have concerns about SOFR. These banks generally do not have large holdings of government securities that are normally posted by borrowing banks as collateral in the market underpinning SOFR, which could lead to an asset-liability imbalance that would create problems in times of financial stress. However, while SOFR may not be a “one size fits all” solution in every instance, it is the only replacement rate to be endorsed by ARRC at this time. In addition to the uncertainty surrounding the replacement rate of choice, market participants should also be aware of the potentially significant collateral consequences that could result from the transition, including tax, accounting, litigation, and regulatory risks involved in amending existing deals.

Copyright © 2025 Womble Bond Dickinson (US) LLP All Rights Reserved.

National Law Review, Volume X, Number 70

Source URL:https://natlawreview.com/article/libor-to-sofr-five-things-every-financial-services-provider-should-know