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Floating-Rate Loans | Leveraged Credit

SOFR on track to replace Libor as loan benchmark by year end

Andrew N. Sveen, CFA
Co-Director of Floating-Rate Loans
Eaton Vance Management

Christopher Remington
Institutional Portfolio Manager
Eaton Vance Management

Boston - The transition to the Secured Overnight Financing Rate (SOFR) as a replacement for the London Inter-bank Offered Rate (Libor) — the predominant benchmark for floating-rate loans — is on a smooth track, and we expect it to be official by December 31, 2021.

SOFR reflects a broad universe of overnight U.S. Treasury repurchase agreement (repo) activity based on more than $800 billion in daily transactions. A repo is a form of short-term borrowing, typically overnight and primarily in government securities.

"The transition from Libor to SOFR is well underway, thanks to the flexibility of most loan contracts. We continue to anticipate an uneventful final transition to SOFR in the years ahead."

Path of transition

The transition began officially in 2017, when the Alternative Reference Rate Committee (ARRC) — a panel convened by the U.S. Federal Reserve — selected SOFR to replace U.S. Libor for dollar-denominated loans. The change has been planned to go into effect no later than the end of 2021.

In November 2020, U.S. and U.K. banking regulators announced that the December 31, 2021 sunset for Libor would remain in place for newly originated loans, although legacy contracts of most U.S. dollar (USD) Libor maturities could be extended to June 2023. The regulators stressed that Libor-based loan originations should conclude "as soon as practicable," but not later than the end of this year.

So newly issued Libor-based loans will soon be a thing of the past, and sometime in 2021 we expect to see the birth of SOFR-based loans. Meanwhile, the extension to remediate existing Libor-based loans to mid-2023 suggests to us that the asset class has a nice long runway to make a smooth transition.

The transition will take a variety of forms: new SOFR-based loans dropping into the market upon issue, legacy Libor-based loans reaching maturity, or other pay downs, refinancing and amendments.

Impact of new benchmark

It should be noted that the $1.2 trillion market for loans is but a speck on the $300 trillion-plus global stage for Libor-based instruments. We see no reason why this asset class won't adopt the new rate as smoothly as all the rest. This is a global effort and the right things are happening to effect it.

We would also remind investors that the move from one base rate to the other should be virtually "invisible" in terms of the performance and characteristics of this asset class. Loans will still float, have similar yields and behave in the same way.

As a practical matter, the transition is already well underway, thanks to the

flexibility of most loan contracts. A longstanding feature of loan credit agreements is that they typically have "fallback" language specifying another reference rate — such as the prime rate — in the event that Libor becomes unavailable.

The Loan Syndications and Trading Association (LSTA) reports that updated fallback language has been routinely included in new and amended credit agreements, enhancing the ability of market participants to adopt SOFR at the appropriate time.

Bottom line: We continue to anticipate an uneventful final transition to SOFR in the years ahead.

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