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USD loans - Countdown to SOFR ... but which one?

From 1 January 2022 lenders should not issue new loans referencing USD LIBOR, even though USD LIBOR for most tenors will continue to be published until 30 June 2023.

As the New York Federal Reserve's Alternative Reference Rates Committee ("**ARRC**") allows market participants to choose between various alternative rates, there is currently no consistency in the approach of ship finance lenders. Furthermore, a few ship finance lenders and borrowers have still not selected their preferred alternative rate.

The purpose of this article is to explain the different alternatives for USD loans, with suggestions on when each rate may be more appropriate.

Backward looking ("in arrears") reference free risk rates

These rates are indisputably the US and the UK regulators' preference because they are anchored firmly on transaction data and are, therefore, more accurate indicators of borrowing costs, compared to a forward-looking rate such as LIBOR, which includes a credit premium (to take into account the risk of lending to another bank on an unsecured basis) and a liquidity premium (to take into account the risk of lending for a term).

For dollar-denominated loans, the recommended reference free risk rate is the secured overnight financing rate ("**SOFR**"). This is a daily rate published by the Federal Reserve Bank of New York which is based on transactions in the US Treasury repurchase market, where investors offer banks overnight loans backed by their bond asset. SOFR has been published since April 2018.

However, using a backward-looking rate like SOFR means more internal work for a lender. For each day of an interest period, the lender will need to obtain the applicable overnight SOFR and calculate daily interest in accordance with the commercial terms. As a result, the lender will only be able to notify the borrower of the amount of interest payable at the end of each interest period. To allow the borrower to have a few days to arrange for payment, a lookback period (with or without observation shift) will be used.

There are three principal ways to calculate interest based on overnight SOFR. These are (by order of complexity – lower to higher - in terms of their calculation):

- ***Simple Daily SOFR***

On each day during an interest period, the lender will calculate interest using the applicable SOFR, without any compounding. The total amount of interest payable for the interest period will be the sum of such daily interest amounts.

- ***Cumulative Compounded ("CC") SOFR***

At the end of each interest period, the lender will calculate a single CC SOFR based on each daily SOFR published during that interest period. Such single CC SOFR will apply to the whole interest period. The parties will need to agree what happens when the loan is prepaid or transferred in the middle of an interest period.

- ***Daily Non-Cumulative Compounded ("DNCC") SOFR***

The lender will calculate first the DNCC SOFR for each day during an interest period and then the sum of these for that interest period.

While DNCC SOFR is more complex to calculate and involves more internal work for a lender, this is the rate that has been recommended in the UK as it provides a more accurate reflection of interest that has accrued at the end of an interest period and on the occurrence of an intra-interest period event, such as a prepayment or a loan transfer. In addition, DNCC SOFR is the rate that has been implemented in ISDA documentation and, therefore, lenders issuing loans with a hedging element have opted for consistency. Finally, DNCC SOFR is the only rate for which the Loan Market Association ("**LMA**") published recommended drafts in March 2021, which means that most ship finance lenders trying to proactively transition away from USD LIBOR have started viewing this as market practice.

The table below summarises the available drafting options for these backward-looking rate options, their level of complexity and the types of loans and lenders who are more likely to use them.

Backward looking rate	**Available drafting in the UK (LMA) and the US (LSTA)**	**Internal implementation for lenders**	**Most appropriate for:**
Simple SOFR	LMA: no drafting available but DNCC template can easily be adapted LSTA: ARRC language available	A bit complex (collecting SOFR daily and aggregating simple interest for each interest period, lookback period needed)	All types of loans Any lender with a team that can provide the sum for each interest period
Cumulative Compounded SOFR	LMA: DNCC provisions can easily be adapted LSTA: no language available	More complex (collecting SOFR daily, calculating one CC SOFR at the end of each interest period, lookback period needed)	All types of loans Banks
Daily Non-Cumulative Compounded SOFR	LMA: recommended forms available LSTA: ARRC language available	Very complex (collecting SOFR daily, calculating DNCC SOFR each day and their sum at the end of each interest period, lookback period needed)	All types of loans, especially syndicated loans that are hedged Larger banks

Forward-looking ("term") rates

Due to the significant practical and operational difficulties that backward-looking rates present for borrowers and lenders, many loan market participants pointed out that forward-looking term rates are essential for loans.

- ***Term SOFR***

As a result of these concerns, the ARRC approved the use of Term SOFR in April 2021 and selected the CME Group as the administrator of Term SOFR in May 2021. The CME Group started to publish Term SOFR soon after and, in July 2021, the ARRC published Best practice recommendations, Term SOFR conventions and certain use cases for how best to employ the Term SOFR Rates to successfully transition away from USD LIBOR.

In such conventions the ARRC states that:

(a) it "*supports the use of SOFR Term Rates in addition to other forms of SOFR for business loan activity —particularly multi-lender facilities, middle market loans, and trade finance loans—* ***where transitioning from LIBOR to an overnight rate has been difficult and where use of a term rate could be helpful in addressing such difficulties***"; **however**

(b) it "***does not support the use of the SOFR Term Rate for the vast majority of the derivatives markets****, because these markets already reference SOFR compounded in arrears and transitioning derivatives markets to the more robust overnight risk-free rates is essential to ensure financial stability as emphasized by the Financial Stability Board*".

At the end of October 2021, the LMA published a Term SOFR exposure draft for their single currency term and revolving facility for use in developing markets.

Term SOFR constitutes forward-looking estimates of overnight SOFR over tenors of one month, three months, six months and twelve months. It is calculated by means of using data from SOFR futures to provide estimates of future overnight SOFRs for each day over the relevant period. A compounded average of those estimated overnight SOFRs is then calculated. That compounded average is then published as "Term SOFR".

Term SOFR is calculated and published:

(a) on each US Government Securities Business Day (US Government Securities Business Days are days which are not: (i) a Saturday or a Sunday; or (ii) a day on which the Securities Industry and Financial Markets Association recommends a full closure for trading of US Government securities);

(b) at 5:00am Chicago time (6:00am New York time and, typically, 11:00am London time) on that day;

(c) on a forward-looking T+2 basis taking into account US Government Securities Business Days. This means that the tenor covered by a published Term SOFR is that which starts on the day which is two US Government Securities Business Days after the publication day of that published Term SOFR; and

(d) without being subject to subsequent correction and republication.

For further information on the characteristics of Term SOFR, refer to CME Term SOFR Reference Rates Benchmark Methodology (Version 1.3 dated 18 October 2021); and the CME Term SOFR Reference Rates Benchmark Statement (dated 20 September 2021).

- ***SOFR Averages***

Another forward-looking rate option is SOFR Averages, which are compounded averages of the SOFR over rolling 30-, 90-, and 180-calendar day periods. These are published on each US Government Securities Business Day on the website of the Federal Reserve Bank of New, shortly after the SOFR itself for that business day is published. For more information on the SOFR Averages and Index's publication schedule and methodology, please refer to Additional Information about Reference Rates Administered by the Federal Reserve Bank of New York.

Because SOFR Averages are provided for daily rather than monthly periods, they do not seem to have become popular in the lending market.

The table below summarises the available drafting options for these term rates, their level of complexity and the types of loans and lenders who are more likely to use them.

Term rate	Available drafting in the UK (LMA) and the US (LSTA)	Internal implementation for lenders	More appropriate for:
Term SOFR	LMA: available exposure draft LSTA: ARRC language available	Easy A licence is required to obtain same day Term SOFR	Loans without hedging Lenders and other entities (e.g., lessors/lessees) who do not have the infrastructure to calculate interest using backward-looking rates
SOFR Averages	LMA: no drafting is available but Term SOFR draft can be adapted LSTA: the ARRC has some suggested language	Easy	Loans without hedging Lenders and other entities (e.g., lessors/lessees) who do not have the infrastructure to calculate interest using backward-looking rates. Tenors will need to be adjusted to daily periods

Other rates

There are some other alternative rates, like fixed rates and credit sensitive rates (e.g., the Bloomberg Short Term Bank Yield Index), but these do not seem to be popular in the ship finance market, especially credit sensitive rates, as various regulators have publicly expressed concerns about the risks embedded in such rates.

Key loan conventions

As some form of "in arrears" SOFR or Term SOFR is likely to become the preferred alternative in ship finance, the table below summarises the key loan conventions that apply to each, in comparison with USD LIBOR.

<table>
<tr><th></th><th>LIBOR</th><th>CME's Term SOFR Reference Rates</th><th>"in arrears" SOFR</th></tr>
<tr><td>Entity publishing rate</td><td>ICE Benchmark Administration</td><td>CME Group Benchmark Administration Ltd</td><td>The Federal Reserve Bank of New York</td></tr>
<tr><td>Available tenors</td><td>Overnight/spot next day, one week, one month, two months, three months, six months and twelve months</td><td>One month, three months and six months</td><td>Only available as an overnight rate</td></tr>
<tr><td>Where to get the rate</td><td>This website</td><td>This website (same-day data requires a licence)</td><td>This website</td></tr>
<tr><td>Type of rate</td><td>Forward-looking term rate</td><td>Forward-looking term rate</td><td>Backward looking daily rate - the rate applicable to any day is only known on the next business day</td></tr>
<tr><td>Alignment with length of interest periods</td><td>Easy alignment between LIBOR tenors and usual loan interest periods</td><td>Easy alignment for tenors of one month, three months and six months. For other tenors, parties can either use the next closest rate or, if the lender/agent has the operational capability to do so, interpolate between the two closest rates</td><td>No alignment possible</td></tr>
<tr><td>Lookback</td><td>Using the rate published two London business days prior to the first day of the interest period and held for the entirety of the interest period</td><td>Using the rate published two US Government Securities Business Days prior to the first day of the interest period and held for the entirety of the interest period</td><td>LMA: five London business days
ARRC: no recommendation
Without observation shift is the preferred approach (but with observation shift can also be adopted)</td></tr>
<tr><td>Rate publication calendar</td><td>Every applicable London business day</td><td colspan="2">Every US Government Securities Business Days</td></tr>
<tr><td>Holiday and weekend convention</td><td>Any day that is a non-business day in London</td><td colspan="2">Any day that is not a US Government Securities Business Day</td></tr>
<tr><td>Business Day Convention</td><td colspan="3">"Modified Following Business Day" convention, meaning that payments that are scheduled to be paid on a day that falls on a non-business day will be adjusted to the next succeeding business day, unless that business day falls in the next succeeding calendar month, in which case the interest payment date will be the preceding business day</td></tr>
<tr><td>Day counts (USD)</td><td colspan="3">Actual/360 days, which is the standard convention in US money markets</td></tr>
<tr><td>Rounding</td><td colspan="3">Rate published to five decimal places; dollar amounts can be calculated to two decimal places</td></tr>
<tr><td>Credit adjustment spread ("CAS")</td><td>N/A
LIBOR has built into it a credit premium and a liquidity premium</td><td colspan="2">Legacy loans: optional – preferred method seems to be ISDA historical median approach. LMA does not provide suggested wording (but ARRC does). Credit adjustment spread to be added after rate compounding (i.e., not to be compounded)</td></tr>
</table>

	LIBOR	**CME's Term SOFR Reference Rates**	**"in arrears" SOFR**
		New loans: not recommended by ARRC; optional (and less expected) in LMA drafting (Baseline CAS) The spread adjustments are available here. In summary, the fixed and static spread adjustment for USD one Month is 11.448bps, for USD three months is 26.161bps and for USD six months is 42.826bps	
Interest rate floors	Optional zero floor wording in the definition of LIBOR	**All loans**: any interest rate floor to apply to the SOFR Average or Term SOFR **Legacy loans**: if a spread adjustment applies, zero floor to apply to the resulting Term SOFR plus the related spread adjustment From a drafting perspective, zero floor reference is likely to be included in definition of Term SOFR	Optional zero floor wording in definition of Daily Rate If there is a zero floor, it is recommended that the floor be calculated daily and not at the end of an interest period. The floor on a newly originated SOFR loan will be applied to SOFR (not to any CAS)
Break costs	Loan agreement may include language that compensates lenders for funding losses (e.g., losses sustained due to an intra-period prepayment, conversions or continuations or the failure to make borrowings or payments when due or scheduled)		No recommendations Debate on whether such costs are appropriate for RFR rates. Bespoke wording to be added to the loan agreement
Temporary unavailability of rate / fallback language	LMA Reference Bank Rate clause LMA cost of funds clause LMA market disruption clause	Recommendation to include a temporary fallback convention if either the relevant SOFR Average or Term SOFR is not published for a short time Alternative: interpolation in the event of any temporary unavailability of any tenor of the benchmark. This option will depend on the operational capabilities of the lender/agent It is important that loans include robust, workable fallback language	Central Bank Rate If no RFR or Central Bank Rate, optional cost of funds clause Optional market disruption clause
Borrowing notice period	Borrower to provide a utilisation request three US Government Securities Business Days prior to the borrowing date Bilateral loans may have more flexibility in borrowing notice periods		No recommendation, no change in approach in LMA draft

Conclusion

With only a few weeks before USD LIBOR is prohibited for use in new loans, ship finance lenders should be finalising their decision regarding the alternative rate they will use in their new USD loans from 1 January 2022 and their preferred commercial terms as such loans will be a priority so far as the LIBOR transitioning process is concerned.

To ensure consistency in their ship finance portfolio, lenders are advised to develop their own template provisions and term sheets for their bilateral loans and syndicated loans where they act as agent.

Finally, lenders should be finishing the update of their internal systems and training relevant staff to generate new interest calculations and to comply with any new notification obligations.

As for borrowers, they should make sure that they are able to process interest payments at short notice when a backward-looking rate applies.

Let the final countdown begin!

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