

THE TRANSITION FROM LIBOR – IMPLICATIONS FOR SUPERTRUMP LEASE AND LOAN PRICING

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Introduction

LIBOR, the London Inter-Bank Offered Rate, used universally for many years, is being phased out. In the US, bank regulators will not permit new contracts based on LIBOR subsequent to December 31, 2021, and all LIBOR rates will cease to be published after June 30, 2023.

Beginning in 2022, all dollar-denominated leases and loans, derivatives, and other forms of debt that otherwise would have been priced based on LIBOR must be priced using a different interest rate. One is SOFR – the Secured Overnight Funding Rate - and another is BSBY – the Bloomberg Short Term Bank Yield Index. Further, all contracts using LIBOR should be terminated or re-structured by June 30, 2023, according to the US Fed and regulators in the UK.

SOFR is calculated as the median of rates that market participants (investors) pay to borrow cash on an overnight basis using Treasury securities or bank securities such as loans and assets backed by bonds as collateral. In contrast, the term structure of LIBOR includes seven rates - overnight, one-day, one-week, two-week, one-month, six-month, and one-year - and because LIBOR rates are based upon borrowing by banks, it has a built-in credit risk component.

Calculating the SOFR rate relies on transaction data; LIBOR is based partially on market data using “expert judgement” to calculate the rates.

Phase Out

The following LIBOR rates will cease publication on December 31, 2021: one-week and two-week. There is a possibility that a synthetic rate may be available for these two terms after December 31, 2021.

The following LIBOR rates will cease publication on June 20, 2023: overnight, one-day, one-month, six-month, one-year.

Complication

Contracts that are based on LIBOR or the term structure of LIBOR and need to be updated prior to termination will need to be based on another interest rate such as SOFR, or a synthetic rate approximating SOFR, or BSBY. Calculating the SOFR rate comparable to LIBOR will involve a complicated calculation and estimate.

Contracts

Loans and leases tied to LIBOR may need to be renegotiated or amended to reflect the use of a new rate, along with any credit spreads which may change. Given that no LIBOR rates will be published after June 30, 2023, it seems that all open contracts based on LIBOR at that date will need to be amended to adopt another rate.

Industry Trends

Most of the equipment finance industry's major lessors use Ivory Consulting's SuperTRUMP, the proven solution for modeling and pricing equipment leases and loans. Although SuperTRUMP is designed to handle many types of interest rates, several of our clients have requested customizations to SuperTRUMP to account for their anticipated use of SOFR or BSBY instead of LIBOR. Each of the requests we have received to modify SuperTRUMP is different, leading to the conclusion that there will be many ways of incorporating SOFR and/or BSBY into equipment leases and loan modeling and pricing.

SuperTRUMP Modifications

To date, several SuperTRUMP customers have requested customizations related to their unique adoption of a new rate. These customizations can be summarized into seven categories:

- Ability to use LIBOR, along with SOFR, BSBY, Average Life and Like Term Swaps on menu of interest rates that are used to calculate overall cost of funds.
- Ability to choose between various indexes on a deal-by-deal basis.
- Ability to include a SOFR index curve with multiple rates including a 30-day and a 90-day rate.
- Add SOFR to tables that are used to calculate rates and add a user-defined spread adjustment.
- Ability to add a liquidity premium adjustment amount to all SOFR rates.
- Ensure all rate lookup tables accommodate both LIBOR and SOFR/BSBY rates.
- Support different Liquidity Premiums for different indexes.

This white paper is based upon generally available data including (1) Morgan Stanley, "Transitioning LIBOR: What It Means for Investors," October 2019; and, (2) The National Law Review, Issue 8, "Libor Transition," March 2021.