LIBOR Transition:
USD Replacement Rate Approach and Experiences

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USD Replacement Rate Approach and Experience

- USD LIBOR Replacement Rate Alternatives – How US Market Got to Term SOFR
- SOFR Adoption Experience
- Credit Spread Adjustment ("CSA") Experiences
- Remediation Menu

Replacement Rate Alternatives Weighed by Loan, CLO Market: Part 1, Daily Rates

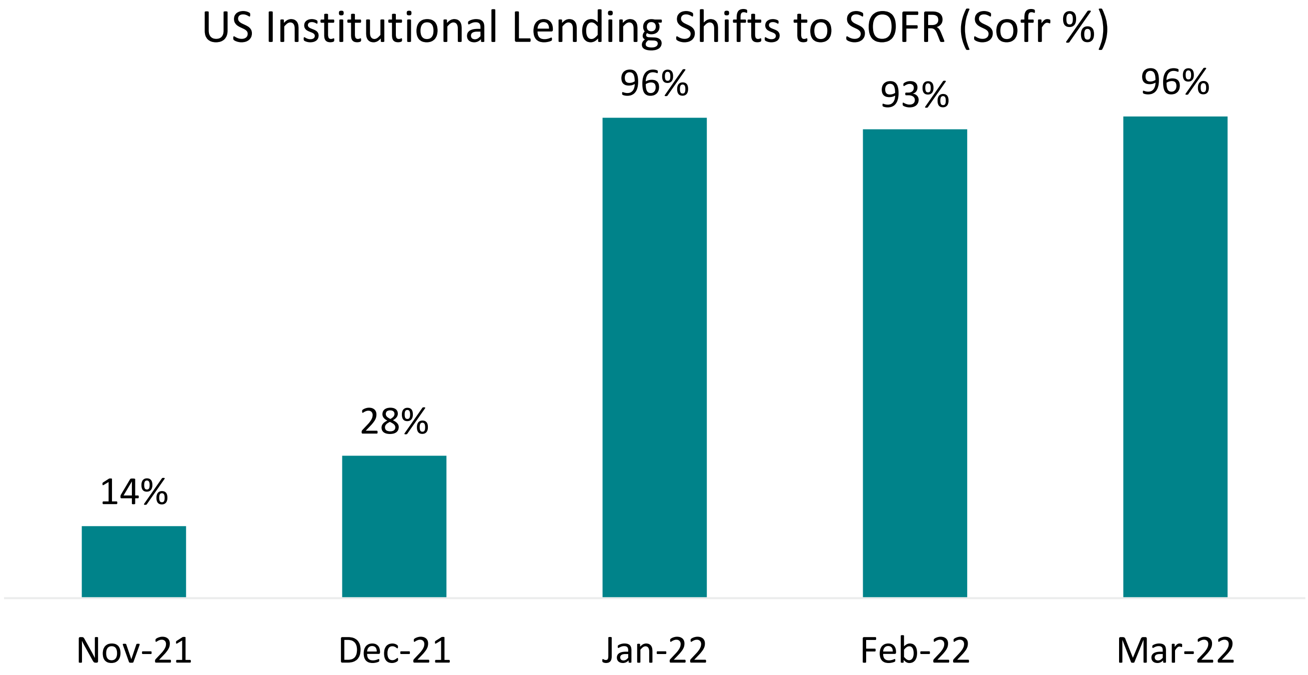
- Daily Compounded SOFR
  - Rate calculated daily and *not* known in advance ("known in advance" was strongly desired in loan, securitization markets)
  - *More* aligned with derivatives, but lookback was hard to align
  - Was viewed as very operationally complex for prepayable loans and CLOs with time sensitive tests (like IC)

- Daily Simple SOFR
  - Rate calculated daily and *not* known in advance ("known in advance" was strongly desired in loan, securitization markets)
  - Somewhat aligned with derivatives, but lookback was hard to align
  - Economically nearly identical to Daily Compounded SOFR
  - While easier implement than Daily Compounded SOFR, still operationally complex for loans and CLOs with time sensitive tests (like IC)

Replacement Rate Alternatives Weighed by Loan, CLO Market: Part 2, “Known in Advance” Rates

- SOFR Compounded in Advance (e.g., using the _previous_ period’s compounded SOFR for the _current_ interest period)
  - Rate is known in advance (which was strongly desired in loan, securitization markets)
  - Used in Agency RMBS
  - Strong resistance from banks who balked at the temporal asset-liability mismatch
- Forward Looking Term SOFR
  - Rate is known in advance (which was strongly desired in loan, securitization markets)
  - ARRC recommended CME Term SOFR; use cases focused on business loans and related securitizations
  - US Regulators accepted Term SOFR
- Some Credit Sensitive Rates like BSBY and Ameribor3M
  - Use market data inputs to create a CSR term structure
  - With regulatory pushback, use may be limited to certain areas of traditional bank lending

USD Leveraged Loan Market Shifts to SOFR in Jan 2022



SOFR: Approaches to Pricing

- SOFR is a Risk-Free Rate; LIBOR is a Credit Sensitive (e.g., Credit-Risky) Rate
- Therefore, the SOFR Curve (e.g., 1M/3M/6M SOFR) should be *lower* and *flatter* than the LIBOR Curve (e.g., 1M/3M/6M LIBOR)
- Market has taken several approaches to adapting to the differences in the SOFR Curve
  - Flat Credit Spread Adjustment ("CSA") - 10 bps across the curve; addresses the fact that SOFR is lower but does not address the fact that it is flatter
  - CSA Curve – typically 10 bps for 1M/15 bps for 3M/25 bps for 6M; addresses *both* SOFR being lower and flatter
  - No CSA, with any difference in LIBOR and SOFR theoretically included in the loan margin
- Many lenders expect we will end up in a "No CSA" world, where credit is priced over the risk free rate (like LT bonds price over Treasuries)
- Market practice with respect to CSAs is evolving

Remediation

- Transition to SOFR-based lending has been smoother than expected
- USD LIBOR will entirely cease on June 30, 2023
- There are trillions of dollars of USD loans that must switch from SOFR to replacement rates before or around June 30, 2023
- Transition approaches
    - Refinance directly into replacement rate prior to June 30, 2023
    - Early Opt-In Fallback language
    - Fallback at LIBOR cessation
    - If loan has no formal fallback language, it is likely to switch to Alternate Base Rate