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No Way CSA

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Recent changes in LIBOR and SOFR levels have upended a multi-year conversation between borrowers and lenders about what credit spread adjustment, if any, is appropriate to be added to SOFR-based interest rates when credits switch from LIBOR to SOFR. LIBOR and SOFR are fundamentally different reference rates because LIBOR is a credit-sensitive rate, which includes the cost of funds to banks, and SOFR is a risk-free rate tied to the cost of borrowing against treasuries. Because the determination of LIBOR factors in bank risk, while SOFR does not, LIBOR can generally be expected to trend higher than SOFR. An economically neutral transition from LIBOR to SOFR has therefore been thought to require a "credit spread adjustment" or "CSA." With this understanding, the Alternative Reference Rates Committee (the "ARRC"), the arm of the Federal Reserve (the "Fed") tasked with managing LIBOR cessation, recommended CSAs for one-month, three-month and six-month interest rate tenors. The ARRC calculated these CSA numbers based on the median difference between LIBOR for a particular interest period and SOFR over the same period calculated over a five-year lookback period. On March 5, 2021, the ARRC published these recommended CSA numbers (11.448 bps for one month, 26.161 bps for three months, and 42.826 bps for six months) and also stated that the numbers were intended to be static and should not change with market shifts to either rate.

Meanwhile, all throughout 2021, leveraged loan market participants waited for a suitable version of SOFR to become available to replace LIBOR in their deals. Certain Borrowers did not want to replace LIBOR with Daily Simple SOFR, which was the version of SOFR available at that time, because use thereof would prevent them from being able to lock in their interest rate costs at the beginning of an interest period. LIBOR cessation was first announced in 2017, and by the first quarter of 2021, a forward-looking, term-based version of SOFR was still not available as a replacement. The Fed and other regulatory bodies exhorted borrowers and lenders to adopt Daily Simple SOFR, and not to wait for a term-based version of SOFR, but loan market participants held out and ultimately turned to other credit-sensitive rates such as BSBY and Ameribor. The ARRC, not wanting to see one credit-sensitive rate replaced with another, finally endorsed the use of CME Term SOFR in August of 2021. By that point, however, LIBOR had shifted. For borrowers that had incorporated the ARRC's CSA numbers into their documents at the Fed's urging, and under pressure from regulated bank lenders, transitioning from LIBOR to SOFR would now make their loans more expensive instead of equally or less expensive. Banks struggled to move their existing loans to SOFR with CSA numbers that made the transition unattractive to their borrowers. In the last quarter of 2021, banks and lenders began to adopt and promote lower CSAs to address this problem. Many banks opted for CSA numbers of 10 basis points, 15 basis points, and 25 basis points for one-month, three-month and six-month SOFR, respectively. Some lenders adopted CSAs of 10 basis points for all tenors. The market continued to debate and negotiate the appropriate level of CSAs from the time Term SOFR became available until today.

The CSA debate reached its apex in July 2022, when SOFR unexpectedly rose higher than LIBOR. The downward shift of LIBOR and upward shift of SOFR were caused by market factors including inflation, supply chain issues, the war in Ukraine, and potential oil shortages, none of which are expected to resolve overnight. SOFR continues to trend higher than expected and LIBOR lower than expected, skewing the expected delta between the two reference rates. Loan market participants are now left wondering what to do with a CSA construct that seems at best unnecessary and at worst nonsensical. The situation is particularly thorny for credits that are transitioning from LIBOR to SOFR, since the ARRC-sanctioned amendment provisions provide that changes to loan documents made in connection with SOFR must be "consistent with market practice." This would mean that while new credits have the flexibility to abandon the CSA and set SOFR margins as they see fit, borrowers in existing credits may be stuck with higher interest rates than anybody contemplated when the ARRC's numbers were promulgated depending on the interpretation of market practice by the relevant participants at the relevant time. All loan documents must be transitioned off LIBOR prior to the end of June 2023, so while existing loans can continue to avoid this issue by staying on LIBOR for a little while, ultimately, they will have to address the issue posed by the now-cumbersome CSA. Having now witnessed the impact of LIBOR/SOFR market dislocation, Borrowers in new credits can be expected to more closely consider inclusion of a CSA construct in their new deals. Similarly, Borrowers in existing loans will likely prevail upon the reasonableness of their lenders in negotiating CSAs in connection with amendments effecting SOFR transition.

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