COUNTDOWN TO SOFR

TIPS FOR TRANSITIONING FROM LIBOR INTEREST RATES

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SOFR is Here
WHAT DO LESSORS NEED TO KNOW — AND DO?

Since the mid-1980s, the LIBOR (London Inter-Bank Offered Rate) has been the foundational interest rate used by banks to frame credit agreements. However, the rate's reliance on estimated bank transactions — rather than actual transaction data — has slowly eroded confidence in its ability to accurately predict interest rates as markets become increasingly interconnected and complex.

Transitioning to SOFR (Secured Overnight Financing Rate) offers the potential to bring much-needed reliability to this seemingly antiquated market barometer. The change will bring positive change for both lenders and borrowers — but navigating through the first major benchmark interest rate changes in nearly 40 years undoubtedly will create new challenges for financial institutions of all sizes and in all markets.

This ebook offers a high-level look at the key differences between the outgoing and incoming benchmark rates. It also identifies some of the important steps lessors can take to minimize business disruptions during the transition. The recent COVID-19 pandemic adds complexity to the issue, which will also be covered in this e-book.

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LIBOR No More

QUICK HISTORICAL REVIEW OF LIBOR AND THE PUSH FOR A REPLACEMENT

After the global financial crisis of 2008, LIBOR was one of many economic practices scrutinized by regulators. The methodology used to calculate LIBOR rates has always leaned heavily on estimated transactions, rather than actual bank transaction data, which opens the door to irregularities — and in some cases, fraud (see the LIBOR Scandal).[1] Following a steady decline in usage, the International Exchange Benchmark Administration (IBA) announced it would no longer require banks to submit inter-bank lending information after 2021 — effectively setting a phase-out date for banks to move to alternative benchmarks.

In order to select an alternative solution for dollar-denominated loans and securities, the U.S. Federal Reserve commissioned the Alternate Reference Rate Committee (ARRC) in 2014. Unlike its predecessor, the new U.S. benchmark — SOFR—is based on actual transactions in the U.S. repurchase agreement (Repo) market.

Additional Differences Affecting SOFR-based Contracts

LIBOR	SOFR
Offers multiple varying term rates—from as small as one day to as large as one year	Functions as a single, daily rate—or overnight rate
Includes built-in credit-risk because it uses average borrowing costs	Offers a "risk-free" solution tied to Treasury transactions[2]

Through 2021, LIBOR and SOFR will continue to coexist and provide lenders with a choice of rate calculation tools. During this transitional period, migrating to a new benchmark rate will not be as easy as plugging new formulas into spreadsheets. According to ARRC research at the time of SOFR's introduction in 2018, there are still trillions of dollars in LIBOR-based contracts still outstanding — some of which will not fully mature until after LIBOR is phased out.[3]

For lessors, this uncertain time of mixed rates will require the repricing of many existing contracts. In most cases, switching to SOFR rates provide necessary protection of profit margins, so it will be worth the effort. But executing a changeover strategy will require careful preparation and foresight in order to properly design and deploy portfolio management practices that mitigate these complexities and set lessors up for long-term success.

[1] NY Times: https://www.nytimes.com/interactive/2015/04/23/business/dealbook/db-libor-timeline.html
[2] Morgan Stanley: https://www.morganstanley.com/ideas/libor-its-end-transition-to-sofr
[3] Reuters: https://www.reuters.com/article/us-usa-bonds-libor/u-s-libor-exposures-larger-than-thought-at-200-trillion-arrc-idUSKBN1GH2Z8

Outdated Solutions Won't Cut It

NEW BENCHMARKS REQUIRE UPDATED CALCULATIONS

No matter which lease origination tools you currently use, the calculations in existing contracts likely don't account for the key differences between LIBOR and SOFR benchmark rates. During the transitional period before LIBOR sunsets in 2021, financial institutions will be tasked with navigating unprecedented complexity as they manage contracts across the two benchmarks — a process that clearly requires automation in order to maintain acceptable levels of accuracy, responsiveness and operation efficiency.

For organizations using spreadsheet-based systems, these contract management challenges will be magnified. Spreadsheet-based management systems present significant disadvantages, as lessors begin recalculating their deals to safeguard against the prospect of reduced- or no-margin contracts under the new benchmark rate.

This new complexity, created by the concurrent use of two rates, opens the door to human errors that could lead to costly mistakes. It also increases the possibility for unplanned operational expenses and reduced critical business efficiency.

As financial institutions make the leap to new rates and calculations, cloud-based accounting systems offer one way to automate lease management and minimize the changeover risks inherent in slow, manual accounting processes on spreadsheets.

> *"Given the degree of uncertainty and complexity, LIBOR transition is likely to be one of the (if not the) biggest transformation programs many firms have undertaken."*
>
> *-Deloitte, 2018* [4]

[4] Deloitte: https://www2.deloitte.com/us/en/pages/regulatory/articles/libor-transition-resource.html

Impact of Coronavirus

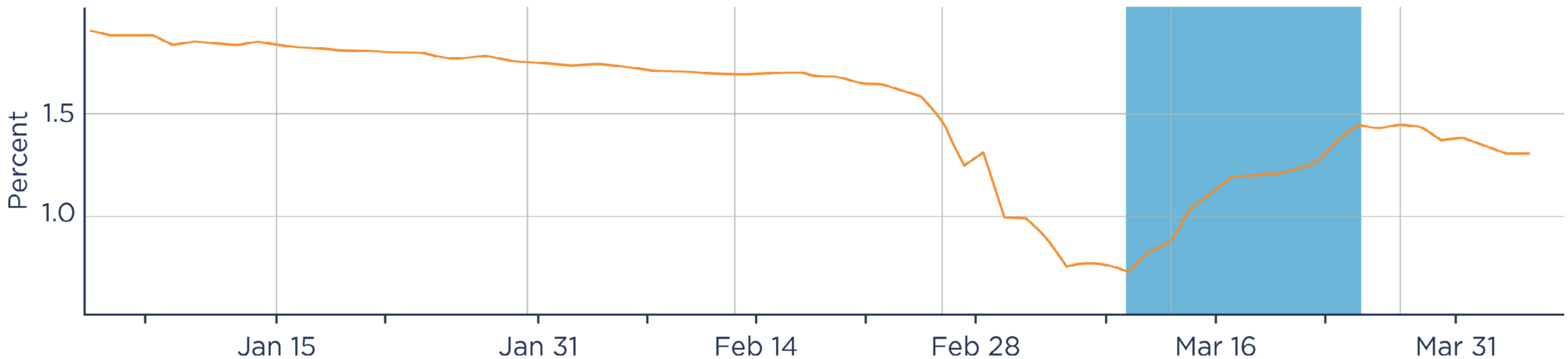
STILL MOVING, BUT WITH SOME CAVEATS

Significant market volatility created by the coronavirus pandemic has reaffirmed the need to shift away from the LIBOR benchmark. Despite considerable efforts from the Fed to ease financial pressure by introducing rock-bottom interest rates, LIBOR rates skyrocketed in March — rising to a peak of just over 1.45%. For LIBOR critics, this is the latest example of the growing disconnect between LIBOR and the rest of the global economy.

LIBOR Losing Touch

In an attempt to encourage economic activity during the 2020 pandemic, the Fed reduced interest rates to zero. Instead of dropping, LIBOR rates soared

3 Months of LIBOR rates



SOFR is not necessarily immune to these same challenges. Like LIBOR, SOFR can be vulnerable to market volatility as well. Last September, for example, the SOFR market rose 10% in a matter of days, forcing the Fed to take action to stabilize it. In response, the ARRC laid out new plans to institute term structures to help prevent similar spikes in the future.

However, additional growing pains throughout the next 12-24 months are to be expected — especially as lenders of all sizes navigate the new SOFR benchmark during an economic crisis. While the hope is that the end result will bring new stability to lending practices, these recent cases illustrate that lessors must be prepared to move quickly to protect their business — regardless of the benchmark they use. Enhancing internal flexibility and efficiency are both critical initiatives forward-thinking organizations must take to stay ahead of unexpected challenges.

[5] Yahoo! Finance: https://finance.yahoo.com/news/libor-replacement-grinds-forward-virus-213011756.html

Simplifying the Transition

IDENTIFYING THE RIGHT TECHNOLOGY TO TRANSACT WITH EFFICIENCY

LIBOR is deeply embedded in many lessors' systems and models. As a result, the decision to sunset LIBOR will necessitate the creation of entirely new benchmark rate calculations for the first time in decades. Most financial institutions simply don't have the processes and tools in place to execute such a move without risking profit margins, customer service or significant increases in operating costs.

In order to transition smoothly and create a stable a foundation for growth utilizing SOFR, agile and flexible tools will be critical. Lessors must be prepared to modify existing contracts that extend beyond 2021 and accurately calculate future contracts in order to protect profit margins. Before 2021 comes to a close, lessors also need to have the ability to manage contract portfolios that use both benchmarks, as remaining LIBOR contracts approach maturity.

For lessors who still use spreadsheets to track and calculate interest, toggling between both benchmark rates efficiently will be nearly impossible. Attempting this mostly manual process will likely frustrate borrowers and slow your carefully constructed workflows. Ditching spreadsheets in favor of cloud-based origination and portfolio management tools can help introduce much needed agility and flexibility to existing workflows. Choosing a solution that can automate calculations will allow your team to quickly navigate these changes and execute both LIBOR and SOFR contracts with confidence.

Key Advantages of a Cloud-Based Solution

- ✓ **Faster time to value** — immediate access to powerful asset finance tools.
- ✓ **Future proofing** — deploy innovative tools automatically and instantly.
- ✓ **Flexibility** — embrace new markets, products and assets without new infrastructure.
- ✓ **Disaster recover** — world-class AWS backup, server redundancy and availability.
- ✓ **Pay as you go** — simply pay for the capacity you use.
- ✓ **Work anywhere** — securely connect and work from anywhere.
- ✓ **Security** — built-in AWS advanced data security technologies.
- ✓ **Agility** — Onboard and authorize users instantly.

Quick Tips

PREPARING YOUR MOVE TO SOFR RATES

While there is no legally binding mandate to move to SOFR, the uncertainty around LIBOR's future makes it risky to continue executing LIBOR-based deals without a back-up plan. For that reason, it's important to plan your transition strategy early. Here are a few helpful best practices to build out your transition program.

1. SET YOUR TRANSITION ROADMAP

For most lessors, the transition period will create a challenging gray area as LIBOR- and SOFR-based contracts exist side-by-side. In order to protect their profit margins, lessors will need to adopt new leasing strategies that introduce fallback language to trigger transitions to the SOFR-based rate.[6]

2. CREATE A CROSS-BUSINESS-UNIT TRANSITION TEAM

The transition to new tools and systems will require an all-hands-on-deck approach. Lessors will need to account for the impact changing over to new benchmark rates will have on the entire organization in order to avoid costly mistakes.

3. ASSESS YOUR PROCESSESS AND TOOLS

Let's face it, your processes probably weren't designed to manage two benchmark rates at once. Before you begin the transition, evaluate your existing processes to see where new tools will be needed to manage leases across both SOFR - and LIBOR-based contracts.

4. CONSIDER A MOVE TO THE CLOUD

For many lessors, moving to a new benchmark interest rate will be a first. This means there will be few past experiences to rely on for guidance during the transition. Leveraging the insights and experience of a seasoned software solution is one way to help mitigate unexpected risks and ensure a seamless transition.

[6] Charles Schwab: https://www.schwab.com/resource-center/insights/content/libor-vs-sofr-navigating-transition

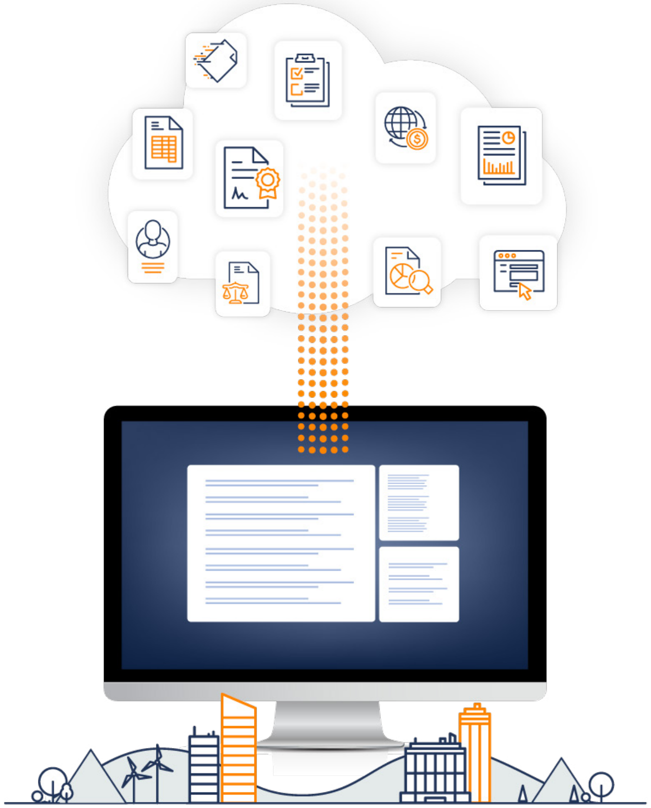
SOFR, New Lease Accounting Rules, COVID-19

PREPARE FOR ANY CHALLENGE WITH IDScloud

The world is presenting your business with lots of change and plenty of challenges. The best way to address it all? Infuse your operations with the agility of a true SaaS solution. IDScloud combines the capabilities of best-in-class Rapport® origination and InfoLease® portfolio management software. Deployment is fast and easy — all you need is an internet connection, and you and your team can work anywhere. Plus, with a true SaaS solution, you only pay for the features and capacity you need.

The modular design of our IDScloud solution offers more than seamless operational growth. It also creates a flexible foundation that allows us to innovate and bring new tools to the platform in real time. This means each time we develop a new tool to simplify the LIBOR-SOFR transition, you can capitalize instantly. No waiting or complicated changeover procedures.

Any industry. Any size operation. IDScloud is designed to scale to meet your exact operational and budgetary needs. See how our highly agile, cloud-based solution can drive new efficiencies into your leasing operation and empower your business to capitalize on emerging opportunities today and in the future.



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