Secured Overnight Financing Rate (SOFR)

Background:

In 2012, International investigations were launched to investigate potential effort to manipulate the rate of profit associated with LIBOR (London Inter-bank Offered Rate). The investigation revealed widespread issues going back as far as 2003. Billions of dollars in fines for were imposed on banks involved in the identified rate manipulation and some traders directly involved we given jail time.

The scandal undermined the credibility of LIBOR and deterred panel banks from continuing their involvement in LIBOR generation. Because LIBOR rates are collected by voluntary contribution, the number of contributing banks and their associated transaction detail has been on a steady decline. In July 2017, Andrew Bailey, Chief Executive of the Financial Conduct Authority (FCA) announced that LIBOR rates would only be formally sustained by the FCA through the end of 2021, due to limited market activity around LIBOR benchmarks and the declining contributions of panel banks.

In 2014, the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York (New York Fed) convened the Alternative Reference Rates Committee (ARRC) in order to identify best practices for alternative reference rates and contract robustness, develop an adoption plan, and create an implementation plan with timelines and associated metrics to gauge success.

In June 2017, the ARRC announced the Secure Overnight Financing Rate (SOFR) as its recommended alternative rate, and the New York Fed began publishing the rate on April 3, 2018.

SOFR Overview:

SOFR is a new overnight borrowing rate published by the Federal Reserve Bank which has a number of characteristics that LIBOR does not:

- It is a rate produced by the Federal Reserve Bank of New York (FRBNY)
- It is derived from an active and well-defined market with sufficient depth to make it extraordinarily difficult to ever manipulate or influence;
    - It is produced in a transparent, direct manner and is based on observable transactions, rather than being dependent on estimates, like LIBOR, or derived through models.
    - It is derived from a market that was able to weather the global financial crisis and that the ARRC credibly believes will remain active enough so that it can reliably be produced in a wide range of market conditions.

AARC identified Key considerations when utilizing SOFR

1. **Averaging: Compound or Simple**

   There are two types of averaging. Use of simple averaging may expedite your use of SOFR, but most ARRC members move toward compounding over time since it better reflects the time value of money.

2. **Payment Notice: In Advance, In Arrears, or Hybrid**
   - In Advance: An average of the overnight rates observed before the current interest period began.
   - In Arrears: An average of the rates over current the interest period and would only be fully known at the end of the interest period.
   - Hybrid: Reference an average of the overnight rates observed before the current interest period began but any adjustments to rates would make an adjustment to principal when payment is received or bill difference of interest on next invoice.

Current Status

IDS formed a working committee in July 2019.

- Initial meeting was held in July, most lessors were still in early gathering stages, the committee agreed to reconvene towards the end of 2019.
- A second meeting was held on Jan 21st, 2020 with 30% of the attending companies indicating they have finalized their strategy/approach to LIBOR being sunset.
- A subject matter expert (SME) meeting was held on January 14th 2020 to review existing InfoLease® functionality. This meeting was for IDS customers Floating Rate SME's to come together and review the SOFR ARRC guidelines and how InfoLease® existing functionality can accommodate the standard.

Current Features being considered by IDS to assist with SOFR processing based on working committee and IDS assessment.

Compounding Interest Cycle	Description
Compounding Frequency	IL-78525: Provide the ability to have daily compounding interest on a principal reduction contract
Compounding Rate Only	IL-78526: Allow the flexibility to compound the SOFR rate only (excluding rate variance)
Enhance Daily Rate Change to support "Look Back" period.	IL-82399: Allow the ability to utilize "Rate set days" when rate change is = daily
Track multiple "rate variances"	IL-80632: Allow the ability to track 2 "rate variances" on a contract. This would only be used to facilitate conversion of existing LIBOR contracts
Compounding Interest in Advance	IL-83924: Compound the interest and not the balance.

Next Steps:

- IDS is finalizing SOFR features that will be delivered on InfoLease 10.8 (targeted for Sept/Oct 2020). IDS continues to solicit feedback on the features and the priorities for the identified features.
- IDS will be reaching out to InfoLease 9 customers to understand their approach to SOFR.
- IDS customers that are not participating in the working committee are encouraged to provide input on the above 4 features being considered. IDS will be making an assessment based on the direct feedback from existing customers.
- InfoLease customers should be testing how their future SOFR contracts will be booked in InfoLease. If there are any additional gaps identified (other than above 4 noted), please contact kkosobuski@idsgrp.com by March 1st 2020.