LIBOR Webinar Transcript

Good afternoon, everyone, and thank you for joining us here today. It's been quite a journey so far with the many changes in terms of the departure from LIBOR. LIBOR is so well ingrained into US financial markets. In the US alone, there are over 200 trillion dollars of contracts tied to LIBOR. There's been many changes in the guidance the last few years. We've been working on this since 2018 with a cross-functional team internally within the bank, as well as drawing on the expertise of some leaders in the industry from Ernst and Young, and also Dentons, the international law firm that specializes in derivatives and contracts such as the ones we'll be talking about. Leading the efforts internally for Commerce are Kelsey Coady and Lauren Dixon Baker. They've been leading this project with regular meetings and keeping us well ahead of schedule and keeping on top of this so that we're in a good position to work with you today, to bring you as current as we possibly can on the activities that we've been taking, as well as some of the other changes and pivots even within the last couple of weeks and some other things happening with the industry on some other rates. You've heard a lot about SOFR, but some other rates are more commonly talked about being used. And we're studying ourselves. But I want to go ahead and turn the program over to Hannah Baker. Hannah is our facilitator today, she has to share a little disclaimer with you, and then she is going to introduce our panelists for today's program. So, again, thank you very much for joining us.

(Hannah) Thank you, Kevin. So we just want to remind everyone that the transition from LIBOR is an evolving process and subject to change as further guidance becomes available. This presentation is for general information purposes only and shouldn't be relied upon as a substitute for obtaining independent advice or undertaking independent research. And the presentation does not take into account any particular borrower's situation or need. So now I'm going to go ahead and introduce our speakers for today's session. From Commerce Bank, we have Kelsey Coady, Lauren Dixon Baker and Justin Seeler, who have been managing the LIBOR Transition Project. And we have a guest speaker joining us today from Ernst and Young, Jeff Vitale. So I'm going to turn it over to Kelsey Coady, who's going to get us started.
(Kelsey) Thanks, Hannah. And thanks, Kevin. And thank you all for joining. This project, as Kevin mentioned, is very important to us. So we're excited to share some information with you and happy to take questions which you can place in the chat throughout the presentation. And then we have allowed some time at the end to take your questions as well. So just going through the agenda today. So first of all, we'll share some background information on the LIBOR transition and associated key milestones. Jeff will share information about SOFR and other alternative reference rates that have come into being and Lauren will talk about the transition, what it means for you and what you can expect from Commerce Bank. And then we'll wrap up with key takeaways and have some additional time for questions. So on the next slide, we'll get into some of the background information and then some of the commonly used acronyms that you might hear. The LIBOR stands for London Interbank Offered Rate, and it captures what banks would lend to one another on an unsecured basis. It comes from Panel Banks submitting their LIBOR quotes on a daily basis. So in 2017, the Financial Conduct Authority, which is essentially LIBOR's regulator, announced that panel banks would no longer be required to submit their LIBOR quotes after December 31, 2021. That triggered a major step in the transition away from LIBOR. And as you've probably seen in the news or any industry publications, more recently, the US dollar LIBOR cessation date was extended to June 30, 2023, to allow more time for a successful transition. So you might be wondering, so why is LIBOR going away? So today there is very minimal bank transaction data

to support the LIBOR quotes that they're submitting. The goal of the transition is to move to a rate or rates that are backed by more robust transaction data. So then we'll talk about also what the ARRC and ISDA means. So these are two commonly used acronyms in the LIBOR transition. So the ARRC stands for the Alternative Reference Rates Committee, which was a group that was convened by the Federal Reserve Board and the New York Fed back in 2014, and really the goal of this group is to help facilitate a smooth transition away from LIBOR in the United States. The ARRC is made up of a number of industry participants, including banks, accounting firms, law firms and other financial institutions. And really, what they have done throughout the last few years is they've issued a great deal of guidance on various products and industries on how to transition away from LIBOR. This is also the group that has recommended SOFR, which we'll talk more about later. That's the Secured Overnight Financing Rate. Another term you may hear is ISDA, or the International Swaps and Derivatives Association. This is a trade organization created by the private negotiated derivatives market, and it represents the participating parties. ISDA released protocol earlier this year, and this is really to provide an efficient way to transition those derivatives from LIBOR to a new index. So moving on to the timeline, there's a few key milestones, and we're really going to start at the beginning of this year with those milestones. So on January 25th, as I just mentioned, the ISDA protocol went into effect for those for swaps and those that have adhered. So I will just mention at that time nothing about the actual transaction changed. What it does is it allows for a mechanism for the swap or the derivative to move to a new index. And this was not previously addressed. So if you're familiar with any type of fallback language in your loan, that maybe has been but I'd say newer, it's a similar function. And that it was not addressed how LIBOR would go away or what would happen. So this addresses that and to ensure a smoother transition. And it's done already in the documentation. And another important date is on March 5th of this year. So I mentioned this on the previous slide, but the IBA or the ICE Benchmark Association announced that the US dollar LIBOR cessation will be moved from 12/31/2021 to June 30th, 2023. And again, just to allow more time for a smooth transition in the United States. So at this time, the spread adjustment was also set. I'm just going to talk more about that in subsequent slides and what that means. So later this month, July 26, the inner daily swaps will move from LIBOR to SOFR. And the significance of this is it will create liquidity in the market and then it'll further drive us forward in our transition away from LIBOR shortly after this date. We do anticipate the article endorsed terms SOFR. So we will be keeping our eye on that. And then perhaps the most important date on the slide is that 12/31/2021 date. And the reason this is very important, even though the LIBOR cessation date has been moved to 2023, is at that time our U.S. regulators are requiring banks and financial institutions to stop using LIBOR on new and renewed transactions. And so finally, it's about December or excuse me, June 30th, 2023 date is the final LIBOR cessation date. So at that time, LIBOR will likely no longer be published. And then between 12/31 of this year and that June 2023 date, LIBOR will continue to be published. And this will allow existing transactions to mature during that time without the rate being moved to something else. So now I'm going to turn it over to Jeff, our partner at Ernst and Young, and he's going to talk about SOFR and some of the other alternative rates out there. Thank you, Kelsey. And hello, everyone. One of the key things to keep in mind as the industry goes through this transition process over the next several years, is that the interest rate environment is going to change, meaning that it's going to be much more of a multi interest rate environment that exists post transition as opposed to the world we live in now, where most transactions are primarily underlined by LIBOR. As it stands today, the anticipation is that a majority of those transactions in the market on a go forward basis will be pegged to SOFR. So as Kelsey mentioned, SOFR, is the ARRC recommended rate based on a pretty stringent vetting process that was undertaken over a two-year period or so. And right now, when you look at what industry participants are preparing for primarily and what banks are also preparing to offer to their customers, SORF in a predominant number of cases is that base rate, is that primary rate that everyone is focusing on. Now there will be certain products, certain segments, certain customers that have transactions pegged to other interest rates as well, which we'll talk about in a little bit. But some of those you may already be very familiar with because they've been around for a very long time, such as Prime. Some of them are a little newer. When you talk about things like BSBY and AMERIBOR. So the key thing to keep in mind is that this is an evolving market. And when we talk about what banks, including Commerce Bank, are preparing for, it's really to be flexible in their approach, but also prepare for what's going to be that predominant market offering. So going back to SOFR, which right now is sitting in that predominant place, one of the benefits of SOFR is that the liquidity of the rate is significantly higher than what you would typically find for LIBOR. So it's I think, approximately a trillion dollars or so worth of transactions that are being used on a daily basis to calculate SOFR. Whereas for LIBOR was in the ballpark of about 500 million or so, that was one of the key drivers for the transition to begin with. It's just the lack of liquidity in actual transactions that were underlying the rate calculation for LIBOR on a daily and a monthly basis. So SOFR's increased liquidity, increased transaction base does help to mitigate some of the risks that that low LIBOR liquidity environment did present. Another key attribute of SOFR, which is different from LIBOR, is there's no credit sensitive component to SOFR. So SOFR is a fully secured risk-free rate, whereas LIBOR was an unsecured rate. And what that means to go to the spread adjustment discussion is that since SOFR does not include that credit sensitive component, it's not a perfect apples for apples comparison to what LIBOR is today. So when you talk about transactions today, that reference LIBOR that need to be amended to reference one of these other alternative reference rates or to include fallback language that provides a path to one of these alternative reference rates, there will need to be a spread adjustment that's made to compensate for those different characteristics between the two rates. So that's broadly the landscape for SOFR. It has been recommended by the ARRC. It was selected by ISDA as the primary replacement for derivatives. So both of those key industry bodies are supportive of that rate. Prime is another option that will be offered to customers in certain circumstances. We don't need to spend too much time on that, because I'm assuming most of you on the phone are very familiar with Prime at this point in time. So we can flip to the next slide. So there's two other rates on here as well that we're seeing are taking up a good chunk of the market, but again, still evolving to a certain capacity. And those are BSBY and AMERIBOR. The thing to keep in mind with both of these rates, neither of these rates have been formally endorsed by the ARRC yet. Now, the ARRC is not a regulatory body. It's more of a working group. But the ARRC's recommendation does carry a lot of weight in the industry when you talk about what potentially will be the predominant rate going forward. So BSBY's the newer of the two. BSBY is published by Bloomberg. A benefit of BSBY that is preferred by certain industry participants is that it includes a credit component and includes a term rate structure. So it's more similar to LIBOR than SOFR. The downside to that is, since it's more similar to LIBOR, it does present a lot of the same risks that LIBOR presented as well with the difference that the liquidity concerns aren't quite at the same level. So BSBY is primarily based on the CD market. There are transactions and commercial paper and deposits that underlie the data that's used to calculate that rate on a daily basis. So that volume of transactions is significantly higher than what you find with LIBOR. Again, BSBY is still evolving. I think we're going to have to see where that goes over the next several months. There have been certain regulatory bodies that have come out to speak against using BSBY too prevalently because of the parallels and similarities with LIBOR and the regulators views, that's just going to put everyone in the market in the same boat as they were with LIBOR on a go forward basis and won't really improve it. Excuse me. Won't really improve anything. So it's something we'll have to closely monitor. And then with the AMERIBOR, AMERIBOR is a rate that's intended to more accurately represent the cost of funding of regional banks. So it's a newer rate. It's sponsored by the American Financial Exchange. We do see some regional banks offering AMERIBOR. And again, it's something that is still evolving. There is a term rate structure with AMERIBOR. So it does include credit sensitive component in that term rate structure. But again, the liquidity in AMERIBOR is significantly below where we see SOFR right now. So it's the best way to view these things are as other options for the time being, rather than something that's quite on the same parallel with SOFR, as of right now. But it's going to be important for you on the phone to make sure that you just keep in close touch with your relationship managers at Commerce just to monitor how the market is going to be evolving over the next several months. You can go to the next slide. So this is just a grid. We won't go through this line by line, but this is a grid view which you will have available when the slides are distributed after the meeting today. That really compares one for one, some of the key attributes of LIBOR and SOFR. Some of these we've already covered when we talked about the secured versus unsecured nature of SOFR compared to LIBOR regarding the daily liquidity in the volume line item of one trillion compared to about 500 million. And the other interesting thing to highlight here as well, which is going to be important to keep in mind going forward, is because SOFR does not currently have endorsed or recommended term rate structure that could change in the near future. But as of today, it does not. SOFR is calculated a little differently than LIBOR. You'll see terms compound average in arrears, compound average in advance daily simple and so forth. Those are all different mechanisms that are used that will potentially change the interest rate conventions in your loan agreement or in your derivative agreement for how interest is being calculated within a specific interest period. And those, for the most part, are all backward looking, with the exception of an advance, which probably more closely emulates a term rate structure today. OK, so we can move to the next slide where we'll have a view of LIBOR versus SOFR versus BSBY. We have about a year's worth of data here. Zoomed in on the right hand graph is probably a little more relevant for everyone on the call here, because you can see during the throes of the pandemic last summer into winter how SOFR responded compared to how BSBY and how LIBOR would have responded in a similar event. And then also as we've gradually moved out of the pandemic in the spring and early summer, now how SOFR has started to increase in parallel with LIBOR and BSBY. So I think the interesting thing to take note of here, while SOFR is lower than the other two rates, there aren't quite as many spikes in the graph. And that is also due to the fact that there isn't that credit sensitive component in SOFR that exists in LIBOR and BSBY. So SOFR can be viewed from this graph as kind of a much more constant rate in the sense that you're not going to have quite as many volume spikes that are occurring on a daily basis as you would have with LIBOR and BSBY. So just an interesting thing to keep in mind there. But big picture, if you were to interpolate a regression line within each of these rates, they have moved pretty similarly, given the environment. And I think the important thing now as we move into the next slide to remember, too, is because SOFR as you'll see on the previous slide with the graph, because the way it's calculated is different, because it's a secured rate versus an unsecured rate. The interest rate, regardless of the methodology that you use, is lower than what you find with LIBOR. And what you find with BSBY over similar measurement periods. So a big conversation that was occurring in the industry is really how do you calculate those spread adjustments for the transition from LIBOR to SOFR for your legacy bank book transition when you're transitioning the loan and transitioning the derivative or a lot of conversations about this and the ARRC working groups and the ISDA working group, and I believe it was late last year, ISDA had selected Bloomberg to publish these fallback spreads and these fallback spreads that you'll see here are published on Bloomberg's website. There will be a link that you can utilize to follow to that website to not only see the rates for USD LIBOR, but also for other currencies as well across different tenors. And those rates were all fixed as of the IBA's announcement a little earlier this year that LIBOR would cease being published on June 30th, 2023. So these spread adjustments that you see for one month, three month and six month LIBOR are static as it stands right now. So I know we had a few questions come in about value transfer. And, you know, the intent of these spread adjustments is to as close as possible mitigate any type of value transfer that will occur as part of this transition. It's probably not going to be perfect, but these spread adjustments are intended to really compensate for that historical difference between LIBOR and SOFR based off of the methodology that was being used, that is publicly available, is published by ISDA using this five year look back period and median average to get those spread adjustments. And these will be used both for derivatives and for loans as well. So that about wraps up the comparison. Could talk a lot longer for this, too. But I know we want to get to other topics, specifically what this transition is going to mean for you and what the next steps will be that you have to keep in mind for your own books, so I'll turn it over to Lauren now. Thanks Jeff. Good afternoon, everyone. Thanks again for joining us today. So what does the LIBOR transition mean for you? Commerce has identified the expected impact for our customers with commercial loans and interest rate swaps, like the LIBOR and the action required to facilitate a smooth transition. Your commercial loan, whether it returns before or after June 30th, 2023, will be reviewed for fallback language, and your relationship manager will contact you if your loan needs amended to include appropriate fallback language. Commerce is currently using hardwire fallback language, which identifies a new index that will be referenced when LIBOR is discontinued. Even if your loan matures before the LIBOR cessation date, it's really important to have robust fallback language in your loan documents. In the unlikely event that LIBOR is deemed unrepresentative prior to June 30th, 2023, you also have the option to proactively convert your existing index to an alternative reference rate like SOFR or Prime through an amendment prior to the LIBOR’s cessation date. For all interest rate swaps, regardless of maturity date, you'll want to ensure you have adhered to the ISDA protocol. It's also important to make sure your corresponding loan and swap are aligned. They should both be based on the same index once LIBOR is discontinued. For example, if your swap will convert to SOFR, compounded in arrears, after the cessation date, it's important to ensure the fallback language in your loan documents also allows for your loan to convert to SOFR compounded in arrears. Any new products or annual renewals will need to be booked in an alternative reference rate. Like we mentioned earlier, all banks must stop issuing USD LIBOR contracts no later than December 31, 2021 and many banks, including Commerce, have already started the process of transitioning away from LIBOR. Your relationship manager will reach out and provide you with additional support to understand the pricing options for renewals and new loans, as well as your options to proactively amend existing contracts. For existing LIBOR loans that require remediation, Commerce Bank intends to put both the customer and the bank in the same or comparable economic position pre and post modification as much as possible. Now we’ll take a look at what you can expect from Commerce Bank and what we are doing to prepare for the transition away from LIBOR, Commerce is committed to facilitating a smooth and successful transition away from LIBOR. To prepare for this transition, Commerce has organized internally to form a cross-functional team to lead the LIBOR transition initiative. This team has identified all impacted products, operational systems, contract pricing models and processes. We are closely monitoring all LIBOR impacted loans in our portfolio, as well as interest rate swap contracts, originated through

Commerce. Commerce is currently offering SOFR based products now as we begin to transition away from LIBOR, and like some have mentioned earlier, we're also researching and continuing to monitor other alternative reference rates. So we're continuing to add hardwire, fallback language to existing LIBOR based loans. We continue to meet with industry groups, peer banks and external advisors such as Ernst and Young to ensure alignment and monitor industry practices. Commerce has conducted screenings and continues to provide education materials to ensure relationship managers are well equipped to support their customers throughout this transition. And finally, we're ensuring appropriate and timely communication with our customers and are conducting outreach to inform and educate impacted customers of the transition. Now, we will go back to Kelsey to go over some key takeaways and additional resources.
(Kelsey) Great. Thanks, everyone. So hopefully you've found some of the information that we shared valuable today. I know it's a lot of information to take in in a short period of time, and we're happy to answer additional questions if you have them. Also, keep in mind, as Lauren mentioned, your relationship manager is definitely a key resource, and we're providing them with continued information and training about this topic as well. If you'd like to do a little bit of research on your own, we do have information on our commercebank.com website. Go to commercebank.com/LIBOR. There's also some of those industry groups that we mentioned that have some great resources on their website, including ARRC, ISDA and LSTA. There's, as I mentioned, there's an abundance of information, especially on the AARC's website. So please don't hesitate to reach out if you're not sure what you're looking for or what you're looking at. And we'll be happy to answer any of those questions or share any information that we've found. I think right now we are going to take a little bit of time to answer some questions that have come in. So give us just one second and we will take a look at those. So I think we have a question about the interest period, I believe is what's being asked. So if you will know your rates or when you will know your interest rate and amount due, if that's the end of the period or at the beginning of the period. So that will depend on what type of SOFR, or what type of interest rate is being utilized on your transaction. SOFR, compounding in arrears, you're not going to know the rate until towards the end of the interest period. However, there are some other options so that you will know your interest rate at the beginning of the interest period like you're probably used to with LIBOR today. One of those options, I guess would be SOFR compound in advance. So that rate would be set at the beginning of the interest period, again, like LIBOR is today. In addition, there is a term rate associated with BSBY, so if that were an index that we were to offer and were to use, that interest rate would be known at the beginning of the period and mentioned earlier in the presentation that we are anticipating that the ARRC will endorse a term SOFR rate potentially in August. So that would also allow you to potentially, if they endorse it, for use in loan products, that would potentially allow you to know your rate at the beginning of the interest period as well. So there to say there's a lot of nuances and different options within this LIBOR transition, I think is an understatement. So, again, happy to answer any questions. I will say if there is a very specific question about a loan or a swap scenario, we can answer that with you individually so that we make sure that we have all the information and can give you the best the best response that we can with having all that information. Let's see a couple other questions that we have. Jeff I think you mentioned this in some of your presentation, but I'm just thinking about the difference between LIBOR and SOFR and that 11 basis points and where it is today, if you could speak to that. Yeah, I think that kind of goes back to the idea that it's not a perfect transition. And it's a transition where that value transfer and trying to get as close to net neutral value transfers as possible is the goal. But given a lot of these agreements are going to be modified at a specific point in time, and the methodology that's

being used to come up with these spread adjustments is based on five years' worth of historical data. It's not going to be absolutely perfect. So that 11 basis points, it's not always going to perfectly represent what the difference between LIBOR and SOFR is that at a given point in time, sometimes it might be above, sometimes below, just depending on what the interest rate environment looks like today. Thanks, Jeff. One other question we received is just explaining what the hardwired fallback waterfall language is. So I think Lauren, are you able to take that one? Sure. So Commerce's hardwired fallback language essentially follows the ARRC recommended waterfall approach. So the first step in the waterfall is term SOFR. So your loan will convert to term SOFR, assuming it is available and recommended by the ARRC. If term SOFR is not available and recommended by the ARRC, it would go to the second step in the waterfall. And Commerce has kind of altered this just a little bit to give some more flexibility. So the second step in the waterfall would be daily simple SOFR or average SOFR. And then if for some reason SOFR isn't available, it would go to the third step, which is a lender selected rate. Thanks, Lauren. Let's see, there's another question if Commerce will utilize term SOFR, so I'd mentioned what we're keeping an eye on right now is that endorsement from the ARRC and what they endorsed term SOFR for. So I think the hope is that they will endorse it to be used in loan products. But we are waiting to see what that will look like and that information should be out relatively soon. Yeah. And on that point with term SOFR too, we're hoping that there will be some guidance on that in the near future. I think an important thing to keep in mind with term SOFR is that right now it's being published by the CME, again, hasn't been formally recommended or endorsed by the ARRC yet, but that license to utilize term SOFR from the CME right now is exclusive to loans. So as it stands today, it's not available to be licensed for derivative transactions. So when you talk about customers that have hedged loans, where you have a loan and then a corresponding derivative hedging, the interest rate exposure there, you might not get a perfect alignment with the term SOFR loan instrument today. If term SOFR is not available for derivative, you may see, compounded average in arrears, which right now is predominantly the underlying interest rate convention for derivatives compared to term SOFR for a loan which will have basis risk. So that's why when we say it's important to keep in touch with your relationship managers and with Commerce Bank throughout this process, it's because of the evolution of circumstances like that that are still being worked through in the industry. How and when will term SOFR be available to be used for derivatives? If it's not available, are there other interest rate conventions that might make a little bit more sense to execute any new products under or potentially transition your legacy book under whether that's daily, simple SOFR and there are daily simple SOFR derivatives or if it's more of the compounded methodology. So there are still a lot of moving items here. So, it's definitely important to try to stay up to date through frequent contact with your representatives and then internally within your organization as well. Thanks, Jeff. So one more question has just dropped. If you could go over I think we covered it a little bit, but just what it means. So we talked about SOFR being a secured rate. Can you speak a little bit more to what that means? Yeah. So secured rate, just basically meaning that it is it's almost a collateralized rate. So it's secured by Treasury securities. So all that means is that the collateralized U.S. Treasury securities essentially look at it as like a repo market rate. So because it's secured, because it's backed by U.S. Treasuries, that's what makes it a risk free rate, whereas LIBOR does not have that same collateralization behind it. It's an unsecured rate. There is that credit sensitive component because it's unsecured. So it's not really an option that anyone chooses per se to say, you know, I'd like my loan to be secured versus unsecured. That's a different conversation that just relates to any type of collateral that a borrower may have to post to secure a loan transaction. This is more about the nature of how the rate is calculated and the fact that a

secured rate will, generally speaking, have a lower interest rate and a lower rate of return than an unsecured rate, just given the risk profile of those two rates together.
Hey, I think that wraps up our Q&A again, just feel free to reach out to your resources at Commerce Bank, if you have questions and we are more than happy to answer those and spend some time explaining any piece of the LIBOR transition to you and anyone on your team.