FAQS ON TRANSITION OF LEGACY SOR LOAN CONTRACTS

15 December 2021

Steering Committee for SOR & SIBOR Transition to SORA

The SC-STS strongly encourages corporate customers to convert their legacy SOR contracts to SORA while the window of opportunity exists to take reference from market pricing.

This document is intended to support banks' discussions with corporate customers with legacy SOR loans, by providing the key facts and data for banks' and their customers' reference.

1. Why is there a need for customers to convert existing SOR contracts?

- Customers will need to convert existing SOR contracts as SOR will be discontinued immediately after 30 June 2023.
    - As part of global interest rate benchmark reforms, the UK Financial Conduct Authority had announced that the widely used USD LIBOR settings[1] will be discontinued immediately after 30 June 2023.
    - SOR relies on USD LIBOR in its computation methodology, and hence, will have to be discontinued after the same date.

2. What is SORA[2]?

- SORA has been identified by the Association of Banks in Singapore (ABS) and the Singapore Foreign Exchange Market Committee (SFEMC) as the alternative risk-free rate to replace SOR in Singapore.
    - SORA is the volume-weighted average rate of borrowing transactions in the unsecured overnight interbank SGD cash market in Singapore.
    - It is a transparent, robust and reliable interest rate benchmark that has been published by the Monetary Authority of Singapore (MAS) since 2005.

3. Why is an adjustment spread necessary when converting a SOR loan to reference SORA?

- SORA is a fundamentally different interest rate benchmark from SOR[3].
    - SORA does not incorporate term risk premium and is nearly credit risk-free due to its overnight tenor of borrowing, while SOR incorporates term and credit risk premium through its use of USD LIBOR. Hence, SORA typically tends to be lower than SOR.
    - The difference is readily observed in the historical pricing of SOR and SORA. While the spread between SOR and SORA is volatile, SOR is almost always higher than SORA.
- This means that an adjustment spread is necessary when converting a SOR loan to SORA loan, so that the overall interest payments are broadly comparable after the conversion. The

[1] Overnight, 1-month, 3-month, 6-month and 12-month.
[2] See SC-STS webpage on SORA (https://abs.org.sg/benchmark-rates/about-sora).
[3] For further details on the adjustment spread and historical comparison of SOR and Compounded SORA, see section 3.3 and Annex 2 respectively of the SC-STS publication "SORA – A Guide for Corporates and SMEs", updated July 2021 (https://abs.org.sg/docs/library/sora-a-guide-for-corporates-and-smes.pdf).

adjustment spread will be added to the SORA rate in the new contract, together with any existing customer margin.

4. How is the adjustment spread determined for corporate loans?

- The SC-STS had recommended in its report in July 2021[4] that the SOR-SORA basis swap mid-rate pricing be used as a starting point for discussions between lenders and borrowers.
    - SOR-SORA basis swaps involve a market-based rate for exchanging a stream of SOR payments for a stream of SORA payments plus a spread.
    - This spread can hence be applied to convert a SOR loan to SORA, whose remaining maturity matches the tenor of the basis swap.
    - An adjustment spread calibrated in this manner reflects the fundamental difference between SOR and SORA, and should offset the expected economic difference between SOR and SORA over the applicable tenor of a contract.

5. Why should customers seek to actively convert their SOR contracts now, especially when SOR will only be discontinued after 30 June 2023?

- Customers who "wait and see" risk transitioning at a higher rate.
    - Customers should note that the difference between SOR and compounded SORA rates is currently at a multi-year lows (see Figures 1 and 2). Current SOR-SORA basis swap mid-rates are also lower than the average or median spread between SOR and SORA in recent years (see Figure 3).

      For example, the 5Y SOR-SORA basis swap mid-rate was 0.20% on 31 Oct 21, while the 5Y historical median spread between 6M SOR and 6M Compounded SORA was 0.37%.

      SC-STS recommends customers to use the current environment to lock-in their transition.

- The window of opportunity for use of market-determined SOR-SORA basis swap mid-rates is closing.
    - SC-STS had noted in its July 2021 report that liquidity in the SOR-SORA basis swap market would eventually decline. Several months have since passed, and as envisaged, there are signs that this window of liquidity could soon close as market participants shift away from SOR[5].
    - Absent representative market-determined SOR-SORA basis swap prices, market participants would only have historical average spreads between SOR and SORA as guideposts for transition.

[4] See SC-STS's report "Recommendations for Transition of Legacy SOR Contracts", 29 July 2021 (https://abs.org.sg/docs/library/sc-sts-recommendations-for-transition-of-legacy-sor-contracts.pdf).
[5] Banks have already stopped offering SOR loans after end-April 2021 and have stopped offering SOR derivatives after end-September 2021, except for risk management purposes.

- When the basis swap market becomes illiquid, SC-STS will have to publish alternative transition guidance, where the recommended adjustment spreads may well be higher than current SOR-SORA basis swap prices.

6. What are the implications if customers choose to insert a contractual fallback to Fallback Rate (SOR) instead of actively transitioning to SORA?

- Inserting Fallback Rate (SOR) as a contractual fallback instead of actively transitioning to SORA, has several disadvantages.
    - First, loans on Fallback Rate (SOR) that mature beyond end-2024 must undergo a second transition to SORA, because Fallback Rate (SOR) discontinues immediately after 31 December 2024. This would likely incur further legal and operational costs.
    - Second, loans on Fallback Rate (SOR) maturing before end-2024 cannot be rolled over into replacement financing if the replacement financing matures after end-2024, because Fallback Rate (SOR) discontinues after end-2024.
    - Third, because SORA will be the rate used by the SGD interest rate swap market, it may not be feasible or cost-efficient to hedge Fallback Rate (SOR) exposures.
    - Fourth, because Fallback Rate (SOR), like SORA, is also fixed at the end of the interest period ("in-arrears"), customers using Fallback Rate (SOR) will still need to test that finance systems and processes can handle interest payments with a few days advance notice.

7. Why should customers avoid waiting for Term SORA rates to transition their SOR exposures?

- Following the Alternative Reference Rates Committee (ARRC)'s recommendation of CME Group's forward-looking Secured Overnight Financing Rate (SOFR) term rates[6], customers might invariably wonder about the possibility of using Term SORA rates to transition their SOR exposures.
- However, customers should not wait to use Term SORA to transition their SOR exposures as it is unlikely that Term SORA will be published before the discontinuation of SOR at end-June 2023.
- For a robust and stable term risk-free rate (RFR) to be constructed, there must be deep and liquid derivatives and cash markets underpinning the RFR.
    - While there has been a considerable increase in the use of SORA derivatives in 2H 2021, with SORA derivatives volume even surpassing that of SOR derivatives by August 2021, the bulk of this volume has been in tenors longer than 1Y, especially the 2Y-5Y bucket (Figure 3).
    - As such, liquidity in short-term SORA derivatives market – particularly the 1-month, 3-months and 6-months SORA derivatives that match the existing tenors of SOR – remains nascent for robust Term SORA rates to be constructed. In fact, over the past

[6] The ARRC has identified SOFR as the rate that represents best practice for use in certain new USD derivatives and other financial contracts, representing the ARRC's preferred alternative to USD LIBOR.

few months, there has been less than one transaction per day in these tenors. In comparison, the short-term SOFR derivatives market is much deeper and more liquid, with CME's Term SOFR benchmark supported by US$218 billion in daily SOFR futures volumes and an average of 118,000 futures contracts per day.

- Even if liquidity were to pick up in the coming months, it is very unlikely that Term SORA could be available by end-June 2023 because of the amount of time required for development, testing and implementation of Term SORA benchmarking methodologies[7].

8. If customers are unable to switch from SOR to SORA today, what is the next best thing that a customer could do?

- The next-best alternative is to embed a rate switch mechanism in the contract. The LMA has published several recommended form templates incorporating provisions[8] that enables a pre-agreed switch to SORA that will apply at a specific time in the future, subject to mutual agreement between lenders and customers (e.g. after the last interest payment before end-June 2023). Interest payments would continue to be based on SOR until the pre-specified date, following which they would be based on SORA.

    - When applying a rate switch mechanism, customers are strongly encouraged to lock-in the adjustment spread now, rather than defer it to a future date.

    - Deferring the adjustment spread to a future date risks incurring a higher adjustment spread, for the reasons under Question 5.

- If that is also not possible, then customers should embed in their contract a Replacement of Screen Rate Clause[9], which was first published by the LMA on 21 December 2018 and has since been incorporated into the LMA facility agreement templates and the APLMA facility agreement templates. This approach is not preferred, because it simply postpones the negotiations required to agree on a replacement rate to a future date.

[Note: The rate switch mechanism and Replacement of Screen Rate Clause are covered in section 4.4.2 of the SORA Market Compendium (https://abs.org.sg/docs/library/sora-market-compendium-on-the-transition-from-sor-to-sora-version-1-1.pdf).]

[7] An estimated 12 to 15 months is required from the issuance of Request for Information (RFI) to potential Term SORA calculation agents, to the publication of Term SORA rates.

[8] It should be noted that the LMA rate switch provisions have been prepared based on certain chosen market conventions that are prevailing in respect of SONIA. As such, parties may wish to consider modifications to the rate switch provisions for consistency with applicable or relevant market conventions for SORA or Fallback Rate (SOR), before incorporating such provisions into existing SOR corporate loan documentation.

[9] The Replacement of Screen Rate Clause essentially provides a regime for parties to agree on alternative benchmarks-related amendments if the existing Screen Rate ceases to be available, primarily by lowering the thresholds for consent required to make such transition. Nevertheless, the RSR Clause is less preferred since it does not contain any operative provision providing for the transition to SORA or Fallback Rate (SOR). This means that a further round of negotiations will be required to agree such provisions, leading to uncertainty should an agreement not be reached.

Figure 1: 6M SOR vs 6M Compounded SORA[10]

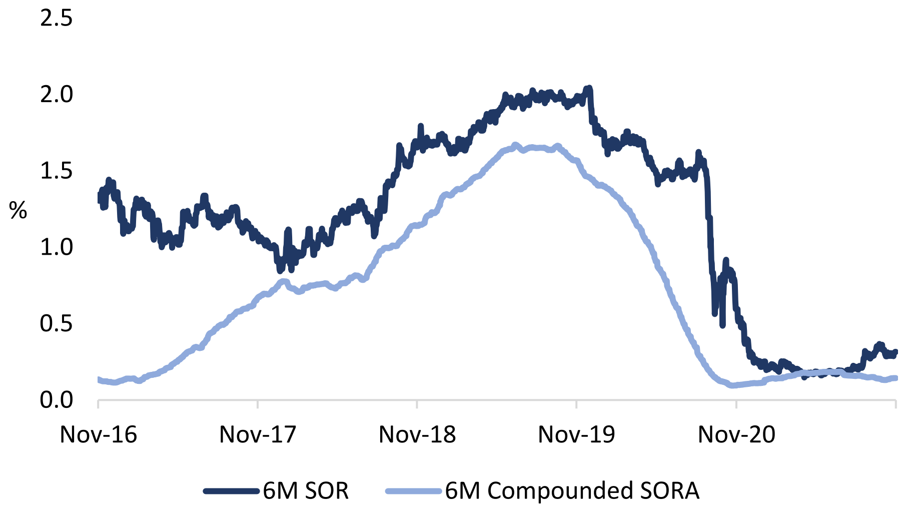
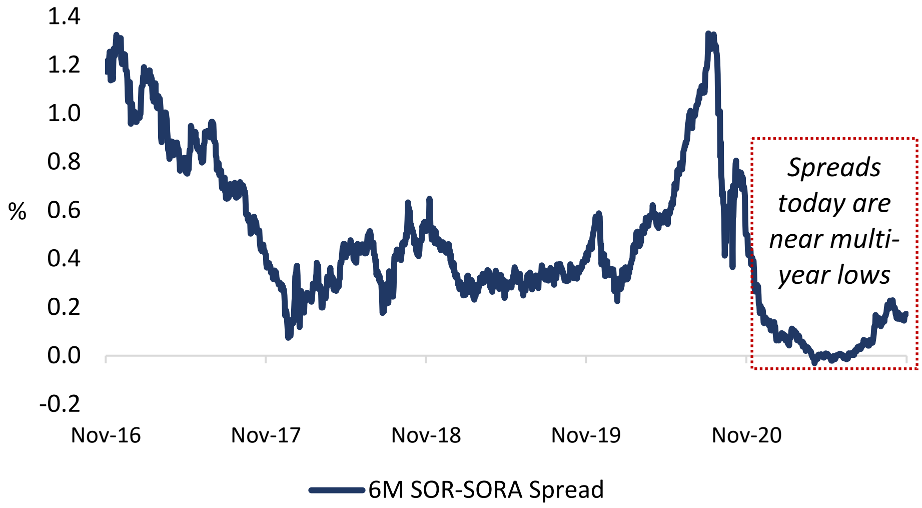


Figure 2: Spread between 6M SOR and 6M Compounded SORA



[10] Note: The SOR data has been adjusted to align the interest period that the respective rates are intended to cover. This is given that SOR is a forward-looking interest rate while compounded SORA is backward-looking. In this regard, the 6M SOR data points have been shifted forward by six months (i.e. the 1 November data point reflects the SOR rate on 1 May).

Figure 3: 6M SOR-SORA basis swap rates are below historical median spread