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**MAS consultation on
adjustment spreads
for the transition of
legacy SOR contracts
in wholesale markets**

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**LEGAL
UPDATE**

In this Update

The discontinuation of LIBOR globally has seen Singapore move away from industry reliance on the Singapore Swap Offer Rate (“**SOR**”) (which includes USD LIBOR as a component in its calculation). Given that the SOR is widely used in Singapore interest rate financial products, including derivatives and cash market products, the Monetary Authority of Singapore (“**MAS**”) and the Steering Committee for SOR & SIBOR Transition to SORA (“**SC-STTS**”) jointly announced on 18 May 2022 an SC-STTS consultation on adjustment spreads that will apply to legacy SOR business loans and derivatives.

This update seeks to set out the background to the formation of the SC-CTS consultation and its key recommendations, as well as highlight some considerations market participants may wish to bear in mind when negotiating on the terms for the transition to the Singapore Overnight Rate Average (“**SORA**”) in their legacy business loans and derivatives in light of this consultation.

03
INTRODUCTION

03
BACKGROUND

03
MOTIVATION FOR SETTING OF SOR-TO-SORA ADJUSTMENT SPREADS

04
KEY RECOMMENDATIONS OF THE CONSULT

04
POSSIBLE APPROACHES FOR SETTING THE ADJUSTMENT SPREADS

05
TRANSITION TO SORA FOR LEGACY BUSINESS LOANS AND DERIVATIVES

05
CONCLUSION

INTRODUCTION

The MAS and the SC-STC jointly announced on 18 May 2022 an SC-STC consultation on adjustment spreads that will apply to legacy SOR business loans and derivatives. The consultation covers, inter alia, the setting of an ‘MAS Recommended Rate’ to provide contractual certainty for SOR contracts that remain outstanding after 31 December 2024 following the discontinuance of SOR after such date, and supplementary guidance to support the on-going transition of legacy SOR contracts for the period before and including 31 December 2024.

BACKGROUND

In August 2019, SORA was identified by the Association of Banks in Singapore and the Singapore Foreign Exchange Market Committee as the alternative risk-free rate to replace SOR in Singapore dollar (“**SGD**”) interest rate products such as derivatives, corporate loans and bonds. This was to address the impending situation that SOR, which relies on US dollar (“**USD**”) London Interbank Offered Rate (“**LIBOR**”) in its computation methodology, would be discontinued when USD LIBOR was expected to be discontinued after end-2021. The UK Financial Conduct Authority subsequently announced in March 2021 that the overnight, 1-month, 3-month, 6-month and 12-month USD LIBOR settings, which are used in SGD SOR, would cease to be provided by any administrator or be no longer representative immediately after 30 June 2023. Consequently, SOR would similarly be discontinued immediately after 30 June 2023, across all tenor settings.

Market participants have since made significant progress in reducing outstanding exposures to SOR, and adopting SORA as the de facto interest rate benchmark for use in SGD financial products.

MOTIVATION FOR SETTING OF SOR-TO-SORA ADJUSTMENT SPREADS

The conversion of a legacy SOR contract in wholesale markets to a SORA-based contract requires an adjustment spread, which represents the price that a SOR borrower transitioning to SORA would pay over the SORA benchmark rate. In the past year, wholesale market participants were able to rely on a liquid SOR-SORA basis swap market to price these adjustment spreads. However, with the bulk of SOR-based derivatives transitioned to SORA, liquidity in the SOR-SORA basis swap market is declining, resulting in difficulties in pricing the adjustment spreads.

MAS has therefore endorsed SC-STIS to make and finalise recommendations towards setting the 'MAS Recommended Rate', including the appropriate calculation methodology for the adjustment spreads to be used. This will apply as a fallback rate for outstanding SOR-based business loans and derivatives that mature after end-2024. Separately, the SC-STIS will also provide supplementary guidance on adjustments spreads to apply for interest rate periods before end-2024, to support the industry's on-going active transition of wholesale SOR contracts.

KEY RECOMMENDATIONS OF THE CONSULT

In particular, the consultation paper sets out the following key recommendations:

- (a) The 'MAS Recommended Rate' should be based on Compounded SORA, given that SORA is now the main interest rate benchmark for SGD financial markets.
- (b) Adjustment spreads within the 'MAS Recommended Rate' should be derived from the historical median spread between SOR and SORA. Such a methodology is transparent, verifiable and readily available, and simple to explain and implement. It also in line with market expectations of the SOR-SORA spreads after end-2024.
- (c) Adjustment spreads for the period before end-2024 should be based on a linear interpolation between a reference spread based on a recent shorter historical median of the SOR-SORA spread and the adjustment spread within the 'MAS Recommended Rate'.

POSSIBLE APPROACHES FOR SETTING THE ADJUSTMENT SPREADS

The SC-STIS is exploring 2 main approaches for setting the adjustment spreads in the 'MAS Recommended Rate'. The first approach is to base the adjustment spread on recent historical prices in the SOR-SORA basis swap market. The second approach is to base the adjustment spreads in the longer term (i.e. for periods after end-2024, as required for the setting of the 'MAS Recommended Rate') on the historical median of the spread between SOR and SORA, while adjustments spreads in the near-term would be anchored to recent spreads between SOR and SORA.

At this juncture, the SC-STIS is recommending the second approach for the determination of adjustment spreads. The reasons for the recommendation are inter alia that the adjustment spreads under the second approach can be robustly determined with SOR and SORA benchmarks, and that it is

also easier to communicate and implement and can be applied to overnight conversion without need for further adjustments.

TRANSITION TO SORA FOR LEGACY BUSINESS LOANS AND DERIVATIVES

In light of the above initiative, market participants who are negotiating on the terms for the transition to SORA for their legacy business loans and derivatives may wish to consider the implications of the implementation of the 'MAS Recommended Rate' and issuance of further guidance on adjustment spreads. For instance parties may wish to consider whether there should be options for the parties to review and, if necessary, make adjustments to the agreed adjustment spreads to align more closely with the 'MAS Recommended Rate' and guidelines and if so, the parameters for such re-negotiations.

CONCLUSION

Ultimately, the SC-STC consultation on the approach to set the 'MAS Recommended Rate' is key to providing certainty to market participants with SOR contracts maturing after end-2024, while supporting the active transition of legacy SOR contracts in the coming quarters ahead of the discontinuation of SOR in mid-2023. Meanwhile, market participants should take note of this development and consider reviewing the terms on SORA transition for their legacy SOR contracts to see if it would be necessary to cater for the option to align the agreed adjustment spreads with the industry recommended rate and guidance once they are available.

The SC-STC is inviting feedback on their recommendations with the consult set to conclude by 10 June 2022. For more information, please refer to the consultation paper issued by the SC-STC at the following link:

<https://abs.org.sg/docs/library/consultation-on-adjustment-spreads-for-the-conversion-of-legacy-sor-contracts-to-sora>.

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If you have any questions or
comments on this article, please
contact:



Pauline Chong
Head, Banking & Finance
Director, Corporate & Finance

T: +65 6531 2796
E: pauline.chong@drewnapier.com



Benjamin Ng
Associate Director, Corporate &
Finance

T: +65 6531 2292
E: benjamin.ng@drewnapier.com

Drew & Napier LLC
10 Collyer Quay
#10-01 Ocean Financial Centre
Singapore 049315

www.drewnapier.com

T : +65 6535 0733
T : +65 9726 0573 (After Hours)
F : +65 6535 4906

 **DREW & NAPIER**