

The Beginning of the End – Phasing Out LIBOR

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There is speculation swirling around the financial community regarding the phase out of Intercontinental Exchange London Interbank Offered Rate (ICE LIBOR) and what impact it will have on the market. In late July, the CEO of the Financial Conduct Authority (FCA) created this buzz by recommending a specific time frame, 2021, to phase out ICE LIBOR.

The British Bankers Association London Interbank Offered Rate (BBA LIBOR) was formally created in the 1980's to facilitate syndicated debt transactions. BBA LIBOR has subsequently grown to become the most widely used benchmark for short-term interest rates. BBA LIBOR is also used as a reference rate/index for financial instruments and for setting rates for short-term unsecured interbank borrowing. As a result, it provides insight into the state of the world's banking system, as well as setting expectations of Central Bank interest rates.

During the crisis in 2007, BBA LIBOR's credibility came into question, with severe divergence in rate. Additional observation exposed weakness in the current system reporting, along with manipulation to improve perceived credit and/or trading positions. In 2012, investigations uncovered misuse and recommendations were made to install an administrator to oversee rate computation and provide oversight. In 2013, Intercontinental Exchange Benchmark Administration (IBA) became the new administrator with oversight from The Financial Conduct Authority (FCA). This is when BBA LIBOR became ICE LIBOR.

With the slew of post-crisis regulatory requirements, financial institutions have moved away from wholesale funding, which has reduced the population of data utilized to formulate rates. The problem with reduced data is that it requires more industry judgment, putting publishing firms at higher



risk for error and increased liability. The FCA is looking for an alternative to replace ICE LIBOR and, by establishing a timeline, is pulling the industry into the mix.

Multiple countries are starting to utilize some version of a risk-free overnight rate (comparable to a hybrid of Treasury rates) and are publishing it to build out historical trending up to the conversion. The concerns are that there are trillions in transactions currently priced utilizing LIBOR or a derivative of it, and not all of these will mature prior to phase out. It raises the question of whether submitting institutions will begin moving away from publishing LIBOR rates, creating further disconnect, in the market leading up to the implementation. Lastly, how are they going to account for the risk component with both overnight and duration features that LIBOR provided?

With an overview of the history and current state of LIBOR established, we can focus on the effects of change in LIBOR from the perspective of the institutional depositor. Institutional depositors have access to the markets through financial institutions, broker-dealers and investment advisors. They utilize a variety of fixed income investments in conjunction with direct deposit product to build out their portfolios. Financial institutions traditionally utilize LIBOR to structure deposit pricing to remain competitive to other fixed income options.

Institutional depositors are more sophisticated

investors, and also look to LIBOR to gain insight on credit risk and indications on where rates are moving. In case of a rising rate environment, market products will price in advance of a rate increase. Institutional depositors directly and indirectly are looking to a market indexes to determine historical spread base on type of investment along with future anticipation. LIBOR brings the depositor and financial institution together on common ground. Both can build models that achieve deposit stability with predictable cost for the financial institution, and a competitive rate of return for depositor.

As an institutional depositor/investor, they will be faced with an onslaught of information over the next several years, including various thought processes on what indexes to use, and how they're trending. Keep in mind, institutional depositors/investors will receive much of the same information as financial institutions, which can create confusion. Similar to learning a new language, financial institutions will need to begin looking at the other overnight index options and trending them to the current secured and non-secured indexes to determine where their product fits in the mix, and be able to communicate with potential investors/depositors.

About D. James Lutter



D. James (Jim) Lutter is the Senior Vice President of Trading and Operations at PMA Financial Network, Inc. and PMA Securities, Inc. where he oversees PMA Funding., a service of both companies that provides over 1,000 financial

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John Vaci manages the PMA Trading team, which supports investment advisory and broker dealer services. He is responsible for all broker dealer functions for PMA Securities, and trade support for Prudent Man Advisors, Inc. His FINRA licenses

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