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LIBOR-ation

Plagued over the years by scandal and risk, LIBOR appears to be on its way out. What does that mean for financial institutions?

Since 1969, the London interbank offered rate – or LIBOR – has served as a reference rate for how much banks charge to lend to each other, but now over $300 trillion in financial assets are tied to that rate. A standard index by which unsecured loans can be priced, the largest institutions use it and the rate ripples down, affecting the entire industry.

LIBOR was rocked by scandal during the financial crisis and seems likely to be phased out by 2021, as the Secured Overnight Funding Rate (SOFR) promises to deliver a better way to price the mortgages, commercial loans, bonds and other products that are currently underpinned by LIBOR without the issues that plague it. What will change for financial institutions between now and 2021?

WHAT'S WRONG WITH LIBOR?

The major problem with LIBOR was clearly exposed during the 2012 scandals – it's easily manipulated. LIBOR is created by taking rates submitted by a panel of banks, discarding the highest and lowest rates and settling on the average of the remaining rates. During the financial crisis, some of the banks on this panel conspired to submit false rates, which was easy to do since LIBOR was not transaction-based but rather just an estimate.

A second critical issue with LIBOR is one of scale. The three-month LIBOR rate is widely considered the most important, but while $300 trillion in financial assets are tied to LIBOR overall, less than $500 million in LIBOR trading takes place on a daily basis.

"That $500 million of trading is the basis for pricing $300 trillion of financial contracts," says Meredith Coffey, executive vice president of research and regulation at the Loan Syndications and Trading Association (LSTA). "That's a lot of contracts being priced off of very little liquidity. Also, because there's so little trading, many banks aren't trading LIBOR on a daily basis, but they still have to provide a LIBOR quotation."

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This raises the third issue with LIBOR. After punishment was doled out to LIBOR manipulators, bankers became leery of providing their LIBOR quotations, most of which were still based on their expert judgment – which was basically their best guess.

"There were obviously a lot of allegations of LIBOR manipulation during the financial crisis," Coffey says. "There were tens of billions of dollars in fines and people went to jail for quoting LIBOR incorrectly, so in today's situation where you can't observe a lot of trades and the regulators are requiring you to quote LIBOR, there's a lot of liability there."

The United Kingdom's top regulator, the Financial Conduct Authority, announced in July 2017 that it would not continue compelling banks to submit LIBOR after 2021. Thus it seems likely that after the pressure from regulators is lifted, some banks will be happy to stop providing their quotes.

"The bankers who are providing it feel that they're exposed to undue risk by providing these estimates," says Jim Lutter, the senior vice president of trading and operations at PMA Financial Network. "They think they can do this to the best of their ability in good faith, but if something derails somewhere they could pay. They don't want to be responsible for it anymore."

WHAT MAKES SOFR DIFFERENT?

Once the UK regulator signaled that LIBOR would be phased out, it became clear that a new benchmark was needed to replace it. Here in the United States, the Alternative Reference Rates Committee (ARRC) has been working to find a viable alternative since 2014. Looking to solve the problems of LIBOR – and worried that it has already begun to deteriorate as fewer banks borrow unsecured – ARRC launched SOFR on April 3, 2018. The biggest differentiator with SOFR is that it's based on actual transaction data from three repo market segments, thus solving two of LIBOR's biggest flaws – it's difficult to manipulate and there's much more trading in it.

"In SOFR's first few days, there was over $800 billion in trading a day in the repos that make it up," Coffey says. "Contrast that to the $500 million in U.S. dollar LIBOR trading. It's a massive difference and a much more robust number."

While SOFR solves many of LIBOR's problems, the shift to a new rate comes with its own challenges. SOFR is a secured rate (as its name makes clear), while LIBOR is an unsecured rate. Since LIBOR includes credit risk while SOFR is risk-free, LIBOR is expected to be higher. Institutions will need to determine a credit spread differential between LIBOR and SOFR in the next four years, which is bound to present plenty of challenges.

The overnight element of SOFR is likely to cause issues as well. There will be a degree of difficulty as financial institutions try to calculate compound terms from daily rates.

"LIBOR has a term curve," says Coffey. "The ARRC plans to develop term curves for SOFR over the next four years so that we have one-week, one-month, three-month rates, and so on. Right now we don't have any of that – just the overnight rate."

HOW WILL THE CHANGE IMPACT YOUR INSTITUTION?

Some institutions that don't use LIBOR may be wondering what all the fuss is about. However, the gravitational pull of this

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benchmark rate is strong, and everyone is likely to feel some effects from its disappearance.

“It truly impacts everybody,” Lutter says. “It’s going to have ramifications for every asset size. It’s your pension funds, your mutual funds, your insurance companies, your Wall Street banks, your lenders, your equipment leases, commercial papers, student loans, bank deposits, mortgages, auto loans – it can touch any loan or deposit taking place. Any time you’re competing with the big banks, whether you call it LIBOR or not, you’re in essence pricing in competition with institutions that are using LIBOR. By default, you’re correlating very closely to the LIBOR rates.”

Institutions risk creating a disconnect between themselves and their competitors – or even within their own structures – by not keeping up with the shift.

“If you want to stay competitive you have to have market-based pricing,” Lutter continues. “Community banks and credit unions are already responding and changing as rates rise and the LIBOR rates change. They’re going to be pushed into it regardless.”

WHAT SHOULD YOUR INSTITUTION BE DOING RIGHT NOW?

While 2021 may seem far away, financial institutions should be taking steps now to get their affairs in order well before the LIBOR shift.

“The most important thing for parties to do right now to put themselves in the best position is to take a look at their current contracts and legacy documents to see what fallback language is provided,” says Tess Virmani, senior vice president and associate general counsel of LSTA. “They should also see what amendment flexibility they have.”

Institutions should also be taking an inventory of their LIBOR exposure to understand exactly which of their loans, deposits and contracts include LIBOR effects.

“Once they know where their LIBOR exposure is and what their current document language is, they can make an informed decision on how quickly they need to act,” Virmani says. “It’s up to them to decide if they need to add in more flexibility now, or if they’re comfortable waiting until they know more about SOFR.”

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The benefit of waiting for a while if you can is that more and more information about SOFR is coming out every day. As more becomes available, it’s likely that the language and response will evolve, and institutions that can afford to wait a while will get the benefit of learning from those who went before them. To reap those benefits, however, institutions need to tune in to the leaders of the transition. Coffey recommends following ARRC, the committee doing a great deal of the heavy lifting on shifting to the replacement rate, and an excellent resource for those interested in learning about SOFR solutions as they emerge.

In the end, while SOFR attempts to solve the problems that became so obvious with LIBOR, transitioning to a new rate is very much a process that the market is only beginning to sort out. But by understanding the basics, how it affects your institution and what you can do now, bankers can stay ahead of the curve during this seismic shift. ▪

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