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Life after LIBOR: What it is, what are its problems and what might be next

By Jim Shanahan, CFA
Vice President, Financial Regulatory Compliance
CoBank ACB

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Key Points:

- The LIBOR (London InterBank Offered Rate) indexes are no longer determined on a deep and liquid market of actual transactions.
- LIBOR rates might not be published after 2021.
- Currently, the market for transactions indexed to U.S. Dollar (USD) LIBOR continues to be considered the most efficient and liquid.
- The transition to alternative benchmark indexed rates has begun, but it is expected to take years to fully develop.
- CoBank and other Farm Credit institutions are participating with other industry groups to monitor and consult on the development of alternative reference rates.

Introduction

It appears that the days of having transactions indexed to LIBOR are numbered. A July 12, 2018, statement by the primary regulator for LIBOR stands firm on the phase-out of the interbank lending rates.

"When I spoke about LIBOR in July last year, I made clear the need to transition away from LIBOR before end-2021. The importance of doing so has not changed," said Andrew Bailey, CEO of the United Kingdom's Financial Conduct Authority.

Since the market will soon see a transition from a rate that indexes the vast majority of financial instruments in the world, it begs the questions, "What is LIBOR? What's the problem with it? And how is the financial community responding to the need to transition to reliable alternatives by 2021?" This paper summarizes the details.

What is LIBOR

LIBOR is an indicative average interest rate at which the panel banks are prepared to borrow/lend to one another on an unsecured basis. Panel banks are a group of large money center banks that contribute quotes that determine the various LIBOR indexes.

Although reference is often made to the LIBOR interest rate (singular), there are actually many different LIBOR interest rates. A LIBOR index rate is calculated for seven different maturities and for five different currencies. The official LIBOR interest rates are announced daily at around 6:45 a.m. eastern time by the Intercontinental Exchange (ICE) Benchmark Administration (IBA).

USD LIBOR is still the dominant U.S. reference rate. The size of the market indexed to USD LIBOR is estimated at more than $200 trillion and growing. Transactions indexed to LIBOR include loans, bonds, securitizations investments, over-the-counter and exchange-traded derivatives, deposits, money market mutual funds, preferred stock, and other financial contracts.

The market for transactions indexed to USD LIBOR is still widely considered to be the most efficient and liquid in existence. The transition to alternative indexed market rates is expected to take years to fully develop.

What is the problem with LIBOR

Fundamental and permanent changes have occurred in the financial markets in recent years.

- Since the financial crisis, the volume of interbank transactions that form the basis for LIBOR indexes have continued to shrink. This reflects a reluctance by banks to lend to each other on an unsecured basis.

- Financial regulators throughout the world have introduced new regulatory capital regimes (under the Basel Accords). These have substantially increased the costs of unsecured borrowings by increasing the amount of capitalization.

Since the number and amount of interbank transactions continues to decline, the panel banks' submissions are increasingly determined by estimates and subjective judgment. This has opened the door to fraudulent activity.

- During the financial crisis, certain panel banks lowered their LIBOR rate quotes to conceal their true borrowing costs.

- After the financial crisis, some panel bank employees conspired to submit higher or lower rate quotes, depending on which side of the trades they were positioned.

After regulators filed charges and collected billions of dollars in fines, several banks asked to withdraw as panel banks. In 2017, the U.K.'s Financial Conduct Authority required all current panel banks to continue to participate through 2021.

In April 2018, the IBA announced the implementation of a new calculation waterfall method for determining the LIBOR benchmarks. The IBA will also look to cut the number of LIBOR rates. Both moves are intended to advance the IBA's continuation of LIBOR in a post-2021 timeframe.

It is yet to be determined if the LIBOR benchmarks will continue to be published after 2021. Many industry groups are advocating for continuation of the current benchmarks for some period beyond 2021 for legacy LIBOR indexed contracts.

Timeline: Developing an alternative reference rate

Concerns regarding the reliability and robustness of USD LIBOR rates are prompting the development of alternative benchmarks. The timeline of events traces progress made on adopting alternatives:

2012: The Financial Stability Oversight Council and Financial Stability Board call for the development of alternative interest rate benchmarks.

2014: The Federal Reserve Board establishes the Alternative Reference Rates Committee (ARRC) to identify best practices for alternative reference rates, identify best practices for contract robustness, develop an adoption plan, and create an implementation plan with success metrics and a timeline.

2016: The Financial Stability Board's Official Sector Steering Group asks the International Swaps and Derivatives Association (ISDA) to form a U.S. Benchmark Workgroup. The ISDA U.S. Benchmark Workgroup is part of the ARRC Paced Transition Plan for derivatives transactions.

2017: The ARRC recommends the creation of the Secured Overnight Financing Rate (SOFR) as the alternative reference rate for USD LIBOR. This index is based on cleared and bilateral overnight repurchase transactions on U.S. Treasuries with an average daily volume of $600 to $800 billion.

2018:

- On April 3, the first SOFR is published by the Federal Reserve. The ARRC also publishes its Paced Transition Plan, with specific steps and timelines designed to encourage adoption of the SOFR.
- The ARRC is reconstituted. Several workgroups are formed to help ensure the successful implementation of the Paced Transition Plan. The groups also serve as a forum to coordinate and track planning across cash products and market participants currently using USD LIBOR.

Farm Credit participation

CoBank and Farm Credit continue to pay very close attention to this issue and are involved with various committees and work groups.

- The Federal Farm Credit Banks Funding Corporation has representation on the ARRC Floating Rate Note sub-workgroup.
- CoBank associates are monitoring developments within the Syndicated Business Loans and Bi-Lateral Loans Workgroups.
- The System banks plan to provide input as appropriate for ARRC consultations, as they are published.
- CoBank also participates in other industry groups addressing issues related to the development of LIBOR alternative reference rates. One example is the Commodity Futures Trade Commission Market Risk Advisory Committee's Interest Rate Reform Subcommittee. Additionally, CoBank joined the ISDA benchmark workgroup, and the four Farm Credit Banks formed the FCBs LIBOR Transition Workgroup in 2017.

What's next in the LIBOR transition

In the next few months, industry workgroups will be working to define a USD LIBOR alternative reference rate. To do so, they must develop consensus on:

- The structure of the recommended replacement rate (overnight or term rates);
- What adjustments will be needed to create an alternative USD LIBOR alternative reference rates; and
- What triggers will determine the conversion to the alternative reference rate.

When the development of a consensus view is determined from the market and regulators, the process of amending existing transactions, such as loans, will begin to allow for the conversion to an alternative rate if USD LIBOR is no longer published. Additionally, new transactions will begin to be issued that are indexed to the new alternative reference rates.

CoBank will provide more information on the LIBOR transition as it develops.