PRO ANALYSIS

WHAT YOU NEED TO KNOW ABOUT

The Libor Transition

BY VICTORIA GUIDA AND TAYLOR MILLER THOMAS

- **Libor — the benchmark for interest rates on trillions of** dollars in contracts, from complicated financial derivatives to everyday mortgages — will likely disappear after 2021, less than a decade after a scandal undermined confidence in the global reference rate. A private-sector panel has recommended another vehicle — the Secured Overnight Financing Rate — be used instead for U.S. dollar-based contracts, which has drawn resistance from some banks.

- **The transition away from Libor, four decades after it** came into broad use, will happen for existing contracts that reference the rate and for new loans and financial products.

- **Banks don't take issue with tying SOFR to** derivatives — contracts used to hedge risk and make bets on future movements in financial prices — but lenders have pushed for a different option for products like business loans and adjustable-rate mortgages. They'd like a rate that would fluctuate more in line with funding costs.

HOW WE GOT HERE

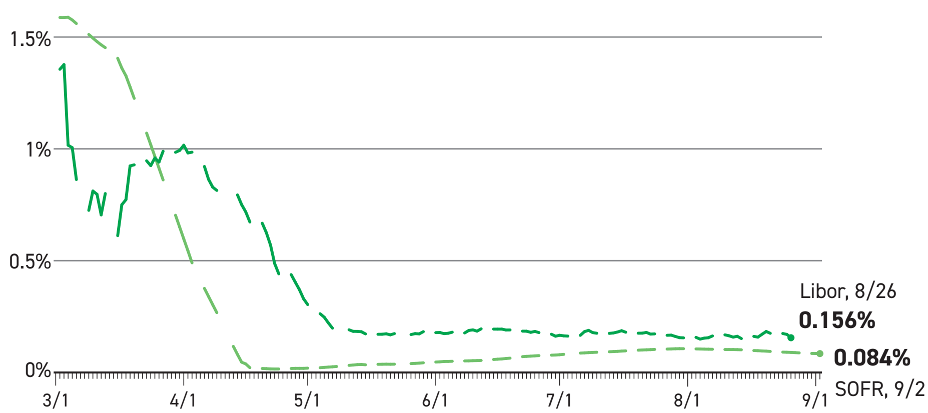
Libor, or the London InterBank Offered Rate, is supposed to reflect the average interest rate that a top bank would be charged by another bank. But since the 2008 financial crisis, regulators have enacted new rules that dictate how much cash banks have to keep on hand. That means big banks don't need to lend to each other much anymore.

It also means that calculating Libor requires some guesswork by bankers because the number of actual transactions in the interbank market has dwindled. That has worsened a dynamic that was already a problem: Banks were previously able to collude to manipulate the rate, as in the scandal that came to light in 2012. During that episode, some of the world's best-known banks submitted falsified rates for calculating Libor, which distorted markets and helped their bottom lines.

Enter the Secured Overnight Financing Rate. The Alternative Reference Rates Committee, a private-sector panel convened by the Federal Reserve, settled on SOFR in 2017 as the alternative to U.S. dollar-based Libor. It's based on secured overnight cash loans, known as repurchase agreements, a deep market with roughly $1 trillion in daily transactions. Because the loans are backed by U.S. Treasury securities, trading is unlikely to dry up in tough economic times.

Comparing Libor and SOFR 30-day rates

PERCENTAGE RATE



Note: Rates not calculated on weekends or holidays

Sources: New York Federal Reserve Bank; Intercontinental Exchange Benchmark Administration Limited; St. Louis Federal Reserve Bank FRED

But some banks are worried that because SOFR is based on a very low-risk rate, the profit they earn on their loans will actually go down during economic stress, just as their own costs to borrow money are increasing. This is of particular concern for large regional banks with corporate clients that have big credit lines with adjustable rates, which they're likely to draw on during a crisis.

Value of interest rate derivatives traded that reference SOFR

NOTIONAL VALUE, BILLIONS OF DOLLARS

Source: ISDA

Still, the Financial Conduct Authority, the independent U.K. body that regulates financial firms, has not committed to forcing banks to submit rates for calculation of Libor past the end of 2021, making it likely that the rate will disappear soon after. That means that all lenders need to have some kind of plan for how to make do without Libor.

SOFR has only been published by the New York Fed since 2018, so investors and lenders are still getting comfortable with how it behaves. And because it's an overnight rate, many different formulations of SOFR — such as the rate's average over a particular period — are used. Ultimately, any rate will behave differently from Libor, which means a lot of work for firms to figure out what that will mean for their business.

WHAT'S AHEAD

The transition is proceeding along multiple tracks. On the derivatives front, International Swaps and Derivatives Association has put together a "protocol" that will essentially incorporate language into existing derivatives contracts on what happens if Libor disappears, known as a fallback. That protocol is pending certification from the Justice Department that it doesn't pose antitrust issues, after which the group will be able to publish it. ISDA also plans to release a list of large financial players that are signing onto the protocol to encourage other market participants to pledge participation before it takes effect a few months later.

New derivatives contracts will also reference this same fallback language.

One event expected to boost the number of derivatives contracts that reference SOFR: Clearinghouses, which act as a middleman for many derivatives, on Oct. 16 will switch the rate that helps determine the value of a contract to SOFR from the federal funds rate. That in turn will encourage additional new derivatives issuance tied to SOFR.

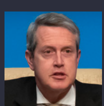
On the lending front, U.S. bank regulators have convened a working group of banks to determine if something that better reflects credit risk can be added on top of SOFR for loans. It's unclear yet whether those efforts will be successful and in the meantime, banks will need to get more comfortable referencing something other than Libor in their loans.

That could be the rate they charge their most creditworthy customers, known as the prime rate. Smaller banks might use Ameribor, which is calculated from loans that they extend to each other on the American Financial Exchange. But in general, the amount of SOFR-linked lending products should increase steadily starting in the fourth quarter, particularly since the ARRC has set Sept. 30 as the deadline by which lenders should aim to stop tying new mortgages to Libor.

The ARRC is also pushing New York state to pass legislation that would deal with floating-rate bonds and other corporate debt instruments whose terms cannot easily be changed because they require all parties to agree. That legislation would explicitly make accommodations for switching to SOFR, which has caused some pushback from skeptics of the rate. But unless a workaround is found, SOFR is likely to end up being the default reference rate on lending products as well.

Look to big banks to be more out-front on issuing SOFR-linked loans. If they can get comfortable, small banks might end up following their lead.

POWER PLAYERS



Fed Vice Chair for Supervision Randal Quarles
The regulatory chief for the central bank is overseeing efforts there to facilitate the transition away from Libor, including regulatory tweaks to smooth the use of other rates.

Alternative Reference Rates Chair Tom Wipf
The Morgan Stanley banker runs the private-sector committee that's been working to reach consensus on how to handle the many different financial products touched by the Libor transition.

The International Swaps and Derivatives Association
The trade organization has been working to ensure that there is agreement about how to treat derivatives contracts that reference Libor.