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LIBOR: No More

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Snapshot

- LIBOR is the most commonly used reference rate for a variety of interest-rate products.
- The U.K. Financial Conduct Authority, which calculates LIBOR, announced they may no longer compel banks to make LIBOR submissions beyond 2021. As a result, LIBOR may cease to exist beyond that point.
- Businesses and investors around the world will feel the impact as the transition away from LIBOR unfolds.

The London Interbank Offered Rate, or LIBOR, is arguably one of the most influential data points in financial markets. To put it precisely, "LIBOR provides an indication of the average rate at which a LIBOR contributor bank can obtain unsecured funding in the London interbank market for a given period, in a given currency."[1]

In plainer English, LIBOR is the average interest rate that large global banks charge to lend money to other banks. It is also the rate used when determining adjustable-rate mortgages in America, as well as serving as a guide for various other financial products and decisions worldwide. Whether indirectly through its effect on the performance of bonds held in a mutual fund or directly through the interest rates associated with certain types of mortgage or student-loan products, chances are you have crossed paths with LIBOR.

A Global Web

To get a better understanding of LIBOR's place in modern financial markets, picture a spider web in which the strands tightly intertwine at many points to form a far-reaching, complex structure; LIBOR's reach has a comparable grasp across financial markets. Left undisturbed, the web functions as intended.

The U.K. Financial Conduct Authority's (FCA) recent announcement—widely perceived as the first step in winding down reliance on LIBOR and potentially leading to its retirement—is analogous to an attempt at dismantling this web. The problem is that the webbing is sticky, so untangling it is a complex and seemingly intractable endeavor.

LIBOR underpins $350 trillion of financial products, so its departure will make an impression on financial markets.[2] Corporations that issue floating-rate debt will feel the impact along with their investors. Insurance companies and pension plan sponsors that hedge future liabilities will be impacted, as will their respective customers and pensioners. Even municipalities that enter into contracts to hedge the interest-rate risk on their debt issues, as well as the respective investors in those municipal bonds, could be affected.

[1] Intercontinental Exchange (ICE): ICE BENCHMARK ADMINISTRATION (IBA) — ICE LIBOR

[2] Bloomberg: Libor's Uncertain Succession Triggers $350 Trillion Headache. July 27, 2017.

Background

Individuals began to gain familiarity with LIBOR during the global financial crisis, but even then it remained fairly obscure outside of corporate and financial circles. That changed in 2012 when Main Street learned about the infamous LIBOR scandal, during which traders at Wall Street banks manipulated the rate-setting process, attracting a tremendous amount of negative press and massive fines.

News of the scandal put a spotlight on the shortcomings in oversight of LIBOR's calculation. As a result, the British Bankers Association relinquished LIBOR oversight responsibilities to the FCA in April 2013. There has been tremendous improvement in LIBOR oversight since the regulatory body took over.

Nevertheless, oversight improvements do not negate the fact that employing LIBOR as a benchmark reference rate relies on an inherently flawed methodology. Transactions in LIBOR have decreased significantly over much of the past decade due to a combination of regulations and the excess liquidity provided by global central banks that have kept interest rates artificially low and increased the amount of money in the global economy. As the volume of LIBOR-associated transactions has plummeted to a fraction of its past levels, LIBOR's accuracy as an indicator of the true clearing level for interbank liquidity has deteriorated.

The FCA acknowledged these limitations in a July 27 speech by Andrew Bailey, its Chief Executive, which effectively put a timeline on when LIBOR may cease to exist, currently scheduled for the end of 2021.

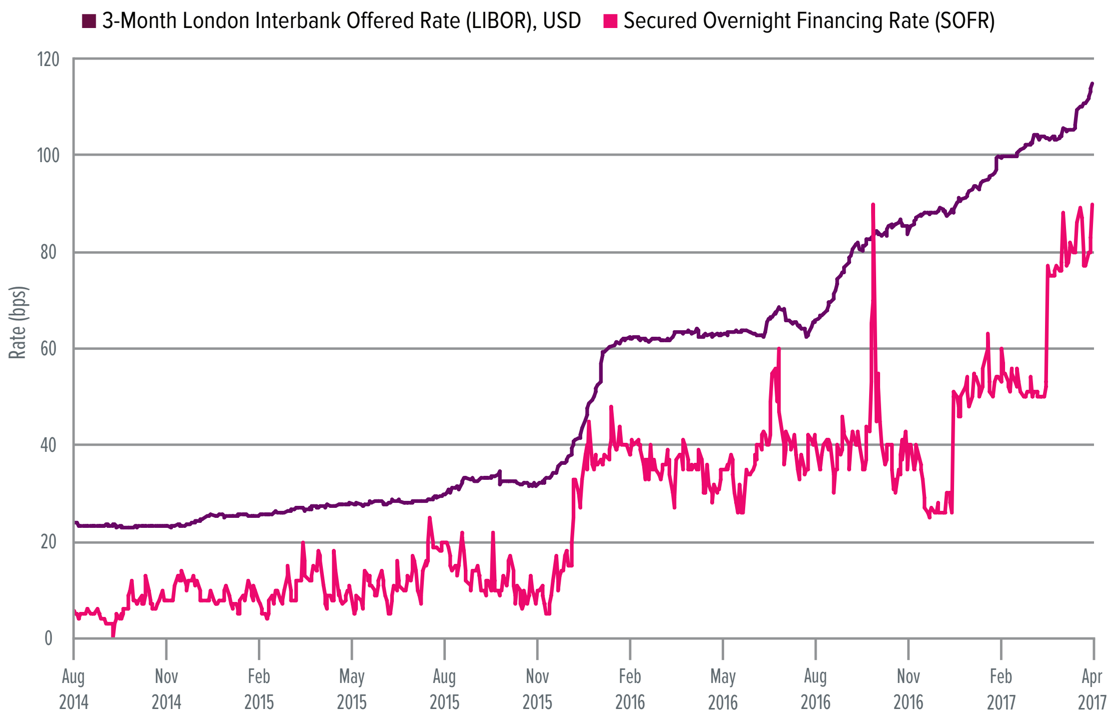
Looking Forward

LIBOR's future appears bleak, but there are more questions than answers at this early stage. Assessing the full impact of a world without LIBOR would be premature at this juncture, although there are some factors that have already begun to come into focus. A new fallback reference rate will need to be selected as LIBOR's replacement. It appears likely that each major economy will choose its own benchmark rather than seek a global replacement for LIBOR. We already know the United States, for example, established the Alternative Reference Rates Committee, which has chosen the Change to: Secured Overnight Financing Rate (SOFR) as LIBOR's replacement.

It might seem fair to infer that the selection of a new reference rate would be the biggest hurdle to overcome in a transition away from LIBOR, but nothing could be further from the truth. Simply changing from one benchmark reference rate to another has many knock-on effects that—as we previously noted—create more questions than answers. Consider the fate of a hypothetical bond with a floating-rate coupon based on LIBOR. If it matures beyond 2021, how will its cash flows be affected after LIBOR's retirement?

The new fallback rate in the United States, for example, is based on a risk-free interest rate, whereas LIBOR has an additional premium built into its rate to compensate investors for credit risk. This implies that the new reference rate—upon which our hypothetical bond's coupon would presumably be calculated after LIBOR's retirement—would be lower, and thus the income received post-LIBOR would fall, unless some type of spread is added to compensate for credit risk. The following exhibit depicts the rate differential between LIBOR and SOFR.

LIBOR versus SOFR



SOURCES: Federal Reserve Banks of New York and St. Louis, Bank of New York Mellon, JPMorgan Chase, DTCC Solutions, LLC, ICE Benchmark Administration Limited

To be clear, those responsible for overseeing these changes are aware of this particular concern and are exploring methods to address this issue and many others. These risks are still real for investors, however, and will need to be overcome.

There is also a question of how accessible these new reference rates will be to consumers of interest-rate products. An active marketplace will need to be established for these new reference rates if they can be expected to serve as viable LIBOR replacements. Consumption of financial-market products is contingent on the confidence and ability of two parties to buy and sell them. In other words, there needs to be an adequate level of supply and demand.

Banks providing investment products to investors must have the ability to capture the new reference rates in a liquid marketplace in order to supply them to investors. Investors need to be confident in the availability and accuracy of these new rates if they can be expected to demand it from the banks. This all must occur in tandem with approval of the new rates from various regulatory and oversight agencies.

Our View

If it seems like this will be difficult for financial markets to implement, that's because it will be. Coordination on a global basis among all LIBOR stakeholders will be necessary to take this from start to finish.

This summer's LIBOR sunset announcement was the first page in a developing story, and we believe the timeline set forth by the FCA is aggressive. We recognize the magnitude of the proposed change and will continue assessing its potential impact over the coming months and years.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

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