LIBOR announces retirement
A key financing rate is set to ride into the sunset.

By Jim Reber and Greg Roll

pop quiz: How many of you know what these initialisms mean (and you may be putting yourself in a certain age demographic if you do): SAIF, FGIC, RTC or GIC? Each of them does, or did, apply to the community banking industry. We'll provide the answers later.

A quarter-century from now, LIBOR, too, will be collecting dust, which is hard to imagine at the moment. A top UK regulator recently said it would phase out the London Interbank Offered Rate, a benchmark used in setting prices for trillions of dollars of loans and derivatives for US banks.

In July, Andrew Bailey, CEO of the Financial Conduct Authority (FCA), said, “I and my colleagues have therefore spoken to all the current panel banks about agreeing voluntarily to sustain LIBOR for a four- to five-year period, that is, until end 2021.” The FCA believes a four- to five-year transition away from LIBOR will be less risky and less expensive if it is planned and orderly, rather than unexpected and rushed. Looking forward, US financial institutions will need to assess the use of LIBOR as a benchmark and plan for its ultimate demise.

Reason for change
LIBOR was created by the British Bankers Association in 1986 as a way to price syndicated loans and interest rate swaps. Since then, it has become a vital pricing benchmark for loans originated by depository institutions across the country. LIBOR is based on the average rate that a group of banks estimate they would be able to borrow funds from each other. The unsecured borrowings are based in one of five different currencies across seven different borrowing time periods.

The demise of LIBOR began shortly after the financial crisis of 2008, when regulators found dozens of firms worldwide had colluded to set the benchmark at levels that would benefit their own LIBOR-linked portfolios. In 2013, officials published a set of principles to make the market more transparent, including using data from actual trades when possible.

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Although the policies set forth were designed to minimize conflicts of interest ultimately leading to a better process for establishing LIBOR rates, many market participants have deemed the rate itself to be unreliable. The lack of actual trade data for certain currencies and/or tenures created a situation in which the contributing bank estimates a rate it thinks it would pay, not what
What we know
In response to this challenge, the Federal Reserve Board and the Federal Reserve Bank of New York created the Alternative Reference Rates Committee (ARRC), engaging with market participants in search of an alternative to US dollar LIBOR. The ARRC has looked to create a quality benchmark by evaluating the liquidity, transaction volume and resilience of the underlying market. The benchmark should be constructed using a sound methodology, have evidence of a process that ensures compliance and governance structures, and be sensitive to the ease of transition.

The ARRC has voted to replace US dollar LIBOR with a benchmark rate based on short-term loans known as repurchase agreements backed by US Treasury securities, also known as Repos. The Federal Reserve Bank of New York, in cooperation with the US Treasury Department’s Office of Financial Research, will publish daily what it calls a broad Treasury Repo rate. The rate will be based on actual Repo market trades, which can see $600 billion to $800 billion in daily volume. The new benchmark rate will go through a round of public comment and will likely be published in the first half of 2018.

Current steps
Community banks will be affected, because their loan portfolios, securities portfolios and hedging structures may include LIBOR-based pricing. No immediate changes are needed, because LIBOR will not be officially phased out until the end of 2021. However, institutions should consider what benchmark to use for future index-based loan structures. Some benchmarks worth considering are Prime Rate, Constant Maturity Treasuries (CMT), and, once published, the broad Treasury Repo rate.

It will become more important to include flexibility in LIBOR-based loan agreements to accommodate changing the index for newly originated loans maturing after 2021. In addition, institutions should amend any current LIBOR-based loans maturing after 2021 to conform with a new benchmark when it is available and market transition plans are fully developed.

Summary
The plan to replace LIBOR as a benchmark interest rate is moving along and now has a proposed target date of 2021. In the US, much progress has been made preparing for the transition from LIBOR to the new benchmark rate. In fact, the new benchmark rate is currently in testing, ensuring it meets all of the required criteria. In the near future, the ARRC will provide more definitive information regarding the implementation timeline and other transition processes.

Fed funds target rate vs. three-month LIBOR

Source: Bloomberg

Webinar series
Jim Reber will present the final segment of the 2017 Community Bank Matters webinar series on Nov. 7 at 10 a.m. CST. He will discuss “Must-Dos for Year End, and the New Year.” One hour of CPE credit is available. To register, visit viningsparks.com.

LIBOR research
Vining Sparks Interest Rate Products, a subsidiary of Vining Sparks, has published a research report titled, “LIBOR Takes a Final Bow.” For your copy of this analysis of the LIBOR issue, contact your Vining Sparks sales rep.

The answers to the pop quiz are:

SAIF: Savings Association Insurance Fund
FGIC: Financial Guaranty Insurance Company
RTC: Resolution Trust Corporation
GIC: Guaranteed Investment Contract

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