INVESTMENT COUNSEL AND MANAGEMENT

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Identifying LIBOR-Based Loans and Securities in Preparation for Post-2021 LIBOR Phase Out

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On July 27, 2017, the Financial Conduct Authority (FCA) in the United Kingdom, which officially oversees LIBOR, announced that LIBOR will be phased out as a benchmark rate by the end of 2021. The decision follows a call by the Financial Stability Oversight Council (FSOC) and the Financial Stability Board (FSB) in the United States, the joint overseers of systemic financial risk in this country, to develop an alternative to LIBOR for use in the $370 trillion swaps and derivatives market, and also with loans, securities and financial contracts currently tied to the LIBOR benchmark.

The decision to phase out LIBOR is a result of flawed system that began to unravel during the financial crisis. In 2008, the interbank lending market dried up. This meant that daily bank updates for interbank loans were no longer based on live transactions. They were based on subjective estimates. This exposed deeper problems. Banks were accused of manipulating their submissions to the authorities, in their favor, to hide the fact that they were having difficulty borrowing.

Following that tumultuous period, in 2014 the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York convened an “Alternate Reference Rate Committee” to identify an appropriate substitute benchmark and to provide guidance on transitioning existing contracts tied to LIBOR to an alternative standard.

The Committee has identified the so-called “secured overnight-funding rate” or “SOFR” (i.e., overnight repo rates) as the most appropriate alternative substitute for LIBOR and will officially begin publishing this rate in the first quarter of 2018. As a reference point, over the last 15 years 3-month LIBOR has exceeded SOFR by approximately 25 basis points.

While many transition questions remain, in preparation for LIBOR phase out it is important that financial institutions attempt to identify all individual loan agreements, floating-rating securities (e.g., TruPS and certain asset backed securities), interest-rate swaps, loan categories (e.g., adjustable-rate mortgages, student loans, home equity loans and lines of credit, credit card loans), debt and other funding arrangements, and any other commitments that are contractually tied to LIBOR and that will extend past 2021 in order to determine what, if any, provisions, they incorporate regarding a replacement for LIBOR.

Further industry and regulatory guidance is expected over the next 12-24 months to assist financial institutions in making this transition. We will keep you apprised of further relevant information as it becomes available.

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