



Will the U.S. abandon LIBOR as a base interest rate?

The London Interbank Offered Rate (“LIBOR”) serves as the leading interest rate benchmark for various loans throughout the world. It is the world’s most-widely used benchmark for short-term interest rates and underpins more than \$350 trillion in securities. LIBOR’s primary function is to serve as the benchmark reference rate for debt instruments, including government and corporate bonds, mortgages, student loans, as well as derivatives, such as currency and interest rate swaps. LIBOR is set by a panel of banks from around the world that submit the rates at which they would be prepared to lend money to one another, on an unsecured basis, in various currencies and at varying maturities.

The LIBOR Phase Out

Despite its long-standing history as a steadfast and reliable benchmark, LIBOR has recently been at the heart of a massive price-fixing scandal since it was discovered that banks were improperly inflating and deflating the rates to benefit themselves. It was found that the LIBOR fixing process in London had become a cartel, and in the United States claims were made regarding mortgage rate manipulation and significant decreases in the payments on interest rate swaps. This widespread manipulation by U.S. and European lenders led to billions of dollars in fines against some of the biggest and most notorious banks. The European Commission fined Deutsche Bank 259 million Euros, JPMorgan 80 million Euros, and the Royal Bank of Scotland 260 million Euros. Deutsche Bank was also fined \$2.175 billion by American regulators and 227 million Euros by British authorities.

In July 2017, the Chief Executive of the Financial Conduct Authority (FCA)¹ indicated that the FCA plans to replace LIBOR by 2021. While the panel banks voiced support for continuing to sustain LIBOR until then, there has been no formal agreement laid down between the FCA and the global banks that help set LIBOR, and thus there is a risk that these banks that currently contribute to LIBOR will back out sooner than that.

While improvements have been made since the FCA started regulating LIBOR in 2013, it has become difficult to ensure that the rate is truly and accurately representative of market conditions.



The underlying market that LIBOR seeks to measure, the market for unsecured wholesale term lending between banks, is no longer sufficiently active, nor, as the Chief Executive stated, does there appear to be any indication of these markets becoming substantially more active in the near future. For example, in one currency-tenor combination, for which a benchmark is produced every business day using submissions from around a dozen panel banks, these banks, between them, executed only 15 transactions of potentially qualifying size in that currency and tenor in the whole of 2016.

U.S. Efforts to Replace LIBOR

The Alternative Reference Rates Committee (ARRC) was convened by the Board of Governors of the Federal Reserve System to identify best practices for alternative reference rates, identify best practices for contract robustness, develop an adoption plan, and create an implementation plan. In an effort to find a replacement for LIBOR, the ARRC identified the Secured Overnight Financing Rate (SOFR) as the rate that represents best practice for use in certain new U.S. dollar derivatives and other financial contracts. On April 3, 2018, the New York Federal Reserve, cooperating with the U.S. Office of Financial Research, launched this new benchmark U.S. rate.

LIBOR interest rates are not based on actual transactions, but rather on the panel banks' judgment regarding at what interest rate they would expect to be able to raise a substantial loan in the interbank money market at that moment. Where LIBOR relies on the expert judgment of bankers, the SOFR is based on real transactions from a variety of firms including broker-dealers, money-market funds, asset managers, insurance companies and pension funds. The SOFR is based on the overnight Treasury repurchase agreement market, which trades around \$700 billion in volume daily, and measures the cost of borrowing cash overnight collateralized by Treasury securities. Additionally, it is a secured rate, since the repurchase agreement rates SOFR is derived from are backed by assets. SOFR is an overnight rate, based specifically on overnight loans, whereas LIBOR covers loan maturities ranging from one day to one year.

As of May 4, 2018, the SOFR overnight rate is at 1.72%, based on \$752 billion worth of overnight transactions. The LIBOR overnight rate on that same date was set at 1.70563%, based on the panel banks' expert judgments. The ARRC plans to grow the demand for trading SOFR derivatives with its Paced Transition Plan², and as part of its plan, CME Group Inc. launched monthly and quarterly SOFR futures on May 7, 2018. Three-Month SOFR futures contract listings will comprise 20 sequential quarterly contracts commencing June 2018 and One-Month SOFR futures contract listings will comprise the nearest 7 calendar months, commencing May 2018.



This effort to develop a deep derivatives market is critical because it would allow regulators to create longer-term SOFR-based reference rates beyond an overnight maturity.

However, just two weeks after its launch, the new benchmark rate is already stirring up some problems. The New York Federal Reserve admitted it had accidentally included certain repurchase agreement transactions in the SOFR settings for April 2 to April 12³. It investigated the settings after market participants commented on the higher-than-expected volumes of repurchase-agreement deals underlying the SOFR rate.

Any transition away from LIBOR is going to take time and, as has already been demonstrated, obstacles, mistakes and miscalculations are more likely than not to arise, and any rush to replace this global benchmark could result in devastating costs and repercussions.

So What Do We Do Now?

The future of LIBOR is uncertain, and it may be some time before a viable replacement is designated and adopted. However, it has been recommended that existing loans tied to LIBOR should be reviewed in order to see if the loan documents include sufficient language that allows a replacement rate to be chosen in the event that LIBOR is no longer set and published. These documents should also be reviewed for any language permitting amendments or whether such an amendment is needed to account for the end of LIBOR and the entry or selection of a new rate. Looking forward, any new loan documents should include fallback provisions that provide the lender and borrower a clear alternative for choosing a rate if LIBOR ceases to exist. These fallback provisions should also include language that protects the lender if LIBOR continues to be a subjective and unreliable rate.

Nevertheless, since LIBOR is such a global benchmark, it will take time to develop any sustainable replacements on the appropriate market and generate support for the new benchmark. With the uncertainty of LIBOR's future and the future of the SOFR, participants nationwide and worldwide are waiting for further developments before making any decisions, and so we too may have to wait and see.

¹ *The FCA is a financial regulatory body in the U.K., but operates independently from the government, and is responsible for conduct and prudential regulation in the U.K. Its authority stems from the Financial Services and Markets Act 2000 (amended by the Financial Services Act 2012) and from EU and U.K. competition law, which grant*



the FCA powers to make rules, investigate and enforce the rules. It can take actions such as suspending firms and individuals from undertaking regulated activities, issuing fines against firms and individuals who breach the rules or commit market abuse, and bringing criminal prosecutions to tackle financial crime, such as insider dealing and unauthorized business.

² *The plan is a 6 step process, consisting of the following steps: (1) ARRC members will input infrastructure for futures and/or overnight index swap (OIS) trading in the new rate in 2018; (2) Trading in futures and/or bilateral, uncleared OIS that reference SOFR will take place by the end of 2018; (3) Trading will begin by 2019 in cleared OIS that reference SOFR in the current effective fed funds rate (EFFR) price alignment interest (PAI) and discounting environment; (4) Central counterparties (CCPs) will begin allowing market participants a choice between clearing new or modified swap contracts into the current PAI/discounting environment or one that uses SOFR for PAI and discounting beginning in 2020; (5) CCPs will no longer accept new swap contracts for clearing with EFFR as PAI and discounting, with some exceptions, in 2021; and (6) By the end of 2021, a forward-looking term reference rate based on SOFR derivatives will be created.*

³ *Forward-settling overnight Treasury repo transactions – overnight repo transactions conducted on previous business days for settlement on the same date as the same-day settling transactions that represented in the SOFR – were inadvertently included in the source data.*