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LIBOR phase out

Why it's happening, what's next, and what it could mean for individual investors

Financial institutions must find new ways to set interest rates as the industry shifts away from LIBOR, a widely-used but too-easily-manipulated benchmark.

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What is LIBOR? Many financial institutions, mortgage lenders and credit card agencies set their interest rates relative to LIBOR, a rate based on a daily survey of leading London banks. This system gained prominence in the 1980s and is now tied to several hundred trillion dollars in financial products including adjustable-rate mortgages, asset-backed securities, municipal bonds, private student loans.

Why does LIBOR have to go? LIBOR has been on its way out since a massive manipulation scheme came to light in 2012. Although measures were taken at the time to prevent further fraud, LIBOR is considered fundamentally too easy to manipulate. It's also been increasingly seen as too arbitrary as LIBOR is based not on actual rates that banks charge each other but on a self-reported, estimated rate. This topic is being more widely discussed lately as regulators move forward with a LIBOR phase out (the last publication of 3-month LIBOR will be June 30, 2023).

What will be used instead? Regulators globally have been investigating alternative risk-free rates that are based on a larger pool of inputs and on observable underlying transactions. Although replacement of LIBOR will not be a uniform transition to one rate, the main replacement in the U.S. will likely be Secured Overnight Financing Rate (SOFR) which was launched in 2018 by the New York Federal Reserve. That rate is secured by Treasury debt and based on overnight loans in the Treasury Repurchase market. Theoretically, this makes it a more accurate indicator of borrowing costs (and therefore a better foundation for interest rates).

Will SOFR work the same as LIBOR though? While it is nearly risk-free, a major criticism of SOFR is that it does not capture bank credit risk—which could result in difference in performance during a financial crisis (when Treasury prices tend to rally while credit spreads widen). SOFR's lack of a credit component means it currently yields about one-tenth of one percent less than LIBOR.

Another criticism of SOFR is that it looks back whereas LIBOR looks forward. Since SOFR is backward-looking, the borrower won't know exactly what they owe until the end of the loan. Despite this change, large banks are likely to adopt SOFR for pricing variable rate issues because of Fed sponsorship and recent New York state legislation supporting it.

What are the other possible replacements? As this topic has heated up, possible replacements besides SOFR have come to the fore.

- **Ameribor**—This index, developed by the American Financial Exchange and in use since 2015, is already in use among larger regional banks. It is forward-looking and has a credit component.
- **BSBY**—The Bloomberg Short-Term Bank Yield Index is published each morning and is based on proprietary inputs that attempt to make up for the two major differences between SOFR and LIBOR (credit risk and forward-looking vs. backward looking).
- **ICE bank yield index**—This has not been launched yet but is similar to Ameribor and BSBY in that it is forward-looking and has a credit component. It will be administered by the same company that took over administration of LIBOR in the wake of the manipulation scandal uncovered in 2012.

Do I need to worry about all this? Chances are you will not notice a material, if any, change as a result of this LIBOR phase-out. Baird has already been moving to minimize any effects of the end-of-year shift away from LIBOR.

One area where clients could see an effect is in adjustable-rate loans. If you have an adjustable-rate loan currently based on LIBOR rates, a shift to another index could affect your future interest rate but that does not mean it will be a dramatic change. You can find out more from your lending institution.

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