Leaving LIBOR – What does it mean for you?

For more than 40 years, the London Interbank Offered Rate, or LIBOR, has been a key benchmark for setting the cost of floating-rate debt around the world. LIBOR also plays a big role in pricing debt issued by corporate borrowers. Following the 2008 financial crisis, the integrity of LIBOR was questioned due to manipulation concerns. A contraction in the unsecured interbank lending market has also substantially reduced the volume of transactions on which to base panel bank estimates. With LIBOR rates a less reliable benchmark, regulatory guidance requires banks to stop making new LIBOR loans by the end of 2021 and shift existing LIBOR loans to other indexes by June 30, 2023.

To help speed the transition, the Alternative Reference Rates Committee (ARRC), a group of private-market participants, was convened by the Federal Reserve Board and the New York Federal Reserve Bank to seek alternatives to LIBOR. ARRC is leading the transition away from LIBOR and is responsible for publishing recommended best practices to outline important transition activities and milestones.

Additionally, the International Swaps & Derivatives Association (ISDA) is leading the transition of the USD LIBOR derivatives (e.g., interest rate swaps) markets away from LIBOR. ISDA and ARRC work closely together to confirm alignment in their objectives.

In 2017, ARRC recommended a new overnight, risk-free benchmark, the Secured Overnight Financing Rate (SOFR), as a replacement benchmark for U.S. bond and loan market transactions. The New York Federal Reserve Bank now publishes SOFR daily, as well as SOFR Averages and a SOFR Index. The Daily Simple SOFR convention, also recommended by ARRC, calculates and aggregates interest daily and is being used for many types of business loans.

However, the transition to SOFR is not without its challenges. Because Daily SOFR reflects overnight borrowing rates, borrowers may dislike it because they are less able to predict payments, and their loans wouldn't reflect expectations of rate changes — one of the key attractions of LIBOR. To address this issue, on July 29, 2021, ARRC formally recommended the Chicago Mercantile Exchange (CME) Group's forward looking 1-month, 3-month and 6-month term SOFR rates for commercial loans, and the number of SOFR-linked products is growing.

Another issue is that unlike LIBOR, the new rates fail to capture the credit risk that banks assume when they lend. As a result, some market participants and industry groups advocate for, and in some cases employ, an established benchmark like Prime, or newly created benchmarks such as the American Interbank Offered Rate (AMERIBOR), Bloomberg Short-Term Bank Yield Index (BSBY), or ICE Bank Yield Index (BYI).

While alternatives to SOFR – including credit-sensitive rates – continue to be discussed, most market participants are following the ARRC recommendation to use SOFR as the replacement benchmark rate. If you have an adjustable-rate loan based on LIBOR, find out what index your lender will be switching to. If you're considering new adjustable-rate debt, ask your lender about options. While there might not be set answers now, keep an eye on the situation. A switch to a different index could potentially mean a change in your base rate in the future.