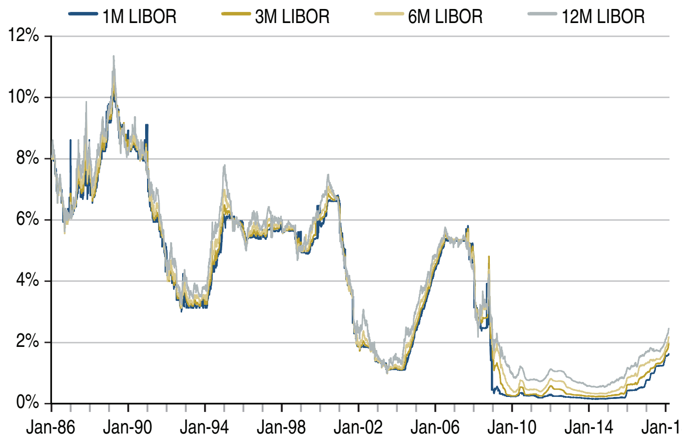
The Future of LIBOR: What's Next?

LIBOR is something that affects everyone in one way or another. Whether it be 529 planning, buying a new car or having an adjustable-rate mortgage, LIBOR is a prevalent component of financial markets. The London InterBank Offered Rate, or LIBOR, is the average interest rate at which banks can borrow from one another. It is one of the key benchmarks for floating rate loans. U.S. dollar LIBOR is considered the most globally significant reference index, setting the price for $150 to $200 trillion in adjustable-rate mortgages, auto loans, student loans, credit and derivative securities. According to the Intercontinental Exchange (ICE), LIBOR "provides an indication of the average rate at which a LIBOR contributor bank can obtain unsecured funding in the London interbank lending market for a given period, in a given currency. ICE LIBOR rates are the end-product of a calculation based on submissions from LIBOR contributor banks."[1] However, with LIBOR on the brink of elimination – expectedly by 2021 – it is imperative for investors to be privy to the various benchmarks that will likely replace this very powerful Goliath which plays a part in over $300 trillion in financial instruments.

Daily LIBOR rates are set for periods as short as overnight to as long as 12 months, with levels driven primarily by the federal funds rate set by the Federal Reserve. Typically, when the Fed is tightening, LIBOR will move in lockstep with front-end rates. Since two more rate hikes are expected in 2018, upward pressure on front-end rates and LIBOR should continue as a result. When higher front-end rates are combined with a flattening yield curve (i.e. front-end rates continue to rise while long-term rates fall, or rise less than short-term rates), LIBOR becomes an even more interesting benchmark. In some yield curve flattening scenarios, short-term LIBOR rates may even yield more than a much longer maturity on the yield curve, an atypical scenario. Rising short-term LIBOR rates in a flattening yield curve environment can give rise to attractive investment opportunities.

Chart 1 shows 1-month, 3-month, 6-month and 12-month LIBOR rates over the last 30 years. While the swings in rates have been drastic, they tend to move together. The most recent rise in rates, while not the most drastic, has been the largest percentage rise.

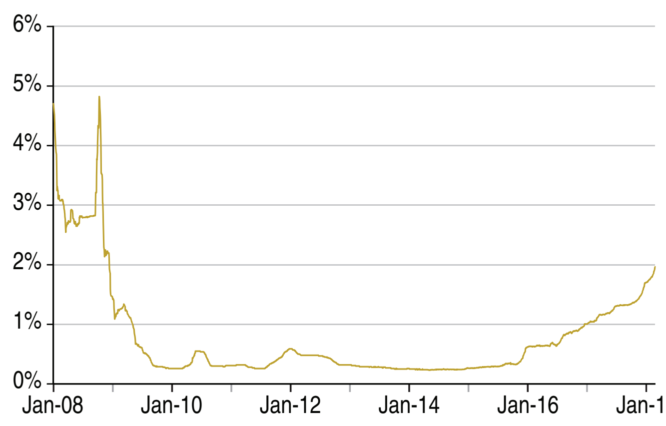
CHART 1 | **LIBOR Rates: 30-Year Historical Chart**



Source: Macrotrends.

The most common benchmark is 3-month LIBOR, as seen with many consumer loans as well as floating-rate securities. *Chart 2* begins in January 2008, prior to the financial crisis, and peaks in October 2008 at 4.81%. About a year later, in September 2009, 3-month LIBOR began hovering around .30% and stayed there until November

CHART 2 | **3-month LIBOR Rates**



Source: Macrotrends.

2015. Since then, 3-month LIBOR has been on a steady rise to 2.22% as of this writing. This drastic leap from .30% to 2.22%, a 640% increase, has increased the cost of many consumer loans, but has also given a much-needed yield increase to floating-rate investments.

In a perfect world, a benchmark as deeply entwined in the financial markets as LIBOR would have unquestionable validity and transparency. LIBOR underlies trillions of dollars in financial instruments. Unfortunately, there has been much controversy about the possible manipulation of the daily setting of LIBOR. It has even been referred to as "LIE-bor" following a price-fixing scandal among contributor banks and brokers. In addition to the well-documented instances of manipulation, the number of contributor institutions actively quoting the inputs used to formulate daily LIBOR rates has dwindled to a point that it is difficult to achieve a quorum, further undermining the validity of the rate. According to the Financial Conduct Authority, for these reasons and others, LIBOR is expected to be phasing out by the end of 2021.

So if LIBOR is going to become obsolete in a few short years, what will replace it? There are several different possibilities, three of which are outlined below. Starting in the second quarter of 2018, the Federal Reserve Bank of New York will produce three rates: Tri-Party General Collateral Rate (TCGR), Broad General Collateral Rate (BGCR) and Secured Overnight Financing Rate (SOFR).[2]

Descriptions of each rate can be found below:

Tri-Party General Collateral Rate (TGCR)
The Tri-Party General Collateral Rate is the measure of rates on overnight, tri-party general collateral repo transactions where the counterparties know each other. All terms are negotiated and agreed upon prior to using the service of a tri-party agent to clear and settle trades. This rate would be based primarily on information from BNY Mellon, the bank that clears many of these repo transactions.

Broad General Collateral Rate (BGCR)
The Broad General Collateral Rate captures all trades where the specific securities provided as collateral are not specified until all other terms of the trade are agreed upon. BGCR includes all TGCR trades plus general collateral trades.

Secured Overnight Financing Rate (SOFR)
The Secured Overnight Financing Rate is the broadest measure of the cost of borrowing in the repo market. It is intended to reflect the general cost of borrowing cash overnight with treasury securities as collateral. SOFR would be the largest volume in the market today because it includes the bilateral repo market.

These proposed rates are all overnight rates, so even if they do become part of the solution for a LIBOR replacement, the challenge of term structure (weekly, monthly, quarterly, etc.) to agree upon remains. What is certainly not "overnight" is the transition process from LIBOR to its appropriate replacement, given LIBOR's pervasive nature. In order to successfully transition LIBOR to reference rates firmly based on transactions, the process must begin now.

There is no question that a benchmark rate is essential to support the financial markets. It is uncertain at this point the precise future of LIBOR and what will succeed it. However, given the scandals surrounding LIBOR in the past, it is imperative that its replacement should be a benchmark that is grounded in integrity and accuracy, and less susceptible to human manipulation.

1 Intercontinental Exchange
2 Federal Reserve Bank of New York

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