LIBOR Leaves Us In 2021. But What Comes Next? SOFR? Stay Tuned.

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Along with the Prime Rate, LIBOR (London Interbank Offered Rate) has been a benchmark index for short-term interest rates, going-on 40 years. Needing a short-term interest rate index besides the Prime Rate, bankers started using the rates that London banks charge each other for overnight lending. Over time, the British Banker's Association, and its replacement, the ICE Benchmark Administration, have collected these short-term rates from London panel banks and published them daily. The common quotes are for an overnight rate, a 30 day/One Month rate, a 90 day /Three Month Rate, a 180 day/Six Month Rate and a One Year Rate. LIBOR has also morphed into a daily index used by some financial institutions for an index that resets every business day based on the daily One Month LIBOR quote.

Trillions of dollars of loans, financial contracts and derivatives are linked to LIBOR. But LIBOR has a short life. After 2021, LIBOR regulators (including the UK Financial Conduct Authority and the US Commodity Futures Trading Commission) will no longer ask banks to provide LIBOR quotes. Why? LIBOR got a black eye during the last banking crisis; it was the peg index for those high risk derivatives that melted down the financial markets (guilt by association). Further, overnight lending, as a source of bank liquidity, has declined, so LIBOR is no longer a robust indicator of short-term interest rates. What standard index comes next?

The Federal Reserve Board convened the Alternative Reference Rates Committee (ARRC) to determine a replacement for US Dollar short-term rate quotes and it has selected the Secured Overnight Financing Rate (SOFR), which is a measure of the cost of borrowing cash overnight collateralized by US Treasury securities. SOFR is gaining momentum in financial markets as a substitute for LIBOR. In July 2018, Fannie Mae issued $6 Billion in floating rate notes, in three different maturities, using SOFR as the reference rate, the first SOFR based securities issuance.

The new SOFR and the old LIBOR are not "apples to apples" however; SOFR is based on collateralized borrowing, LIBOR is not. Being derived from rates on secured transactions, and therefore less risky, the SOFR quotes will likely be lower than the LIBOR quotes. This means that LIBOR-referenced indexes cannot be just switched to SOFR without some adjustment, but there is not yet a

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"conversion table." Further, SOFR is currently only an overnight rate; there are no one-month, three-month etc. quotes, as there are now with LIBOR.

To conclude, LIBOR is on its "last leg", that's for sure. SOFR is the leading candidate in the US to replace LIBOR after 2021. But how we get there is a work-in-progress. Stay tuned.