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LAW OF THE LAND

YEAR-END DEPARTURE

A Long Goodbye to LIBOR

Benchmark with Checkered Past Shelved After Four Decades

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The London Interbank Offered Rate (LIBOR) was a widely accepted benchmark interest rate among financial institutions for over 40 years. Trillions of dollars in loans and other financial products were tied to LIBOR pricing. But LIBOR became tainted by scandal, and its time in the U.S. is coming to an end.

LIBOR is not a single interest rate, but 35 different interest rates determined by the Intercontinental Exchange (ICE) on a daily basis for the U.S. dollar, the British pound, the euro, the Japanese yen and the Swiss franc, on loans with maturities of one day, one week, one month, two months, three months, six months and one year.

On a daily basis, ICE asks a panel of major global banks, such as Bank of America, Barclays, Citibank, JPMorgan Chase, Citibank, UBS and Deutsche Bank, to quote what interest rates they are willing to pay on loans at the stated maturities. ICE then discards the highest and lowest quotes, producing trimmed averages as LIBOR for each currency and maturity. This method of determining LIBOR is based on what major banks say they are willing to pay for short-term loans, not on what they are actually paying for such loans.

Trillions of dollars in loans and other financial products were tied to LIBOR pricing. But LIBOR became tainted by scandal, and its time in the U.S. is coming to an end.

Although interest rates tied to LIBOR can be competitively priced, LIBOR is subject to constant change, making some borrowers and investors uncomfortable. Many borrowers and investors prefer fixed interest rates, which allow predictable debt services costs for borrowers, and predictable returns for investors.

In contrast, some borrowers and investors prefer floating rates, such as LIBOR, which allow borrowers to benefit from rate decreases, and investors to benefit from rate increases. In response, banks market profitable interest rate swaps as financial products. Swaps enable borrowers and investors to trade fixed rates for floating rates, and vice versa, to mitigate undesired risks.

An Invitation for Mischief

The method of determining LIBOR, and LIBOR's popularity in interest rate swaps, gave rise to considerable mischief that surfaced in the wake of the 2008 recession. An analysis by The Wall Street Journal indicated that some banks on the LIBOR panel quoted lowball rates that did not reflect in-

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creased loan defaults during the recession, and were out of line with rates quoted by other banks on the panel.

Also, financial institutions on the panel were parties to interest rate contracts tied to LIBOR, giving them incentives to make daily LIBOR quotes that manipulated LIBOR to increase the value of their contracts. A complicated scheme involving these activities was revealed in 2012. Subsequent investigations discovered collusion among multiple banks to manipulate LIBOR over many years. The investigations resulted in over $9 billion in fines against banks, and criminal charges against traders and brokers.

Responding to this misconduct, in 2014 the Federal Reserve convened the Alternative Reference Rates Committee (ARRC), a group of private-market participants, to manage a transition from U.S. Dollar (USD) LIBOR to a more reliable benchmark rate. In 2017, the ARRC identified the Secured Overnight Financing Rate (SOFR) as a desirable replacement benchmark rate. Since then, use of LIBOR has declined.

The Federal Reserve Bank of New York's website publishes SOFR on a daily basis. Unlike LIBOR, SOFR is based on an average of interest rates that banks actually pay for overnight loans secured by Treasury securities. The methodology for determining SOFR is complicated and requires challenging data collection and mathematical formulas, but regulators and financial institutions seem confident that SOFR will not be prone to the same manipulation as LIBOR.

The Inevitable Ending

LIBOR's phase-out became inevitable on Nov. 30, 2020, when the Federal Reserve's Board of Governors, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp. issued an interagency statement encouraging banks to move away from USD LIBOR as soon as practicable.

ICE will cease publishing the one-week and two-month USD LIBOR rates on Dec. 31, 2021, and the remaining USD LIBOR rates on June 30, 2023. USD LIBOR will remain in limited use until June 30, 2023, so existing USD LIBOR contracts can mature before LIBOR experiences disruptions. The interagency statement warns that financial institutions that fail to prepare for the end of USD LIBOR could undermine their financial stability. The statement strongly discourages financial institutions from entering into contracts based on USD LIBOR after Dec. 31, 2021.

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Given LIBOR's checkered past, few people will grieve as it disappears over the next several months. It remains to be seen whether SOFR will gain acceptance as a replacement to LIBOR, and whether it will prove to be safe from manipulation.

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