ABA Backgrounder: Transitioning from Libor to Alternative Reference Rates
December 2018

The transition from the London Interbank Offered Rates, which underpins more than $200 trillion in mortgages, commercial loans, bonds and derivatives, to alternative reference rates such as the Secured Overnight Funding Rate, poses economic, customer relations and operational challenges. As such, ABA encourages bankers to review their loan agreements and other contracts based on Libor and engage in the Alternative Reference Rates Committee's deliberations surrounding the transition.

A key economic challenge is that although Libor, in theory, correlates to bank funding costs (i.e., moving up or down as those costs move), SOFR, as a risk-free secured rate pegged to overnight Treasury repurchase transactions, is less likely to do so. Especially in stressed markets, SOFR is likely to decline, while actual bank funding costs are likely to increase. For loans and other assets based on SOFR, lenders and investors would expect a decrease in asset yields when funding costs rise, in contrast to the generally positive correlation vis-à-vis Libor-indexed assets.

A second economic challenge, for both banks and borrowers, would result from expected changes in derivatives markets. Though interest swaps and other hedging instruments based on Libor are relatively liquid, the expected development of overnight index swaps tied to SOFR will make hedging term assets more difficult, at least in the short term prior to development of a term structure for SOFR. During the transition period, mismatching of hedges based on overnight SOFR and assets based on a different benchmark will complicate asset-liability management for both institutions and their customers. Eventual development of a SOFR term structure and increased liquidity in SOFR-based derivatives markets should mitigate this issue. However, the disconnect between SOFR and bank funding costs in distressed markets, as discussed above, is less easily solved.

Lack of customer familiarity with SOFR will understandably complicate the transition to the new benchmark. Customers are generally familiar with historical Libor behavior in a variety of market scenarios, and they will require some time and effort to achieve a similar familiarity with SOFR. The Federal Reserve Bank of New York publication of indicative SOFR based on historical data is useful, but wider publication of information, including comparative behavior of indicative SOFR and other, better-known market indices should continue, with increased emphasis, to attract wider public attention.

This effort is important with commercial and institutional products, as is currently underway, but consumer financial products tied to Libor present an even greater challenge. In addition, because of the different economic behavior of Libor and SOFR discussed above, a successful transition will require some type of spread adjustment. Market participants will initially face uncertainty in working out the economic translation between the two, which will be critical to avoiding a transfer of value – and the creation of winners and losers – as a result of the transition. The current efforts in derivatives markets to address the spread concern will likely be useful, but market participants frequently mention this uncertainty as a key concern.

Finally, the transition for both existing transactions based on Libor and new transactions present significant operational problems. Existing transactions present a wide variety of fallback terms to address a possible Libor cessation, but consumer financial products are believed generally to lack robust provisions. Some institutions have expressed a desire for a “synthetic Libor” to continue until legacy transactions have matured or been restructured in the ordinary course of business, but government authorities’ concerns about the implications of continuing LIBOR quotations longer than absolutely necessary make this option highly uncertain. If legacy and new transactions (i.e., those completed prior to actual Libor cessation and before some of the current uncertainties about SOFR-based market activity have been resolved, but presumably with more robust fallback language) have to be negotiated or amended in a compressed timeframe, banks and borrowers will face considerable operational challenges. Avoiding major economic impacts at least at the firm level due to the disruption of hedge alignments will add to the operational burden, as hedges may have to be restructured or adapted as well.

Questions? Contact ABA’s Hu Benton for more information.