Libor Transition: What Borrowers Need To Know

LIBOR, the London Interbank Offered Rate, is the world's most widely used benchmark for short-term rates, but its era of influence is slated to end by the end of 2021.

Therefore, financial institutions globally must transition any products currently linked to LIBOR to alternative reference interest rates. This change will affect some adjustable (or variable) rate loans and lines of credit like commercial loans, adjustable-rate mortgages (ARMs), reverse mortgages, home equity lines of credit, credit cards, auto loans, student loans, and any other personal loans that are indexed to LIBOR.

Following are a few things borrowers need to know about the LIBOR transition.

What is LIBOR?

LIBOR is a variable interest rate and financial benchmark, based on the rate at which banks lend to one another on an unsecured basis in the London interbank market.

LIBOR is widely used as a reference rate for financial contracts and as a benchmark to gauge funding costs and investment returns for a broad range of financial products, including adjustable-rate mortgages, credit cards, floating-rate bank loans, and interest rate swaps.

In addition, variations in the "spread" between LIBOR and other benchmarks indirectly act as a key indicator of changing investor sentiment in global financial markets.

Why replace LIBOR?

Global markets have grown in size and complexity. Yet, the methodology for calculating LIBOR rates has remained largely unchanged. Each day a group of large banks, known as panel banks, report their funding rates to the Intercontinental Exchange Benchmark Administration (IBA), which took over administering LIBOR in 2014. Those numbers are averaged, adjusted and released at approximately 11:45 a.m. London time each business day.

This process is outdated, but the bigger concern is the significant decline in sample size for calculating LIBOR since the 2008 financial crisis. In its aftermath, fewer panel banks have been reporting, and those that do are reporting fewer transactions. Instead, LIBOR has increasingly relied on what the IBA calls "market and transaction data-based expert judgment."

What is LIBOR's replacement?

Banks will be transitioning to alternative reference rates such as the Wall Street Journal (WSJ) Prime Rate, the Federal Funds Rate, and the newly created Secured Overnight Funding Rate, or SOFR.

At its core, the WSJ Prime Rate is tied to America's benchmark interest rate, the Federal Funds Target Rate (FFTR). The Wall Street Journal asks 10 major banks in the United States what they charge their most creditworthy corporate customers. It publishes the average on a daily basis, although it only changes the rate when 70 percent of the respondents adjust their rate. While each bank sets its own prime rate, the average consistently hovers at three percentage points above the funds rate.

The federal funds rate is mostly relevant for the U.S. economy, as it represents the rate at which highly creditworthy U.S. financial institutions trade balances held at the Federal Reserve, usually overnight. The federal funds rate is set by the U.S. Federal Reserve.

SOFR is based on transactions in the U.S. Treasury repurchase, or repo, market, where banks and investors borrow or lend Treasurys overnight. The Fed began publishing SOFR in 2018.

Other countries are introducing their own local-currency-denominated alternative reference rates for short-term lending.

What is the timeline for the LIBOR transition?

USD LIBOR's formal retirement is set for the end of 2021—but that timeline isn't absolute. It's possible that rates based on LIBOR could continue to be published after that point. However, it's also possible that LIBOR will effectively end before 2021 if the number of panel banks reporting to LIBOR—currently between 11 and 16—falls below four.

What will the LIBOR transition mean for customers?

At PlainsCapital, we are taking steps to ensure our customers have the necessary support through this transition. Our goal is to ensure our customers are informed with the appropriate information and equipped to make educated decisions. If you have any questions, please contact your loan officer directly.