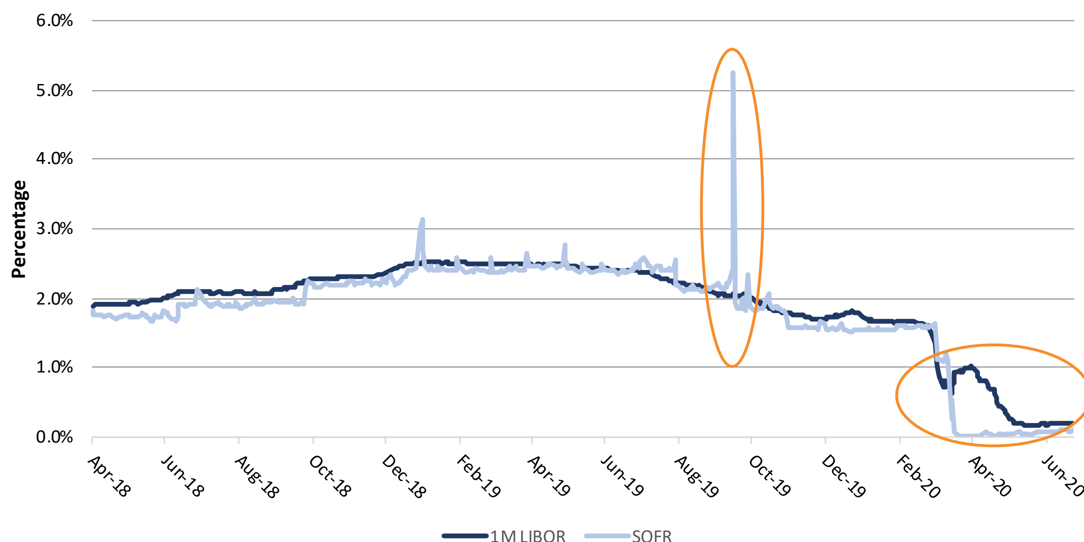
The LIBOR Transition: Alternatives to the Alternatives

The transition from London Interbank Offered Rate (LIBOR) to alternative reference rates (ARR) is well underway. Financial services companies are working to update technology platforms and products to reflect discounting and accruals using these new ARRs in time for the cessation date determined for each LIBOR tenor. Currently the target date for cessation is December 31, 2021, but in a paper titled *Statement on IBOR Transition*[1] dated November 30, 2020 the Federal Reserve Board (FRB) discussed the ICE Benchmark Administration's (IBA) consultation on potentially extending certain LIBOR tenors to June 30, 2023. It should be noted however, they cautioned entering in new contracts that use USD LIBOR after December 31, 2021 as it would create safety and soundness risk.

In the US, the FRB and Alternative Reference Rate Committee (ARRC) members have championed the Secured Overnight Funding Rate (SOFR) as the replacement for U.S. Dollar LIBOR. Since its recommendation, a few milestones related to SOFR implementation have been accomplished, but there is much debate as to whether SOFR is up to the task as a replacement for all of LIBOR's uses. Although imperfect, LIBOR has proven to be quite useful in a variety of financial products and applications, which is where the challenge begins in selecting a suitable or universal replacement rate.

SOFR is quite different than its LIBOR predecessor. SOFR is a secured rate measured by the overnight cost of borrowing cash collateralized by treasuries and has been subject to higher levels of volatility when compared to the recent historical performance of LIBOR. This volatility has at times required the FRB to step in and provide liquidity, such as in September 2019 when SOFR increased to over 5 percent as the repo market seized up. Additionally, the early months of the pandemic saw a divergence in Libor versus SOFR as the FRB sought to provide support to the economy by reducing rates. The magnitude of these events is depicted in the chart below. The secured nature of SOFR also means that it lacks a credit sensitive component, a solution for which is still under debate. See our article for additional differences between LIBOR and SOFR: The LIBOR-SOFR Spread Adjustment: Current Approaches and Implications for Financial Institutions.

CHART 1: LIBOR VS. SOFR STRESS EVENTS



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The use of SOFR in commercial and consumer products causes legitimate concern that stress environments may create situations in which financial institutions see their own funding costs rise while market appetite for secured SOFR debt increases. This could result in a precipitous decline in lending rates, creating additional margin compression at the worst of times. There are also concerns that the rate itself is not truly reflective of a bank's funding costs and that the ARRC's membership and decision-making were more appropriate for the largest market-making banks, leaving regional and community banks wanting a more representative rate for their circumstances.

The FRB understands these concerns and has stated their openness to utilizing more than one replacement rate. In a *Letter to Senator Tom Cotton* dated May 28, 2020[2] Jerome Powell commented that market participants should seek to transition away from LIBOR in a manner that is most appropriate given their specific circumstances. Additionally, in a more recent release titled *Statement on Reference Rates for Loans* dated Nov. 6, 2020,[3] the FRB made a similar comment. Given the diverse nature of financial institutions impacted, this is a welcome position, and given the adaptable nature of financial markets, there are a few potential candidates being discussed to address the concerns of its participants, though no rate appears to be a one-size-fits-all solution.

The American Interbank Offered Rate (AMERIBOR®) is one such alternative. AMERIBOR® is an interest rate benchmark that reflects unsecured borrowing costs of more than 1,000 American banks and financial institutions. As an unsecured rate, it is inclusive of the dynamic credit spread component absent in SOFR and may provide an appropriate benchmark for lending products. Per the American Financial Exchange (AFX®)[4] as of Nov. 18, 2020, the exchange has over 200 member institutions, including banks, hedge funds, broker-dealers and insurance companies. Additionally, AFX has traded over $1 trillion since inception. In the same letter exchange with Senator Tom Cotton noted earlier, Fed Chairman Jerome Powell solidified AMERIBOR®'s place as a suitable LIBOR replacement for banks who fund themselves through the AFX or for whom AMERIBOR® may reflect their cost of funding. Currently, there is a lot of interest in using AMERIBOR® from small and mid-sized financial institutions.

Another viable alternative rate is the ICE Bank Yield Index. This index was introduced by the IBA and is currently undergoing review and periodic updates. Per the IBA, this rate is a forward-looking, credit-sensitive benchmark, developed over one to six-month term structures to measure the average yields at which investors are willing to invest U.S. dollar funds in large, internationally active banks on a wholesale, senior or unsecured basis. The index is derived from two types of transactions representing unsecured bank investment yields: wholesale primary market funding transactions and secondary market bond transactions. Per their last update, in May 2020, the IBA is looking to launch the index in the latter of 2020 but may be delayed due to COVID-19. However, this is contingent upon solidification of agreements with an adequate number of banks to provide sufficient quantities of data to produce the index. It is important to note that per the ICE, "There is no guarantee that IBA will continue to test the U.S. Dollar ICE Bank Yield Index, be able to source data to derive the Index or publish the Index in the future. Users of LIBOR should not rely on the potential publication of the U.S. Dollar ICE Bank Yield Index when developing and executing transition or fallback plans." This caveat is likely due to the need for banks to provide the necessary data.

The Overnight Bank Funding Rate (OBFR) was one of the original finalists in the list of potential rates championed by the ARRC. In the May 20, 2016, document titled *ARRC Interim Report and Consultation*,[5] the ARRC narrowed the potential replacement rates to OBFR and "some form of overnight Treasury general collateral repurchase agreement." Like AMERIBOR® and the ICE Bank Yield Index, OBFR is inclusive of a dynamic credit spread. OBFR is calculated as a volume-weighted median of overnight federal funds transactions, Eurodollar transactions and the domestic deposits reported as "Selected Deposits" in the FR 2420 Report. The OBFR was ultimately not chosen by the ARRC as SOFR's resiliency, higher transaction volume and broader range of market participants made it a better overall choice in the committee's opinion. However, given that SOFR is not seen as a one-size-fits-all rate, OBFR may provide a better representation of funding costs for small and mid-sized institutions and may provide a better fit for other applications such as model recalibration.

The charts below show the YTD performance of the rates discussed through Nov. 2, 2020, for O/N and one-month tenors. The alternative rates performed similarly over much of the period save for the earlier stress period caused by the COVID-19 pandemic. For institutions impacted by LIBOR cessation, SOFR is the recommended rate by the FRB and ARRC, but using it is not a requirement. Each institution must choose the alternative rate that is reflective of their overall business and how they fund and manage their balance sheet.

CHART 2: LIBOR ALTERNATIVE ON RATE COMPARISON YTD

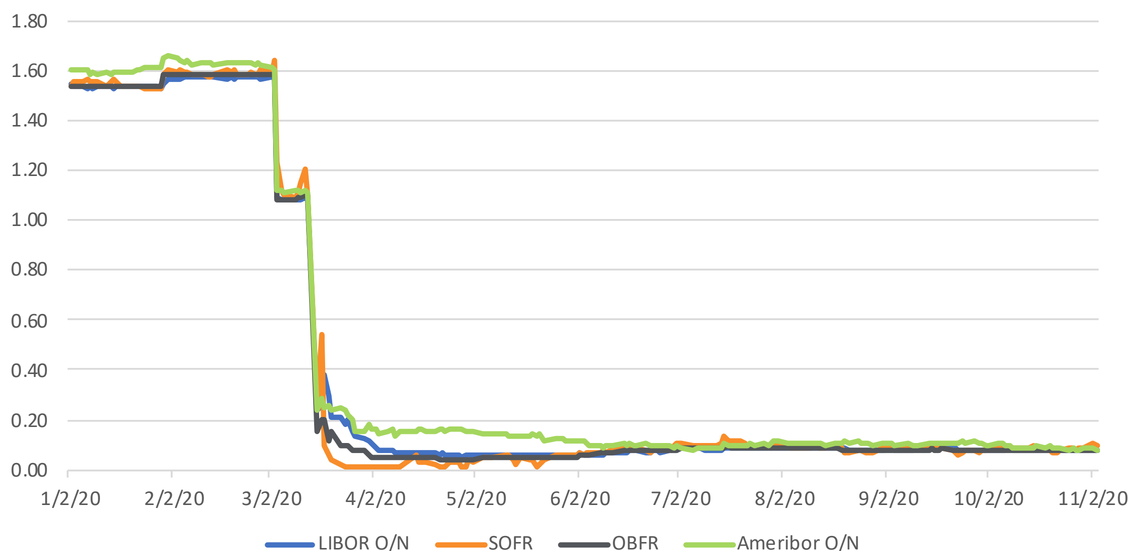
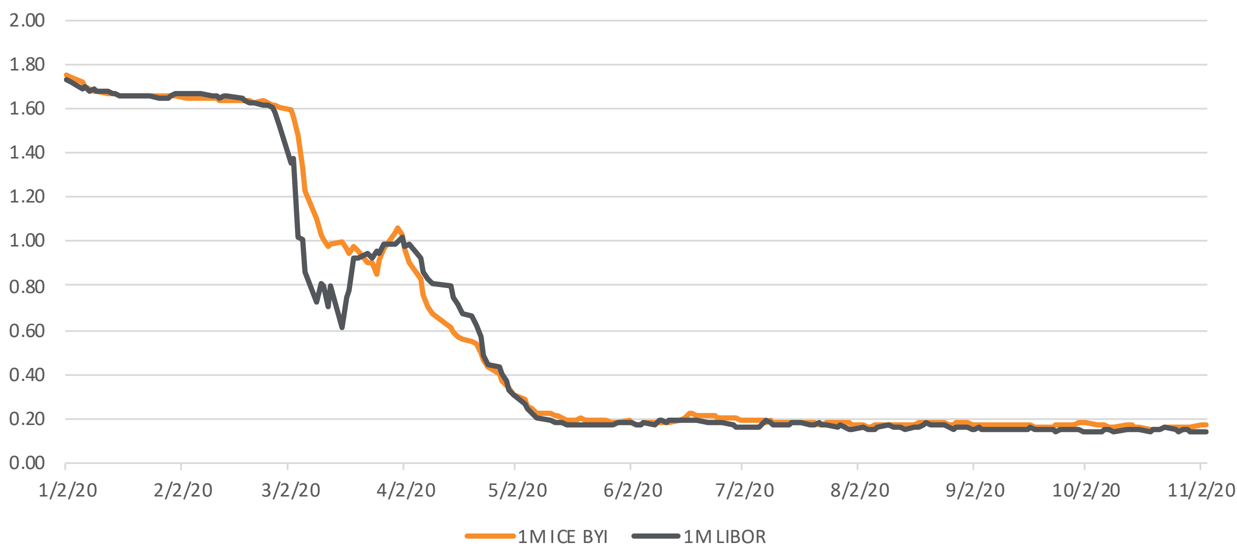


CHART 3: LIBOR ALTERNATIVE 1M RATE COMPARISON YTD



For more information about DHG's LIBOR Transition Advisory capabilities, reach out to us at DHGAdvisory@dhg.com.

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[1] federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf

[2] *Letter to Senator Tom Cotton dated May 28, 2020 in response to a question from a February 2020 hearing of the Senate Banking Committee*

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