Community Bank Views – LIBOR Transition August 2019

In this month's installment of Community Bank Views, we will discuss the ongoing transition away from LIBOR and its potential impact on banks. Our goal is to share what Commerce Bank has learned and offer insight on how our bank is managing this transition. We hope you will find this article useful in your own bank's transition away from LIBOR.

Why is this being done?

The almost 10-year old discovery that LIBOR was being manipulated spurred a coordinated global effort to seek out an alternative reference rate. This action led to the formation of the Alternative Reference Rates Committee (ARRC) in 2014. This Committee was charged with the creation of a plan to transition the market away from the use of LIBOR as a benchmark rate. This undertaking is massive given LIBOR is the reference rate in over $200 Trillion of financial agreements. These agreements range from over the counter derivatives, business loans, floating rate notes, various securitizations, retail mortgages, consumer loans and other securities. Whether or not you believe this transition is a good idea, this change is coming and will impact your bank.

Background and Immediate Challenges

In June 2017, ARRC identified the Secured Overnight Financing Rate (SOFR) as the preferred alternative to LIBOR and the NY Fed began publishing daily SOFR rates on April 3, 2018. At about the same time, the Financial Conduct Authority announced that it will no longer compel banks to contribute (publish) LIBOR rates beyond 2021. Unfortunately, SOFR's current form is only a daily rate, with no one-week, one-month, 3-month, 6-month or one-year rate. These rates are necessary to build out a "SOFR Curve", similar to the "Swap Curve" that the market has created by using similar LIBOR reset rates. This author anticipates the NY Fed will publish additional SOFR resets and the "SOFR Curve" will eventually be articulated by the market and used in a similar fashion to today's Swap Curve.

LIBOR versus SOFR

LIBOR	VS.	SOFR
Relies on **expert opinion**	**Basis**	Based on **executed transactions**
Relies on **panel bank submission rates** (excluding several higher and lower rates)	**Calculation**	Volume weighted median of **actual transactions** (for combined repo datasets)
Unsecured - Reflects perceived credit risk	**Secured/Unsecured**	Secured - Nearly risk free rate
Published across seven maturities; ranging from overnight to one year. Published at 11:00 am in London in 5 currencies	**Publication Info**	Overnight maturity, **term not available** Published at 8:30 am Eastern Standard time in USD
Fairly stable (estimated rate)	**Stability**	**Can be volatile at QE & YE**
More consistency across regions using different variations & several different tenors available	**Advantages**	Based on actual data -less vulnerable to manipulation & reflects lower rate
Reduced confidence due to manipulation scandals & rate is unsecured – additional risks built in to adjust	**Disadvantages**	Only one maturity is available & spread adjustments needed to be comparable to LIBOR

Plan

Despite not being given explicit regulatory guidance, we believe it is a best practice to convene a documented LIBOR steering committee comprised of key members from your bank's Commercial, Retail, Compliance, Bond Portfolio, Legal, Audit, Tax, Marketing and Operations departments. This Committee should first identify all potential financial, legal, operational, vendor impacts or outcomes from the LIBOR transition. Next, seek to quantify any of these potential impacts. For example, our bank quantified each financial exposure (notional size, number of loans, maturity of loan) by product type. Finally, what if anything, can your bank do to influence an outcome? Our bank sorted potential outcomes into three broad buckets: No Control, Have Influence But No Control, and Have Control. Below are just a few examples of what made our list:

No Control:

- ISDA (the governing body for over the counter derivatives) will issue alternative rate language for all contracts governed by an ISDA agreement. We anticipate (hope) this will result in a fair and reasonable outcome for both parties to a LIBOR transaction.

Have Influence But No Control:

- Vendors.
    - Who are your providers? What steps have they taken to handle this transition? Exert pressure to ensure your vendor will be in a position to seamlessly transition when the day comes. To strengthen your voice, collaborate with other users of the systems you use.
    - ALM. Will your inhouse system or ALM Provider be able to handle this transition effectively? What is their plan?

Have Control:

- Internal Loan Documentation. Ensure Alternate Rate Language is included in all of your LIBOR based loans. ***The ARRC has offered guidance on Alternative Rate Language, please refer to the NY Fed ARRC Link at the bottom of this document***
    - Ensure your Legal department (or your Legal provider) is apprised of this change and that all new loans have this change. Furthermore, any loan amendments should include Alternate Rate Language if not previously included.
- Communication Strategy. Ensure your Bankers are educated on this coming change so they can proactively educate your customers.

We hope you found this piece informative and helps with your transition away from LIBOR. If you have any insight to share, we would appreciate it. If you seek additional information on this topic, please reach out to your CMG representative.

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Additional Resources:
https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin18/si-winter-2018.pdf
https://www.newyorkfed.org/arrc