Transitioning away from Libor

August 21, 2020

Libor, the London Interbank Offered Rate at which leading London banks borrowed from each other on a short term, unsecured basis, is being "phased out" and may not be available after 2021. Libor has long been used in the United States for rate-setting, so the phase-out has implications for all manner of transactions and for the financial markets as a whole. For the auto finance market, it may be important to note several effects of this phase-out.

The Libor phase-out affects you, even though you may not price off it. As secondary market transactions are often priced off Libor, transitioning to another benchmark index impacts the price at which portfolios are offered and traded in the secondary market. Uncertainty around secondary market prices translates into higher retail rates, so even where consumer rates are fixed or floating, the Libor transition is likely putting pressure on pricing.

SOFR is (probably) the new standard. Many of the largest U.S. banks, industry participants and trade associations, in coordination with the federal financial institution regulators – collectively, the ARRC – have proposed a replacement index: the Secured Overnight Financing Rate (SOFR), which is intended to address risk in existing loan agreements and minimize the disruption. SOFR is a broad measure of the cost of borrowing cash overnight, collateralized by U.S. Treasury securities. It is calculated as a volume-weighted median of transaction level triparty repurchase transaction data from the Bank of New York Mellon, as well as bilateral Treasury repurchase data for transactions cleared through the Fixed Income Clearing Corporation as reported by an affiliate of the Depository Trust Clearing Corporation. SOFR aims to reflect similar activity – the average cost of overnight borrowing between banks – as Libor. While institutions are certainly not required to use SOFR, the influence of ARRC is expected to drive its widespread adoption. Indeed, current secondary market transactions – such as Ford Credit's 2019 asset-backed notes offering – are priced on Libor but anticipate a transition to SOFR over the life of the transaction.

SOFR and Libor are similar but not the same. These indices differ in that – among other things – Libor reflects unsecured borrowings and SOFR reflects secured borrowings. As such, Libor and SOFR calculations yield different results. For instance, as of July 20, daily SOFR is roughly 12 basis points (bps), while overnight Libor is roughly 8.5 bps. On Dec. 1, 2019, SOFR was roughly 163 bps, where Libor was roughly 154 bps. The ARRC has not yet finalized an appropriate "benchmark replacement adjustment."

The Libor phase-out must be addressed in loan documents. Loan documents should provide the method for determining a successor index, whether through mutual agreement, prevailing rates in a given market, or lender discretion. The Ford Credit transaction noted above follows the ARRC-advocated approach, specifying both the timing of the transition, or the "benchmark replacement date," and the method for determining the alternative index, or the "benchmark replacement," following a benchmark transition event. Keep these notes in mind as the Libor phase-out is likely to impact you.

This article was first published on Auto Finance Excellence, a sister service of Auto Finance News, and is reprinted with permission. McGlinchey is pleased to serve as the official Compliance partner of Auto Finance Excellence, providing insights and thought leadership through webinars, podcasts, and monthly columns.