The London Interbank Offered Rate (LIBOR) Q&A

You may have heard about upcoming changes to the London Interbank Offered Rate (LIBOR) such as its scheduled discontinuation on December 31, 2021. The questions and answers below pertain to what you need to know about the changes coming to this short-term interest rate benchmark and how it may affect you and your loans with Woori America Bank.

What is LIBOR?

For many years, the London Interbank Offered Rate (LIBOR) has been one of the most widely used interest rate benchmarks in the world. Launched in 1969, LIBOR was first used in the syndicated loan market as a way to spread the risk of a loan across multiple lenders, using a periodic reset in the rate based on the banks' funding costs plus a spread for profit. Over the last 50 years, LIBOR has become the most widely used interest-rate benchmark in the world.

The ICE Benchmark Administration (IBA), as the benchmark administrator for LIBOR, calculates and publishes daily LIBOR rates for five currencies (CHF, EUR, GBP, JPY and USD) and seven tenors. Rates are issued for seven different terms, ranging from overnight to 12 months.

How is LIBOR used?

LIBOR is used worldwide in a wide variety of financial products. They include the following, but not limited to:

- Consumer loan-related products such as some adjustable (or variable) rate loans and lines of credit like adjustable-rate mortgages (ARMs), reverse mortgages, home equity lines of credit, credit cards, auto loans, student loans, and any other personal loans that use LIBOR as the index.
- Standard interbank products like the forward rate agreements (FRA), interest rate swaps, interest rate futures, options, and swaptions, whereby options provide buyers with the right, but not the obligation, to purchase a security or interest rate product
- Commercial products like floating rate certificate of deposits and notes, variable rate mortgages, and syndicated loans, which are loans offered by a group of lenders
- Hybrid products like collateralized debt obligations (CDO), collateralized mortgage obligations (CMO), and a wide variety of accrual notes, callable notes, and perpetual notes

LIBOR is also used as a standard gauge of market expectation for interest rates finalized by the Federal Reserve and other nations' central banks. It accounts for the liquidity premiums for various instruments traded in the money markets, as well as an indicator of the health of the overall banking system. A lot of derivative products are created, launched and traded in reference to LIBOR. LIBOR is also used as a reference rate for other standard processes like clearing, price discovery, and product valuation.

Why is LIBOR being discontinued?

Since the 2008 financial crisis, the robustness of LIBOR as a benchmark of banks funding costs has been called into question, leading to the creation of alternative reference rates (ARRs) in several of the major currencies to enable a transition away from LIBOR. The UK's Financial Conduct Authority (FCA), which has supervisory oversight over the administration of LIBOR, announced in July 2017 that it will no longer compel LIBOR panel banks to submit rates for LIBOR after 2021. This has increased the uncertainty about the future of LIBOR and certain other rates or indices, which are used as interest rate benchmarks. The Alternative Reference Rates Committee (ARRC), convened by the Federal Reserve Board and the New York Federal Reserve Bank to seek alternatives to LIBOR, has recommended a new index – the Secured Overnight Financing Rate (SOFR) – as the new benchmark for U.S. Bond and loan market transactions. The New York Federal Reserve Bank now publishes the SOFR daily.

What is LIBOR transitioning to?

Each of the five currencies that currently rely on LIBOR are in the process of transitioning to alternative risk-free benchmarks. For example, LIBOR is being replaced by SOFR (Secured Overnight Financing Rate) in the United States. The Sterling Overnight Interbank Average Rate (SONA) is being replaced for LIBOR. The EU has selected the Euro Short-Term Rate (ESTR). Switzerland has chosen the Swiss Average Overnight Rate (SARON). Japan has chosen the Tokyo Overnight Average Rate (TONAR).

What is SOFR?

The Secured Overnight Financing Rate (SOFR) is based on actual transactions in the U.S. Treasury repurchase (repo) market, one of the largest markets in the world. This is the market where borrowers can sell their U.S. Treasury bond assets to investors with a promise to repurchase them the following day, thus effectively creating an overnight loan where the collateral is U.S. Treasury bond assets.

SOFR is the preferred alternate reference rate for U.S. dollar-denominated LIBOR contracts, as selected by the Alternative Reference Rates Committee (ARRC) (see Q.6 below for a description of the ARRC), because SOFR is based on actual transactions in a market where extensive trading happens every day. In contrast, LIBOR is based on estimates of interbank borrowing rates in the London market provided by global banks that agree to serve as LIBOR panel banks.

The Federal Reserve Bank of New York (New York Fed) began publishing SOFR in April 2018 as part of an effort to replace LIBOR. SOFR complies with the governance standards of the International Organization of Securities Commissions (IOSCO).

What is the difference between Libor and SOFR?

Both SOFR and LIBOR reflect short-term borrowing costs, but key differences between them make the transition tricky. SOFR is considered “risk free”. SOFR relies entirely on transaction data, whereas LIBOR is based partially on market-data “expert judgment."
LIBOR is often at least 20Bps or 0.20% higher than SOFR. The spread between the two rates often expands when credit markets are under pressure. Therefore, a direct switch from LIBOR to SOFR is inappropriate as each rate has different underpinnings. When converting interest rates for existing transactions that mature after 2021, creation of a spread adjustment will be necessary to ensure the consistency of rates, and a uniform credit spread adjustment has not yet been adopted.
While LIBOR is calculated for multiple terms, SOFR is currently only available as an overnight rate. While SOFR curves are being developed for additional time frame, it will take time for the market to create them.

How is Woori America Bank assisting its clients?

Woori America Bank has established an enterprise wide initiative to identify, assess and monitor risks associated with the potential discontinuation or unavailability of benchmarks, including LIBOR, and the transition to ARRs. The following indexes provide ARRs or risk-free rates (RFRs) as alternatives to LIBOR.
Home Mortgage ARM: 1 YEAR CMT +Margin Adjustment
Investments & Swap: SOFR + Term Adjustment
Syndicated Loans: SOFR + Term Adjustment
Commercial Mortgage: WSJ Prime +Term Adjustment

What is the 1 Year CMT?

The one-year Constant Maturity Treasury (CMT) represents the one-year yield of the most recently auctioned Treasury securities. The U.S. Treasury publishes the one-year CMT value daily, along with the respective weekly, monthly, and annual one-year CMT values. Constant maturity yields are used as a reference for pricing debt security issued by entities such as corporations and institutions.

Are CMTs and Mortgage Interest Rates related?

The one-year CMT value is a popular mortgage index to which many fixed-period or hybrid adjustable-rate mortgages (ARMs) are tied. As economic conditions change, lenders use this index—which varies—to adjust interest rates by adding a certain number of percentage points called a margin—which doesn't vary—to the index to establish the interest rate a borrower must pay. When this index goes up, interest rates on any loans tied to it also go up.

Who will receive the new benchmark index, 1 Year CMT instead of LIBOR?

Woori America Bank has selected an alternative benchmark rate called 1 YEAR CMT (Constant Maturity Treasury), the weekly average yield on United States Treasury securities adjusted to a constant maturity of one year, as made available by the Board of Governors of the Federal Reserve System. A new benchmark index will be applied to customers who own existing adjustable-rate mortgages that are subject to the LIBOR index. The existing customers' index rate will be replaced to 1 Year CMT in compliance with the change of index provision in their Note.

What is the Wall Street Journal Prime Rate?

The Wall Street Journal Prime Rate (WSJ Prime Rate) is a measure of the U.S. prime rate, defined by The Wall Street Journal (WSJ) as "the base rate on corporate loans posted by at least 70% of the 10 largest U.S. banks". The print edition of the WSJ is generally the official source of the prime rate. The Wall Street Journal prime rate is considered a trailing economic indicator. Many (if not most) lenders specify this as their source of this index and set their prime rates according to the rates published in the Wall Street Journal. Because most consumer interest rates are based upon the Wall Street Journal Prime Rate, when this rate changes, most consumers can expect to see the interest rates of credit cards, auto loans and other consumer debt change.

How often does WSJ Prime change?

Generally, the rate is dictated by changes from the Federal Reserve's Federal Open Market Committee, which meets every six weeks and reports on the level of the federal funds rate.

Who will receive the new benchmark index, WSJ Prime instead of LIBOR?

Woori America Bank has selected an alternative benchmark rate called WSJ Prime Rate for customers who own all existing variable rate real estate loans secured by any commercial properties that are subject to the LIBOR index. The existing customers' index rate will be replaced to WSJ Prime Rate in compliance with the change of index provision in their Note.