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Start Preparing Now for the End of Libor-Linked Loans, Securities.

That's what New York Fed President John Williams, Fannie Mae and Freddie Mac officials and Wall Street executives recommended at a recent SIFMA briefing.

If your clients have adjustable-rate debt or in floating-rate corporate or municipal bonds, start preparing them now for the end of Libor. The London Interbank Offered Rate, which is the reference rate for these and other loans and bonds, is due to expire at the end of 2021 and be replaced with another reference rate, which in the U.S. will mostly likely be the Secured Overnight Financing Rate (SOFR), developed by the Federal Reserve Bank of New York.

"2022 feels like it's a long way away, but believe it or not 901 days can disappear, almost in an instant," New York Fed President John Williams said at a Libor Transition Briefing in New York City on July 15 held by the Securities Industry and Financial Markets Association. That's less than the number of days Donald Trump has been president of the United States.

"Don't wait until Jan. 1, 2022 to manage your business' transition away from Libor because it's going to be too late," warned Williams. "The clock is ticking."

Currently an estimated $200 trillion worth of financial contracts are based on a spread to U.S. dollar Libor. The rates, set by a panel of private British banks, have lost legitimacy following revelations in 2012 that several banks had colluded to manipulate Libor, costing billions in overpayments by borrowers.

The new SOFR rate is based on $1 trillion worth of U.S. Treasury overnight repurchase agreements (repos) per day. In contrast, the three-month Libor is based on $1 billion worth of transactions. On July 18, the three-month Libor was 2.28%; the overnight SOFR was 2.46%.

Williams said the biggest challenge of Libor's demise isn't liquidity of the lack of a term rate — SOFR is an overnight rate unlike Libor, which had forward term rates of 12 months or less — but "the willingness on the part of the market to stop using Libor. "We need a mindset shift where firms realize that every new U.S. dollar Libor contract written digs a deeper hole that will be harder to climb out of."

Williams suggested that companies issuing Libor-linked products include "robust fallback language" in contracts "so that if Libor ceases to exist, chaos does not ensue."

That is one of several recommendations endorsed by the Alternative Reference Rates Committee (ARRC), which is leading the transition effort from Libor to SOFR. The committee, consisting of private-market participants and convened by the Federal Reserve Board and New York Fed in cooperation with the U.S. Treasury, Commodity Futures Trading Commission and Office of Financial Research, also recommends that consumer products linked to SOFR, such as adjustable-rate mortgages, use an average of SOFR rates over a period of time rather than individual overnight rates because averages are less volatile.

The committee is still working on contract language and structures for SOFR-indexed home equity loans, reverse mortgages, car loans and credit card rates.

“There’s still a lot of work to do, “ said Timothy Kitt, head of pricing and execution at Freddie Mac, who also spoke at SIFMA’s Libor Transition Briefing.

In the meantime advisors whose clients invest in variable-rate securities linked to Libor, have outstanding loans linked to Libor or are considering new Libor-linked loans or investments can keep up with developments during the transition through the AARC website, where they can also comment on “consultations” that ask questions about proposed structures, SIFMA’s SOFR primer and briefs and SEC publications.

SEC staff recently published a statement on the Libor transition encouraging market participants to “proactively manage their transition away from Libor.”

Among the statement’s many recommendations for advisors:

- Consider the effects of Libor’s discontinuation when recommending products to clients or monitoring them for clients.
- Whether to disclose risks of the transition to investors after considering the impact on liquidity and value of their investments.

According to SIFMA, 27 institutions have issued more than $136 billion notional in floating-rate securities tied to SOFR as of June of this year, in June and outstanding SOFR-linked notional across all products has grown from less $100 billion in May 2018 to over $9 trillion as of April 2019.

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