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LIBOR Transition

As noted in a number of articles over the past year, federal regulations will require banks to stop using LIBOR (the London Interbank Offered Rate) as a reference rate on June 30, 2023. However, many banks have been transitioning away from it over the past 18 months. This newsletter provides a little background about the switch from LIBOR, and some things to keep in mind that may affect you as the formal end date draws near.

"The bank found suspicious activity on my credit card. It was being used responsibly to buy necessary things."

Reference Rates

Banks have long used a reference rate to set the interest rate on loans. The most prominent reference rate is the Prime Rate that we often hear quoted in news reports. Banks use a reference rate as the focal point in setting the interest rate on a loan. If a reference rate is seen as being authoritative, independent, and reflecting current market conditions, it gives banks and borrowers some comfort that the interest rate on the loan is being set fairly.

While the Prime Rate is seen as being authoritative and independent, it can lag changes in market conditions. For smaller loan amounts (let's say under $5 million), the Prime Rate seems to work well, but for larger loans both banks and borrowers wanted a reference rate that reacted fairly quickly to market conditions.

Since about the mid-1980's, banks have used LIBOR as their reference rate for larger loans. For roughly 25 years LIBOR seemed to answer all three requirements for a reference rate (authoritative, independent and reflects current market conditions). But during the financial crisis in 2008/2009 and later years, finance professionals and bank regulators saw that LIBOR had serious flaws that made it possible for certain bankers to manipulate LIBOR quotes. It was a big scandal. A few of the ringleaders of the LIBOR-rigging scheme went to jail over it.

Since about 2012, banks and regulators struggled to find something to replace LIBOR. They looked at a number of different possible reference rates, but none seemed to work that well. However one possible reference rate seemed to consistently hold some promise. It is known as SOFR, or the Secured Overnight Financing Rate.

As Peter Mack (Chief Operating Officer – Commercial Group at First Financial Bank) told me, banks and regulators kept working on SOFR, and by 2021 they came up with a way to measure it, known as Term SOFR, that hits all the marks. Banks across the country have been lining up behind Term SOFR, and federal regulators seem to like it too. So when June 30, 2023 arrives, it looks like the consensus reference rate for larger loans is going to be Term SOFR.

What does it Mean for Me?

I talked with Peter Mack and David Dannemiller (Regional President, Northeastern Ohio at First Financial Bank) to get a few ideas to help small businesses prepare for the formal end of LIBOR. They were kind enough to share a few thoughts, listed below:

1. If your loan is based on the Prime Rate, don't worry. Nothing should change.
2. If your loan is based on LIBOR and your bank has not contacted you yet, you should contact them now. It is better

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to be proactive and at least have a plan to deal with it when the changeover comes.

3. Make sure you have access to information about Term SOFR. You can find current Term SOFR quotes from the Chicago Mercantile Exchange's website (Look for "Term SOFR" midway down the web-page; 1 month quotes are used most often): https://www.cmegroup.com/market-data/cme-group-benchmark-administration/term-sofr.html
4. Remember that the "spread" over LIBOR may need to be re-set when the reference rate is changed to Term SOFR. That's because LIBOR was based on transactions that are unsecured, while Term SOFR is based on transactions that are secured. It is generally accepted that unsecured loans require a higher rate of interest than do secured loans, and this difference between LIBOR and Term SOFR needs to be considered when setting the "spread." In general it is not a big difference, but it will need to be addressed.

The big thing to keep in mind is to make sure you are communicating with your banker. As long as you keep lines of communication open, any issues should be handled quickly. Good luck with the changeover!

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Please contact Ronald DiMattia at Corporate Value Partners at (216) 741-1330 or ron@corporatevaluepartners.com with any questions or if you need help with a valuation or corporate finance matter.

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