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Lending and Libor: The Consumer Pain Point

As impediments to the benchmark transition fall away, costs and impacts at the consumer level are still to be determined.

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In the U.S., consumers and borrowers are standing at the precipice of the biggest upheaval in the world of interest rates since the 2008 financial crisis. Surprisingly, they are largely unaware that anything is about to happen.

Now, in the distant wake of scandals around the London Interbank Offered Rate (Libor) nearly a decade ago, the end is nigh for the process of replacing U.S. dollar Libor with the Secured Overnight Financing Rate (SOFR). A final straw was the Commodity Futures Trading Commission's recently backing the SOFR First initiative, wherein "the use of Libor rates in new contracts should, with very limited exceptions, be ceased as soon as practicable and no later than December 31, 2021 . . ."

As the new reality begins to sink in, many lenders, including banks and others, are now faced with a slowly consolidating picture of what it will look like after Libor is gone.

Consents Required

Firstly, the floating rate payments on existing loans will have to switch to a new rate, which will take place on a day coming soon. There is a huge burden being shouldered to determine alternative rates and fair value adjustments across everything, but consumers will also need to be informed so that it is possible for their consent to be given in order to change some of the fine print.

"All new loans will work differently," FINCAD's Jonathan Rosen writes.

In the scramble to make this all happen swiftly, there are many risks to lenders venturing into uncharted waters outside of Libor's safe harbor.

Lenders are, of course, not just exposed to interest rates, but also to credit risk, including defaults on loans and their exposures to other banks. Back in 2008, we saw rates like Libor go up significantly to reflect the degrading credit quality of financial institutions. At the same time, rates like SOFR actually went down due to the scarcity of high-grade bonds that provide the benchmark's collateral.

Rate Divergence

Much like the 2008 crisis elevated the importance of overnight lending rates and collateral, the present upheaval continues the paradigm shift by bringing secured overnight rates to center stage – now as the primary interest rate benchmark for U.S. lenders. The fact that SOFR itself doesn't include credit risk means that lenders will take on additional risks going forward, when the actual borrowing rates go up but SOFR goes down.

In the near future, all new loans will work differently, as they will be based on floating rates which reflect the cost of financing against collateral like Treasury bonds. But since SOFR itself doesn't reflect the actual cost of borrowing, there will always be a fixed payment above SOFR included in the actual rate. These fixed spreads need to compensate lenders for default risks that are not otherwise accounted for in SOFR.

The shift of systemic credit risk from borrowers to lenders will have implications all the way down to retail consumers who could soon need to face higher margins and upfront costs.

Awaiting the Impact

The key to all this can be found in the fine print of the terms and conditions. Everything from credit cards and mortgages to syndicated loans is potentially affected by the change in benchmarks.

Buried in the fine print is the stark reality that we are sitting on the verge of a major upheaval of borrowing costs across the board, from institutions, banks, corporations, all the way down to everyday consumers. And while the impacts have yet to be fully felt by everyday people, we can see that the train has already left the station.

Planning ahead now, getting in touch with your agents and updating your understanding of the risks can help you prepare for any turbulence lying just over the horizon.

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