With LIBOR's Long-Awaited Sunset, the Future of Interest Rate Benchmarking Must Be Defined by Choice

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As of June 30, 2023, a chapter in financial markets history has come to an end. The London Interbank Offered Rate (LIBOR), once a crucial benchmark for the overnight lending market, has been sunset -- but not without fanfare and controversy. During its tenure, the calculation of the LIBOR rate became less reliant on observable interbank lending transactions.

LIBOR found itself at the center of controversy for its behavior during the 2008 financial crisis. In 2012, after extensive investigations into the method through which LIBOR was set, it became clear the rate had been manipulated for profit. This proved to be most troublesome for the markets. What began as an observable rate morphed into an interbank quote. The large banks became more reliant on non-transactional-based brokering and interpolation to set the funding rate. LIBOR no longer reflected its stated purpose. This left the door open for conflict of interest among those banks that collaborated to set the credit-sensitive rate each day. As we embark on the official sunset of LIBOR, banks and financial institutions are now in a better position to gain a true understanding of their lending and borrowing costs.

To date, much of that improved understanding has come via the Secured Overnight Financing Rate (SOFR), which is based on observable transactions in the treasury repurchase agreement market. SOFR, however, does not account for key segments of the US capital markets where unsecured overnight lending occurs daily between financial institutions. SOFR represents a great start, but the US capital markets are not a one-size-fits-all marketplace – they are highly complex.

The US economy is an intricately designed instrument, like a sophisticated timepiece: each part affects the others, at times codependent, requiring all elements to work together to determine the exact time of day. Thousands of banks and financial institutions make up the US economy, each serving varied constituents that together create a vibrant economy. It's what separates the US economy from any other. Each financial institution is different, occupying its own market niche with its own strategy in response to diverse sets of client needs. If the industry fails to account for the intricacies of this diverse market ecosystem, sunsetting LIBOR exclusively in favor of SOFR, which is mostly focused on the largest institutions in the US capital markets, could have a negative impact on how our economy funds itself and meets the needs of its participants. For the US capital markets to operate optimally, they need more than a single source of overnight lending intelligence – they need choice.

AMERIBOR – a credit-sensitive benchmark interest rate powered by observable transactions executed on the American Financial Exchange (AFX) – offers exactly that. AFX has eight years of observable transactions and has weathered many key inflection points, including the failures of Silicon Valley Bank, First Republic and Signature Bank in Q1 2023.

AFX has found that America's financial institutions require a combination of SOFR and AMERIBOR. Compared directly to LIBOR, 3-Month AMERIBOR, which is based on observable transactions, creates a definable term structure for determining an AMERIBOR term rate alongside the daily determined AMERIBOR overnight rate. All of this originates from transactions between counterparties on AFX. Observable transactions create the foundation for a determinable, credit-sensitive term structure of rates from which banks and financial institutions can more accurately measure their risk and funding needs.

Many of America's most well-known academics and capital market participants agree that SOFR doesn't capture the full essence of the requirements of the overnight lending market. As a secured rate, SOFR only reflects loans for which a significant amount of treasury collateral has been posted. The repo market is a highly liquid and active market,relying heavily upon the flow of overnight funds between the largest capital market participants. It does not, however, reflect all capital market participants. Many US financial institutions are not active in the repo market and do not have large positions in government securities – they can borrow only on an unsecured basis and therefore need a rate that better reflects this segment of the market and funding risk. That means that the industry's use of SOFR – which is used to determine the interest rates and borrowing costs for approximately 95% of U.S. loans, according to Reuters – does not fully reflect the borrowing costs of the entirety of US capital market participants.

Credit sensitivity is a critical risk management factor for many US market participants. These participants include small businesses, farmers and the 4,000 community and regional banks and financial institutions that power America's economy. What does this mean relative to the cessation of LIBOR? Essentially, that reforms that were meant to protect banks and financial institutions could be leaving these participants without a credit-sensitive benchmark from which to drive continued economic growth in key sectors of the US economy.

AMERIBOR, on the other hand, is both observable and credit-sensitive, providing a true reflection of overnight unsecured borrowing costs. This is a crucial distinction. During times of market stress, credit spreads rise, increasing banks' cost of funds – but secured rates such as SOFR are influenced by broader economic factors and result in an inverse market reaction, often decreasing in adverse conditions due to a flight to quality – namely US Treasuries and the Treasury repo market. Financial institutions that rely solely on SOFR are likely to encounter increased borrowing costs, decreased margins and an asset-liability mismatch as SOFR-derived lending rates hold steady or decrease, inviting the potential for significant monetary loss. This is the exact opposite of what US capital markets need in periods of market stress.

The International Organization of Securities Commissions (IOSCO), which provides guidance and oversight on financial benchmarks such as SOFR and AMERIBOR, refers to this disconnect in its Principles for Financial Benchmarks. The report, produced in 2013, holds that a benchmark should represent "an accurate and reliable representation of the economic realities of the interest it seeks to measure." AFX believes that for many US banks and financial institutions that engage in credit-sensitive borrowing and lending, SOFR falls short of meeting these criteria.

To be clear, this is not a debate between SOFR and AMERIBOR. It is simply an advocation for the many banks and financial institutions in the US capital markets to determine which financial benchmark or benchmarks are best suited for their unique funding requirements. Free market capitalism allows for that choice – so these firms should be free to choose a benchmark from which to manage their ongoing operations and risk tolerance.

AFX believes competition breeds more precise offerings for the varied financial markets that exist within the US economy. To support our point, AFX and AMERIBOR are being adopted at a rapid pace throughout the US capital markets, and our goal is to coexist as a viable credit-sensitive rate alongside SOFR with a deep and robust derivatives market from which all participants can properly hedge their risk positions. Both SOFR and AMERIBOR are important benchmarks for a fast-evolving market system. To accomplish this collective objective, US capital market participants must recognize that both SOFR and AMERIBOR can coexist for a wide range of financial institutions, including the largest significantly important financial institutions (SIFI's) through to the smaller banks and financial institutions throughout the nation that feed into and make up our capital markets. This notion not only promotes healthy competition, but also allows markets to determine a true, observable credit-sensitive rate.

This conversation around SOFR alternatives is not limited to us. There are other benchmark rates out there, each with their own unique approaches to reflecting the overnight market. This case for choice is also being made at some of the highest levels of government. In a joint letter from the Federal Reserve, FDIC and OCC, dated November 2020, the agencies stated that banks "may use any reference rate for its loans that the bank determines to be appropriate for its funding model and customer needs."

AFX sees the market evolving and crucial choices being made now that LIBOR's official cessation is finally here. The bottom line: within free market economies such as the US capital markets, banks and financial institutions require a choice in terms of interest rate benchmarks, given the unique demands of managing balance sheets relative to their market and clients. The strength of the American economy has and will continue to be in the free markets, so as the LIBOR era closes, there's no time like the present to ensure US capital market participants are choosing a benchmark that represents a true reflection of their lending and borrowing costs.