What's Up With Libor

by Steve Brown

Many banks are preparing for an increase in interest rates in the near to medium term, so given that shift many are adding floating rate loans in order to have an increasing income stream when rates do rise. This is probably a good idea given that typical community bank funding structures are positioned for a rising interest rate environment. As bankers know, floating rate loans are typically priced at a spread pegged to a benchmark. Over the years, though, many banks have been shifting from Prime to Libor as they seek to better match funding sources (large banks typically use Libor to price deposits). Certainly, bankers know and understand Prime and also the Fed Funds rate, but what about Libor?

Libor, or the London Interbank Offered Rate, is a global floating interest rate that initially acted primarily as a benchmark for transactions between banks. Over time, more and more banks have used Libor as a benchmark for commercial loans because it is seen as more current and flexible in the face of global economic events. For our part, we have generally recommended community banks use Libor as the benchmark for floating rate commercial loans as well, given its clear linkage to deposit funding.

Over the years, Libor has admittedly had its own trials and tribulations. There have been lawsuits over the last year by U.S. and European regulators and investors regarding the manipulation of Libor rates in the credit crisis by the largest global banks. As a result of all of this, a new administrator took over from the British Bankers Association (BBA) called the Intercontinental Exchange (ICE). ICE began administration of the benchmark in February of 2014 with the mission of restoring credibility to Libor and eliminating the opportunity for manual manipulation. On July 1 of this year, ICE introduced new licensing arrangements for the use of the index. The first licensing agreements went to clients who were previously licensed by the BBA, but it seems that many other institutions may eventually be affected so we discuss it here.

While much is in motion still and banks worldwide are just waking up to this issue, the language from ICE reads as follows: A usage license is required for any party that uses Libor rates in valuation and pricing activities, including collateral calculations, interest rate fixing, pricing curves etc, plus any party that uses Libor rates as a reference rate in transactions which could include swaps, mortgages and loans.

This is shocking in its broad reach and seems to require a license for practically every bank, credit union, core provider and servicer in the U.S. ICE indicates licenses cost $16,000 per year, so if this holds, suddenly the use of Libor in a community bank seems like an impossibly expensive proposition. As written, any loan or mortgage document that uses the word Libor would require the institution to have a license.

Before you panic, however, there may be hope. It seems ICE may not have realized that numerous institutions in the U.S. use the benchmark for transactions and that the license fee would be prohibitive to say the least. There are currently no exemptions to the language, but the ABA and the ICBA are actively communicating with ICE to help them get a better understanding of how U.S.

institutions use the index and to get this fee eliminated. Our latest information indicates there will be discussions with the ABA in the near future and the ICBA is also making recommendations to ICE.

For now, some big banks have already received a bill for their license. If your community bank receives one down the road, we would recommend speaking to ICE before paying it, alerting us to see if we can help and alerting both the IBCA and ABA to see what they might be able to do. If your bank receives notification of the rule from another institution, we suggest you might want to wait and see where current discussions go. While we know of one correspondent bank that has notified customer banks of the necessity of the license, we would say given the efforts underway by the ICBA and ABA you may instead want to sit tight to see what happens in case changes occur. Of course, get your own expert advice, but in the meantime there is not a need to panic, because the association wheels are quickly turning.

BANK NEWS

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Columbia State Bank ($7.2B, WA) will acquire Panhandle State Bank ($908mm, ID) for approximately $121.5mm in cash and in stock.

M&A

Business First Bank ($690mm, LA) will acquire American Gateway Bank ($377mm, LA) for an undisclosed sum.

Extending

The Wall Street Journal reports the Treasury is seeking input from market players about potentially issuing debt with maturities beyond 30Ys.

Whopper ALLL Change

The International Accounting Standards Board (IASB) has issued a new rule (IFRS 9) that requires lenders and other businesses in over 100 countries (except the U.S., where FASB still rules) to recognize expected credit losses at all times. The rule must be implemented by Jan 2018 and is an attempt to require an ongoing assessment of losses and write downs in an effort to avoid larger hits from occurring as happened during the crisis. The IASB said it expects the changes will increase loan loss provisions by 50% on average. FASB has its own version called CECL expected to be finalized at year-end.