The Hardworking Facts Of LIBOR

lending profitability risk management

Summary: LIBOR is the largest floating rate index in the world and underpins an estimated $200T in financial instruments. Today, we look at how banks can leverage its increase.

Yesterday we began by highlighting a Bankrate survey focused on what people are planning to do when it comes to taking vacation this year. That survey found that sadly, only 36% of those with paid time off said they planned to use it all. The rest were as follows: use almost all (19%), about half (19%), about a quarter (13%) and none (13%). Americans sure do work hard.

As you know, the Fed has also been working hard the past few years to raise rates back to a more normalized pre-crisis level, given good economic strength. That effort has pushed floating rates higher and indices, such as the London Inter-bank Offered Rate (LIBOR), Fed funds and Prime, have been rising. This is generally good news for community banks.

Today, we take a look at LIBOR, as it is the largest floating rate index in the world, and underpins an estimated $200T in financial instruments. This is important in the US, because the largest banks here use it as a benchmark to set their funding or deposit prices each day and use it for loans on the asset side as well. Given the top 9 US banks with assets >$250B control about 50% of all deposits, this sets the baseline for the rest of the industry.

Needless to say, it is critical to understand as a community bank too. Most community banks set their deposit and loan rates by looking at the levels posted by the biggest banks in their local market and then add (deposits) or subtract (loans) basis points on top of (deposits) or below the big bank levels (loans) to adjust for size/liquidity differences.

In the past 12 months, LIBOR has increased by almost 100bp, and it is expected to climb another 60bp by the end of 2018. That means community banks have an opportunity to see loan coupons rise as rates rise.

The good news is that, given Dodd Frank changes, the largest banks have to hold much larger amounts of deposits. Since they control much of the industry's deposits, they have really no incentive to increase deposit pricing, even as the Fed raises rates. This helps community banks, because the pressure to match pricing is decreased given this structural change.

Shifting to the asset side of the balance sheet, one way to capture upside is to review and convert fixed rate loans that are currently on the books. Converting these loans to floating rates gives banks the full advantage of LIBOR's increase. However, customers with fixed rate loans are likely holding onto lower rates instead of refinancing. In this scenario, assets effectively decline in value as LIBOR rises.

For example, consider a $1mm loan indexed to 1-month LIBOR that was issued 12 months ago when 1-month LIBOR was around 1.00%. Recently, 1-month LIBOR was 1.93%. Over the course of the 93bp rise, the monthly LIBOR accrual on the loan has almost doubled, having increased from about $860 to about $1,660 (assuming actual/360 day accrual).

One way to start benefitting from LIBOR's surge and protect the bank is to offer customers fixed rate loans that are hedged back to LIBOR (or something else). This gives your customer a fixed rate and your bank a floating rate. As interest rates increase, hedges allow banks to benefit from rising interest income without the deterioration in debt service that typically accompanies rising rates. We have a hedging solution that can help you with this, without putting a derivative on your books. Feel free to contact us for more information.

HEDGING SERVICES FOR COMMUNITY BANKS

Community bankers seeing long-term fixed rate demand from business clients can transform payments into a floating rate on their books using Borrowers' Loan Protection (BLP). Contact us today for more information.