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The End of an Era – LIBOR Interest Rate

AUDIT, INTERNATIONAL
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The London interbank offered rate (LIBOR) is arguably one of the most important numbers in the finance world. You can find it within most variable-rate debt agreements, adjustable mortgages and private student loans. This rate is the standard for approximately \$260 trillion of loan and derivative contracts today. But LIBOR's days are numbered due to being scheduled to be phased out by 2021.

LIBOR is a daily rate produced by a large group of banks; it is the rate that banks would charge other banks to borrow money. It is calculated by averaging the rates by the group of banks after excluding the highest and lowest rates submitted. The rate became notorious during the 2012 financial crisis due to it being incredibly easy to manipulate. This has made many banks involved in the rate-setting process to become nervous. Additionally, the rate has become less important due to new rules encouraging banks to use other forms of borrowing rates such as the Secured Overnight Financing Rate (SOFR), which is sponsored by the Federal Reserve. Many ask: why would banks still respond to the LIBOR survey? This is due to British regulators encouraging them to do so in fear of the results of an abrupt stoppage in the rate and the impact on the outstanding debt agreements and derivative contracts. The phaseout implemented is providing time for the industry to prepare itself for life after LIBOR.

Preparing for life after LIBOR is making many in the finance world nervous. Many variable-rate debt agreements will need to be amended, causing contracts to be rewritten, computer systems to be updated and a lot of non-revenue generating administrative work by banks. Additionally, derivative contracts do not provide a workable option to replace LIBOR. This will cause approximately \$190 trillion of LIBOR-linked derivative contracts to be renegotiated establishing new derivative contracts. These renegotiations will be significant and costly for banks.

The outcome of the change is still uncertain, and there are still many questions that will need to be answered throughout the course of the phaseout.

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