An Introduction To LIBOR

by Todd Shriber (Contact Author | Biography)

When most Americans think of British imports, their minds probably conjure up images of James Bond and Monty Python movies. These are all fine contributions, and with the success of the aforementioned British imports, it's hard to argue their significance, but quite possibly the most important import from England has a direct impact on the wallets of many Americans, especially homeowners. In this article we'll explain a little understood yet extremely relevant financial tool used across the globe: the London Interbank Offered Rate (LIBOR).

What Is LIBOR?

LIBOR is equivalent to the federal funds rate, or the interest rate one bank charges another for a loan. The advent of LIBOR can be traced to 1984, when the British Bankers Association (BBA) sought to add proper trading terms to actively traded markets, such as foreign currency, forward rate agreements and interest rate swaps. LIBOR rates were first used in financial markets in 1986 after test runs were conducted in the previous two years. Today, LIBOR has reached such stature that the rate is published daily by the BBA at about 11:45am GMT.

LIBOR's reach is felt thousands of miles away from the Thames; it is used as the key point of reference for financial instruments, such as futures contracts, the U.S. dollar, interest rate swaps and variable rate mortgages. LIBOR takes on added significance in times of tight credit as foreign banks yearn for U.S. dollars. This scenario usually sends LIBOR for dollars soaring, which is generally a sign of imminent economic peril. (To learn more, see *Top 5 Signs Of A Credit Crisis*.)

The Reach of LIBOR

LIBOR is set by 16 international member banks and, by some estimates, places rates on a staggering $360 trillion of financial products across the globe. Included in those products are adjustable rate mortgages (ARMs). In periods of stable interest rates, LIBOR ARMs can be attractive options for homebuyers. These mortgages have no negative amortization and, in many cases, offer fair rates for prepayment. The typical ARM is indexed to the six-month LIBOR rate plus 2-3%. (For more, see *This Arm Has Teeth*.)

LIBOR's reach doesn't end with the homeowner. The rate is also used to calculate rates for small business loans, student loans and credit cards. More often than not, LIBOR's heavy hand isn't felt directly by homeowners or others in need of a loan. When the U.S. interest rate environment is stable and the economy flourishes, all is usually well with LIBOR. Unfortunately, there is another side to that coin. During times of economic uncertainty, especially in developed countries, LIBOR rates show signs of excessive volatility, making it harder for banks to make and receive loans among each other. That problem is passed down to people seeking loans from the bank. If cash is scarce or at a premium for your local bank, the bank simply charges you, the borrower, a higher interest rate, or worse, doesn't loan you the money at all.

If Times Are Bad, Watch LIBOR

Another prominent trait of LIBOR is that it can dilute the effects of Fed rate cuts. Most investors think it's great when the Fed cuts rates, or at least they welcome the news. If LIBOR rates are high, the Fed cuts look a lot like taking a vacation to Hawaii and getting rain every day. High LIBOR rates restrict people from getting loans, making a lower Fed discount rate a nonevent for the average person. If you have a subprime mortgage, you need to watch LIBOR rates with a close eye as almost $1 trillion in subprime ARMs are indexed to LIBOR. (For more information, read our *Federal Reserve* tutorial and to learn more about subprime mortgages, see *Subprime Is Often Subpar*.)

While LIBOR action in relation to the foreign exchange markets pertains more to currencies, such as the euro, the British pound, the Japanese yen, and others, its daily impact on the value of the dollars spent in the United States is negligible, though it is worth noting that LIBOR is very relevant to rates on the euro, or U.S. dollars held by foreign banks. The euro accounts for roughly 20% of total dollar reserves.

Bottom Line

LIBOR isn't sexy, and it's doubtful anyone is looking forward to the next release of LIBOR data with the same anticipation of seeing the next James Bond movie. That said, anyone with a credit card or a desire to own a home needs to be of aware of LIBOR. LIBOR is the true British monarchy, at least for the global financial markets - and your personal bottom line.

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