Interest Rates and LIBOR

NIW does not profess to be interest rate experts. This white paper is purely to help clients, advisors, and agents become more knowledgeable by using plain English logic based on our 16 years of experience dealing exclusively in this space. Please consider this to be a rough guide.

LIBOR simply stands for "London Inter Bank Offered Rate" and ironically has very little to do with London other than history. It is the notional rate at which major banks borrow money from each other. It tracks very closely to the treasury risk free rate on average over time purely because of the essentially zero risk of major banks lending to each other.

In Financed insurance, we are interested in LIBOR because it is the primary baseline by which bank loans are priced. Any loan document will typically quote the LIBOR plus a margin. The margin, in most cases, is the bank's profit. A lot of Premium Finance spreadsheets do not break this out and it is vital that the client knows this so that they know the real position on their loan.

For example, is a 5% loan a good or bad rate? If they are assuming LIBOR is 4% with a 1% margin it is pretty good (just because we assume LIBOR is 4% won't make it 4%, and 1% is a good margin.) However, if the assumption is 1% LIBOR and a 4% margin then this is not only a very expensive loan, and they are unrealistically assuming that LIBOR will stay at 1% for the entire life of the loan.

The Prime Rate is essentially LIBOR +3%. Please note that many Premium Finance loans are priced at this rate because it is simply an expensive loan. LIBOR is usually expressed as a 30 day, 90 day 180 day or 1 year rate. This is merely the period of time for which the rate is fixed. A new rate based on the current rates will be set at that time. No one bank controls LIBOR and so this is an extremely liquid and global market. Usually the shorter the time period the cheaper the rate, but this does not hold true when interest rates rise quickly.

LIBOR rates are published daily by lenders and are only fixed on the day the loan actually happens, so illustrations that are 12 months old are completely out of date.

Chart Showing Historical LIBOR (Source: Federal Reserve)

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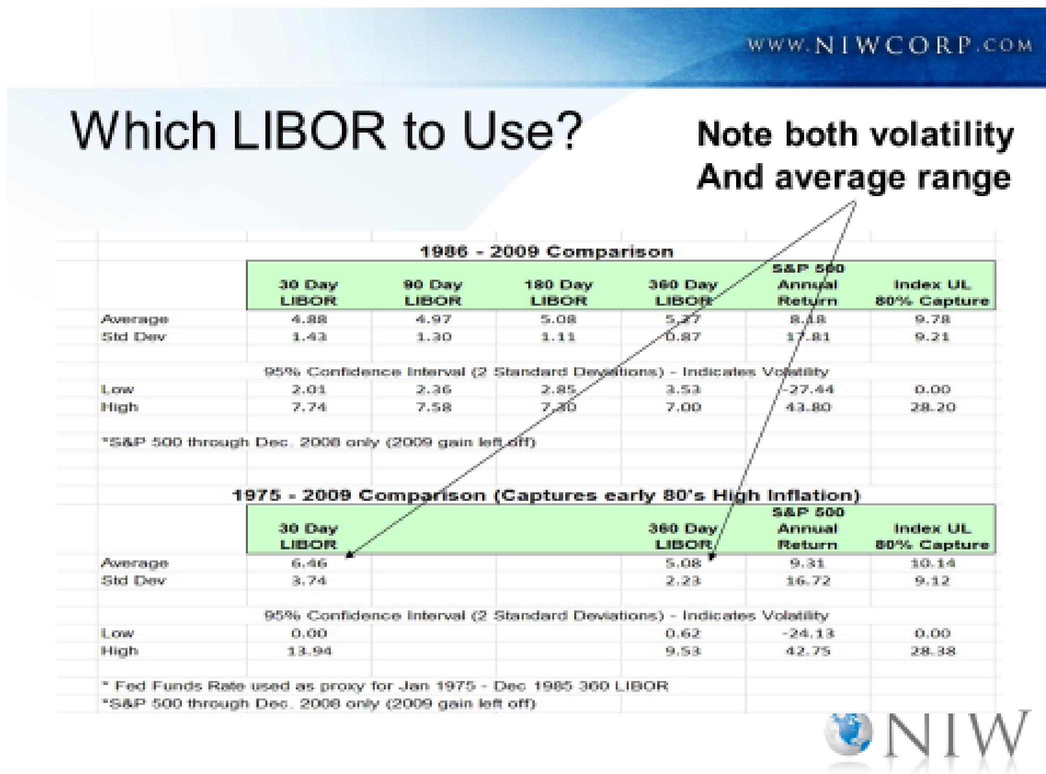
Average Historical 1 year LIBOR is 4.6%, so keep this in mind when considering the LIBOR forecast on your financed insurance illustration. For example, a stress test that takes LIBOR up to 4.5% and back down again is really only assuming the interest rates in this “stressed “condition do not go above the average rates. We mention this because in this low interest rate environment, this concept is sometimes forgotten. Also, any bank can access 30 day, 90 day, 180 day, and 1 year LIBOR so do not let yourself be swayed by sales personnel describing it as some special deal.

Likewise, any major bank can access interest rate hedges that fix or control the interest rate. Hedges are like insurance policies so they transfer the risk of a critical rate change to another party. On average, a client will pay more for a loan when they are transferring the rate risk to another party, unless rates go up at a faster rates than the experts who price these risks predict. Hedging is a vast market and no one lender has any special pricing advantage unless it is a small lender competing with a large one. Generally, the larger the bank the lower the hedge pricing they obtain but only to a certain extent. If a lender you have never heard of before is offering a below market rate then they are either not being accurate or making the money up elsewhere.



1986 - 2009 Comparison

	30 Day LIBOR	90 Day LIBOR	180 Day LIBOR	360 Day LIBOR	S&P 500 Annual Return	Index UL 80% Capture
Average	4.88	4.97	5.08	5.27	8.18	9.78
Std Dev	1.43	1.30	1.11	0.87	17.81	9.21
95% Confidence Interval (2 Standard Deviations) - Indicates Volatility						
Low	2.01	2.36	2.85	3.53	-27.44	0.00
High	7.74	7.58	7.30	7.00	43.80	28.20

*S&P 500 through Dec. 2008 only (2009 gain left off)

1975 - 2009 Comparison (Captures early 80's High Inflation)

	30 Day LIBOR			360 Day LIBOR	S&P 500 Annual Return	Index UL 80% Capture
Average	6.46			5.08	9.31	10.14
Std Dev	3.74			2.23	16.72	9.12
95% Confidence Interval (2 Standard Deviations) - Indicates Volatility						
Low	0.00			0.62	-24.13	0.00
High	13.94			9.53	42.75	28.38

* Fed Funds Rate used as proxy for Jan 1975 - Dec 1985 360 LIBOR
*S&P 500 through Dec. 2008 only (2009 gain left off)

This chart shows average LIBOR rates for a given period of time.

Note: In high interest rate environments, the shorter term rates were actually higher because they were more quick to change to the rate increase. The shorter the LIBOR term the lower the rate, but the higher the risk of sudden spikes in interest rates (volatility). 30 day and 1 year LIBOR are the most common base rates used in financed insurance or premium finance lending deals.

In normal conditions, a client can expect 30 day LIBOR to be cheaper but it will change through the policy year and therefore may result in collateral changes both good and bad, and potentially on a monthly basis. The rate, while cheaper, is more volatile and therefore has greater risk of sudden changes. In 1980’s type situations, 30 day LIBOR

is actually more expensive than 1 year LIBOR purely because of the quicker ability of suppliers of LIBOR to pass on rate changes. On average, 1 year LIBOR will be a little more expensive loan because the rate is set for the year. It has less change and so it is typically better for clients who are more conservative or don't want any surprises within the policy year.

Remember one thing – banks make their money from lending, so no bank will lend at below the rate they can get somewhere else unless their risk is lower.

If there are any further questions on interest rate please contact NIW or the lender involved in the transaction.