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WELLINGTON MANAGEMENT®

KEY POINTS

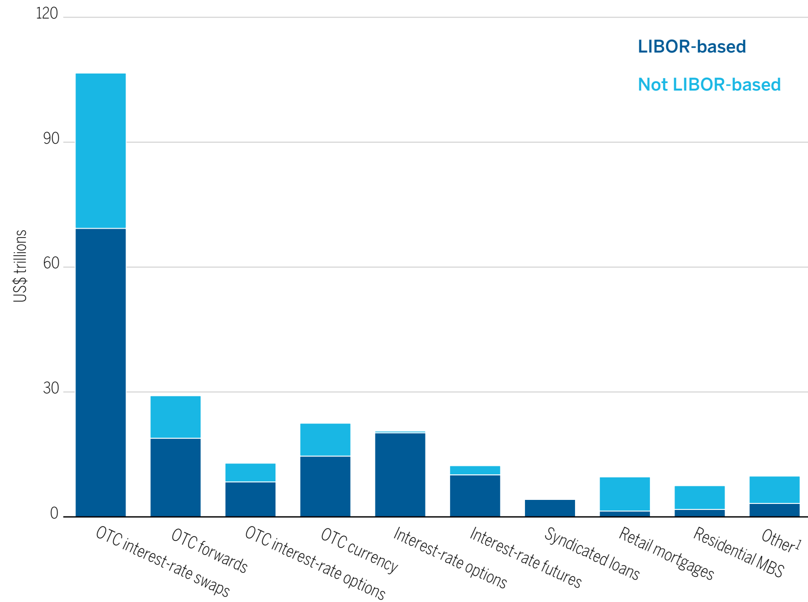
- The regulator overseeing LIBOR (the London Interbank Offered Rate), a key market interest rate used in pricing and benchmarking securities around the world, wants to phase it out by the end of 2021.
- LIBOR is expected to be gradually replaced by other benchmarks; LIBOR and new benchmarks will likely coexist for a long period of time, and the method for calculating LIBOR may change.
- We believe LIBOR will continue to be published for many years after 2021, which should help alleviate some of the concerns over legacy contracts.
- Our sector specialists outline how they think the phaseout will play out in derivatives, securitized sectors, and bank loans.

What's happening with LIBOR — and why you should care

IN JULY 2017, THE UK'S FINANCIAL CONDUCT AUTHORITY (FCA), WHICH REGULATES THE LONDON INTERBANK OFFERED RATE OR LIBOR, SIGNALED ITS INTENTION TO PHASE OUT THIS KEY MARKET INTEREST RATE by the end of 2021. However, there is a high likelihood that LIBOR will continue to be published in some form beyond then. There are still many unanswered questions and it will take time to work through all the consequences, particularly for contracts referencing LIBOR that expire after 2021. We share some initial observations and outline potential implications of the phaseout of this widely used rate (**Figure 1**).

Figure 1

Exposure to LIBOR across asset classes exceeds US$150 trillion



[1]"Other" includes corporate and other business loans, floating-rate notes, asset-based securities, and collateralized loan obligations. | Sources: Alternative Reference Rates Committee (working group convened by the Federal Reserve), Loan Syndications and Trading Association

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Why the need to replace LIBOR?

In theory, LIBOR measures the interest rate at which large banks can borrow from each other in the wholesale interbank market. Over the years, however, reality has diverged from theory as unsecured interbank borrowing has declined. Currently, more than 70% of banks' submissions to the daily fixing of LIBOR are based on estimates by the banks rather than on actual interbank transactions. This has left LIBOR vulnerable to manipulation, as laid bare by regulatory actions brought against some submitters earlier in this decade. Although reforms have been implemented since then to improve LIBOR and shield it from manipulation, market participants and regulators have been seeking ways to transition to a more transactions-based measure.

Efforts to identify replacements now underway

In the sterling market, the SONIA (Sterling Overnight Index Average), administered by the Bank of England (BOE), has been identified by the central bank as its preferred alternative. The BOE expects to roll out the SONIA in early 2018. In the US, a committee convened by the Federal Reserve has proposed the Broad Treasury Financing Rate (BTFR) as a replacement for US LIBOR. Based on overnight Treasury repo rates, BTFR is also a new benchmark and not expected to be published daily until the first half of 2018. Both SONIA and BTFR are transactions-based and hence deemed less prone to manipulation. Other rates are being considered in Japan and Switzerland.

Whether LIBOR would continue to be published after 2021 is up to its administrator, a subsidiary of ICE (a publicly listed company that owns several securities exchanges), and the submitting banks. The administrator may simply modify its process and continue to maintain LIBOR, or the benchmark could be redefined to equal the alternative measures plus a spread.

Investment implications

The FCA plans a long and orderly transition to give the markets time to adapt to new benchmarks. Still, the uncertainty over implementation of LIBOR's phaseout has stirred concerns since it will affect many market sectors.

There will probably still be a need to fix and publish LIBOR after its proposed phaseout in 2021.

Jerome Yim
Derivatives Strategist

Derivatives

Over time, the potential phaseout should encourage participants in swaps to gradually shift their trading of new positions into new floating-rate benchmarks. However, the sheer volume of outstanding LIBOR-based swaps will likely remain very large.

For example, there are currently more than US$17 trillion in swaps based on LIBOR (or LIBOR equivalents such as EURIBOR, its euro-based counterpart) outstanding at LCH Group, a major clearing house, alone; this number does not include non-cleared bilateral swaps and other non-cleared products such as swaptions. As such, there will probably still be a need to fix and publish LIBOR after its proposed phaseout in 2021.

A simple solution may be that banks continue to submit LIBOR rates to the panel even after they cease to be compelled to do so by regulators.

Banks have substantial exposure to LIBOR. Historically they have tended to issue longer-dated fixed-rate debt and then swap the fixed coupons back to floating LIBOR. Even before the FCA's announcement, banks had started to shift some of that swap activity from LIBOR to the floating Overnight Indexed Swap (OIS) rate, as the latter more accurately reflects their funding costs. The FCA's announcement may serve to accelerate that shift, which could widen LIBOR/OIS spreads as banks move more of their swap activity from LIBOR into OIS.

A simple solution may be that banks continue to submit LIBOR rates to the panel even after they cease to be compelled to do so by regulators. Another possible solution might be to fix a spread above the new reference rate (for example, BTFR or SONIA). The "new" LIBOR rate would be simply the new reference rate plus a fixed spread.

Whatever shape it might take, the end result will almost certainly materialize well past LIBOR's proposed phaseout — if indeed it ever ceases to exist. Meanwhile, the market impact of the FCA's late-July announcement on LIBOR-based derivatives has been negligible so far; these instruments have continued to trade with the same liquidity and volumes as before the announcement.

Steve Vazquez
Fixed Income Credit Analyst

Securitized sectors

LIBOR is often used as the reference rate to calculate interest income on floating-rate collateral and issued notes. Some securitized bond indentures are silent on LIBOR going away. But more recent deals have started to incorporate language addressing the eventual phase-out, and we suspect new deals will almost certainly adopt contingency language given the FCA's recent announcement. Still, prospectus documents are not standardized. In some cases, investors could seek to modify the indenture by changing the reference rate on the liabilities. In some deals, though, amending the rate would require approval by all participating investors, which would be very challenging to obtain.

As with derivatives, we believe it is highly unlikely that LIBOR will entirely cease to exist in the securitized markets after 2021. Instead, LIBOR will probably continue to be published in some form given the significant number of legacy contracts that reference it. In the unlikely event that LIBOR disappears after 2021, we believe loan indentures would provide for pivoting to a successor rate or to the overnight prime rate. Additionally, most deals provide alternatives for determining LIBOR should it no longer be quoted.

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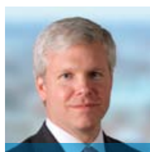
While the process of transitioning away from LIBOR will create uncertainties, we believe that regulators and investors will strive to avoid major market disruptions.



Jeff Heuer, CFA
Fixed Income Portfolio Manager

Bank loans

We expect any transition to a LIBOR replacement in bank loan credit agreements to be managed so that targeted overall loan coupons would not be altered. For example, BTFR is a secured/collateralized rate, while LIBOR and SONIA are unsecured rates; a margin tied to BTFR would likely include an incremental credit spread. Also, currently BTFR is only an overnight rate, not a term rate, and would therefore also need to include a term premium. However, credit agreements could be amended to include the specific methodology for any new base rate. Of note, existing bank credit agreements already include contingent language in case LIBOR ceases to be published.

Conclusion

While the process of transitioning away from LIBOR will create uncertainties, we believe that regulators and investors will strive to avoid major market disruptions. That said, many questions remain to be settled and we will continue to monitor the situation closely.

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