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Planning for the End of LIBOR - Questions fixed-income investors should consider

Summary

» *Despite COVID-19 and market volatility, we continue to anticipate the end of LIBOR (the London Interbank Offered Rate) to occur around year-end 2021.*

» *LIBOR's demise is being brought about by both market realities and direction by the world's regulators that want to replace LIBOR with more transparent rates that are based on actual transactions and not prone to manipulation.*

» *Although much has been written on the Secured Overnight Financing Rate (SOFR), LIBOR's replacement rate in the U.S., investors should understand that the use of SOFR is not mandatory and that other rates may prevail in various cash products.*

» *In the past, investors have used LIBOR-based securities to help manage exposure to rising interest rates. Given the current rate environment, we believe that investors should consider the impact that "lower-for-longer" interest rates may have on their LIBOR-based securities and longer-term investment strategies.*

Investment Overview

In our last report, "Preparing for LIBOR's Demise-What fixed-income investors should know" dated November 14, 2019, we addressed three key questions: what is LIBOR, why is LIBOR going away, and how might the end of LIBOR impact investors who own a LIBOR-based security?

In our opinion, now may be a good time for investors with an out-sized exposure to LIBOR-based preferreds and/or LIBOR-based debt securities to reconsider their investments and, if necessary, exit or reduce their exposures accordingly. LIBOR is no longer the dynamic interest rate benchmark it once was, and as a result, currency-based industry working groups are currently in the process of determining a way to transition out of LIBOR. However, one key consideration in this process is how the market will deal with the many long-duration securities that may remain outstanding and how these long-duration securities will transition to a replacement index.

What is LIBOR?

LIBOR is one of the most widely used interest rate benchmarks in the world. LIBOR was designed to produce the average rate at which large, globally active banks can borrow from one another. At present, LIBOR is calculated in five currencies (the U.S. dollar, British pound, Swiss franc, Euro dollar and Japanese yen) and over seven tenors ranging from overnight to one year. Each LIBOR calculation is based on the input provided by a panel of between 11 and 16 Contributor Banks for each of the LIBOR currencies.

LIBOR is a base rate commonly used in bank loans, derivatives and other credit-related products. LIBOR is a forward-looking, credit-sensitive rate that investors once viewed as a measure of overall banking system risk. However, given the limited examples of actual LIBOR-based transactions, LIBOR is no longer regarded as a valid proxy for banking system risk. Despite LIBOR's anticipated demise by year-end 2021, many of the LIBOR-based contracts have long-lives and will remain outstanding long after 2021.

Why is LIBOR going away?

LIBOR's demise reflects both market realities and regulatory concerns. Since the Financial Crisis, LIBOR has come under increased regulatory scrutiny. Several large banks across the globe were found to have colluded in the manipulation of LIBOR quotes over a long period of time. Although efforts have been made to improve the reporting process, the reality is that the volume of bank-to-bank transactions backing LIBOR has diminished or is non-existent and based purely on "expert" judgment by the panel banks. The actual amount of 90-day dollar-based LIBOR financings has fallen so sharply that LIBOR may not meet the qualification requirements to retain its benchmark status. LIBOR is no longer the robust, transactions-based interest rate benchmark it once was. The Financial Conduct Authority (FCA), which is responsible for regulating LIBOR and the Bank of England recently reiterated their commitments to end LIBOR and find suitable replacement rates by year-end 2021.

How might the loss of LIBOR impact investors who own a LIBOR-based security?

Investors have used LIBOR-based securities to help them manage interest-rate risk based on the belief that if longer-term interest rates rose sharply, that short-term interest rates (such as LIBOR) would also rise. However, in the current very low interest-rate regime, which also anticipates the permanent loss of LIBOR, we believe that investors should now consider the potential risk that lower-for-longer rates could have on their long-term return potential. Investors in fixed-to-floating rate preferreds and/or LIBOR-based debt securities should take into account both the base rate (LIBOR) and the spread (either over- or under-LIBOR) based on the particular security. Based on data provided by the Federal Reserve Bank of St. Louis, U.S. dollar-denominated 90-day LIBOR was quoted at a historical low of 22.285 basis points (0.22285%) on May 1, 2014. By comparison, U.S. dollar-denominated 90-day LIBOR was quoted at 0.26813% on July 13, 2020, very near the historic lows. Given the current low base (LIBOR) rate, there is little in the way of current yield to help bolster the value of these fixed-to-floating rate preferreds and/or LIBOR-based debt securities. With some securities, there is a risk that they become low coupon fixed rate instruments if and when LIBOR ends. We continue to generally prefer those LIBOR-based securities with a re-set spread of at least 350 basis points (3.50 percentage points) over LIBOR as these securities have a better chance of trading at par and/or being redeemed by the issuer.

Know what you own

Many (but not all) LIBOR-based securities were issued with "fallback" provisions that detail the various procedures an issuer would undertake to find an alternative rate if/when LIBOR were no longer available. We provided more detailed information on the fallback process in our last report, "Preparing for LIBOR's Demise-What fixed-income investors should know" dated November 14, 2019. In a majority of cases, the issuer (or its Calculation Agent) would first poll several London-based banks for a quote. Then, if such banks were not quoting, the issuer (or its Calculation Agent) would poll several New York-based banks for a quote. Assuming that at least two quotes (or sometimes more) are made available, the base rate would be the average of those two quotes. The market broadly expects such a quotation process to fail as it is unlikely that, in the absence of LIBOR, there would be banks willing to provide market quotations. As a result, the market has been very focused on alternative approaches to address legacy contracts. However, investors should also understand that issuers are not legally obligated to redeem any LIBOR-based security simply because LIBOR goes away and that, in the absence of LIBOR, investors might have to rely on the fallback provisions provided in the security's original prospectus. There will likely be a range of outcomes, as issuers balance reputational risk (not calling securities with onerous re-set rates) in light of what the prospectus fallback provisions allow (potential for very low funding costs).

Conclusion

Given the uncertainties surrounding LIBOR-based securities, we believe it may be a good time for investors with an out-sized exposure to LIBOR-based preferreds and LIBOR-based debt securities to reconsider their investments. While most securities have fallback provisions to determine a new coupon or dividend rate in the absence of LIBOR, it remains to be seen how the market will deal with the many long-duration securities that may remain outstanding while the industry plans for the end of LIBOR. We believe investors unwilling to tolerate the uncertainty surrounding the LIBOR issue should review and adjust their positions.

Risk Considerations

Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Preferred securities are subject to interest rate and credit risks. Interest rate risk is the risk that preferred securities will decline in value because of changes in interest rates. Credit risk is the risk that an issuer will default on payments of interest and principal. Preferred securities are generally subordinated to bonds or other debt instruments in an issuer's capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

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