Advice & Research
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# Taxable Fixed Income Insights

## Preparing for LIBOR's Demise - What Fixed-Income Investors Should Know

» This Fixed Income Insights report provides an overview of LIBOR (the London Interbank Offered Rate) and addresses three key questions: what is LIBOR, why is LIBOR going away, and how might the loss of LIBOR impact investors who own a LIBOR-based security?

» Although LIBOR is the most widely used interest rate benchmark in the world, its demise is being driven by both market realities and regulatory concerns. While industry participants are working collectively to manage the issue, the future of LIBOR beyond 2021 is at best uncertain.

» A smooth transition out of LIBOR remains questionable as existing contracts may be difficult to amend. Under certain conditions, the LIBOR rate on some securities could be frozen at the last quoted rate.

**Investment Overview**

In our opinion, now is a good time for investors with an out-sized exposure to LIBOR-based preferreds and 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, regulatory authorities are currently in the process of determining a way to transition LIBOR-based securities off of LIBOR. However, one key consideration in this process is how the market will deal with the many long-duration (a measure of a bond's interest rate sensitivity) securities that may remain outstanding while the future of LIBOR is in doubt.

Investors in a perpetual preferred stock and/or long-duration debt security should recognize that issuers have no legal obligation to redeem a security if LIBOR goes away. However, issuers have a number of options they may pursue:

- Securities might be called at par, once the security becomes callable.
- Issuers may voluntarily tender for the old LIBOR-based security for cash or a different security.
- Securities may have their coupons re-set, in line with the terms outlined in the original prospectus.

**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 and in the open markets. 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 has often been used as the base rate in bank loans, derivatives and other credit-related products. As such, it is regarded as a forward-looking credit-sensitive rate that is used to measure the overall health of the global banking system. During times of economic and/or credit stress, LIBOR rates would generally increase, an indicator of investor unease. Many of the LIBOR-based contracts have long-lives and will remain outstanding long after 2021.

**Please see page 5 of this report for Disclaimers**

The focus of this report will be limited to preferred stock and longer-duration debt securities, those maturing after 2021. These are long-duration securities whose coupons are based on LIBOR plus some yield spread. This spread is designed to compensate the investor for the credit risk of investing in the particular issuer. Some long-term debt securities may entail an investor put feature. These securities tend to have coupon rates based on a discount to LIBOR (such as LIBOR minus 0.30%, for example).

**Why is LIBOR going away?**

The demise of LIBOR 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. 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 limited number and size of US LIBOR transactions implies that the panel banks responsible for quoting LIBOR are increasingly having to use their own "expert judgement" as to the rate one bank might be able to borrow from another bank rather than on hard evidence supported by actual transactions. Panel banks are becoming increasingly uncomfortable in providing submissions based on expert judgment. The Financial Conduct Authority (FCA), which is responsible for regulating LIBOR, said that it would not compel LIBOR panel banks to make LIBOR submissions beyond year-end 2021. Therefore, LIBOR's existence after 2021 cannot be assured.

**What new rate will replace LIBOR: Introducing SOFR**

In June 2017, the Alternative Reference Rates Committee (ARRC) a large group of market participants assembled by the Board of Governors of the Federal Reserve (Fed), the Federal Reserve Bank of New York, and includes the United States Department of the Treasury, selected the Secured Overnight Financing Rate (SOFR) as its recommended alternative to U.S. LIBOR. Investors should note that the other major central banks around the world have also taken steps to replace LIBOR, in their respective currencies, with a more transparent, market-based rate alternative, so the U.S. is not alone in this effort.

SOFR was selected to replace U.S. dollar LIBOR because SOFR is a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities; the rate is published daily by the Federal Reserve Bank of New York and it is based on a large number of actual transactions, which are transparent and liquid.

Table A, below, outlines some of the key differences between SOFR and LIBOR.

| **Table A: How SOFR Differs From LIBOR** | |
|---|---|
| ***SOFR (the secured overnight financing rate)*** | ***LIBOR (the London interbank offered rate)*** |
| Overnight/Risk-Free Rate | Rate reflects both credit and term risk |
| Backward looking rate-reflects quality of collateral* | Forward looking rate based on bank credit quality-no collateral |
| Calculated/published by the NY Fed | Calculated/published by ICE Benchmark Administration** |
| *repos-collateralized with U.S. Treasury securities (no credit risk).<br>**Depends on the willingness of Panel Banks to continue to provide rate quotes. | |
| Sources: the Alternative Reference Rates Committee (ARRC), and Wells Fargo Advisors. | |

**How will the loss of LIBOR impact fixed-income investors?**

In the paragraphs below, we outline some of the key investment considerations for LIBOR-based preferred stock (such as fixed-to-floating rate preferreds) and long-duration debt securities, some of which may contain investor put features. From a "value" perspective, we generally prefer those LIBOR-based securities with a fixed-rate coupon of around 6% (or higher) and 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.

***Fixed-to-Floating Rate Preferred Stocks***

- Pay a fixed-rate coupon or dividend until the security becomes callable, normally 5-to-10 years from the date of issuance. Many fixed-to-floating rate Preferreds become callable after 2021.

- Have a re-set rate which is based on some pre-determined spread over the primary reference rate (usually 3-month LIBOR). If the security is not redeemed at par by the issuer when the security becomes callable, then the coupon of the security would change from a fixed-rate to the floating-rate formula (a spread over 3-month LIBOR), and remain outstanding.

***LIBOR-based Debt Securities***

- Many of the LIBOR-based debt securities are older securities that lack a clearly defined procedure to determine what would happen if LIBOR is no longer quoted.

- In some cases, there is a "holder put feature" that, subject to certain conditions, would permit the holder of the security to put the security back to the issuer every 1, 2 or 3 years. The put may be below the security's par value (at least initially).

**Fallback provisions, what happens if LIBOR is no longer quoted?**

If LIBOR is no longer quoted (as per our assumption) then the issuer, or its Calculation Agent, will have to rely on an alternative means to find a suitable replacement rate for LIBOR. While the fallback procedure varies from security to security, a typical process would look like this:

> ***STEP 1:*** The issuer, or its Calculation Agent, would first request a rate quote (for deposits in U.S. dollars) from several London-based banks. Assuming at least several quotes are provided, the new rate would be the average of the rates received.
>
> ***STEP 2:*** However, if the London-based banks do not provide a viable quote, the process would repeat with several major New York City banks. The potential exists for a small subset of banks to continue to provide quotes in order to maintain an "active" LIBOR market and to help manage their various preferred and debt securities outstanding.
>
> ***STEP 3:*** If no rate can be obtained from the New York-based banks, the rate for the security will be determined by the procedure outlined in the prospectus.

If the above process fails and the required bank quotes are unavailable, each prospectus will detail what alternative rate the issuer or the Calculation Agent will use to replace the LIBOR component of a security's floating rate coupon formula. While these alternative measures fall into just a few general categories as outlined below, it is imperative for investors to understand that each security is unique and fallback measures vary from security to security.

**General Fallback Provisions:**

***Last Quoted LIBOR:*** LIBOR would equal the last quote available, or the last LIBOR quote used if the security is floating already. Under this scenario, the LIBOR rate is potentially frozen and the security becomes a fixed rate security at LIBOR plus the re-set spread as determined in the prospectus.

***Predetermined Fallback Rate:*** Some securities have provisions that state what the replacement LIBOR or coupon rate will be. In some cases, the prospectus will specifically determine what the new rate for "LIBOR" will be (i.e. LIBOR will be 0.2521%, for example). In other instances, the prospectus will specifically determine what the new coupon rate will be (i.e. the coupon rate will be 5.5%). Again, there is risk that the security effectively becomes a fixed rate instrument.

***Calculation Agent:*** Some fixed-to-floating rate securities would re-price at a rate the Calculation Agent determines to be a reasonable alternative to LIBOR. The Calculation Agent has full discretion in this regard and the rate determination would be binding.

***Other:*** There are some securities where the documentation, or lack thereof, makes determining a new reference rate difficult to determine. Most fallback provisions did not contemplate the permanent absence of a LIBOR quote. As such, some provisions are worded vaguely and can be open to interpretation. In other cases, the securities are older and finding a prospectus can be difficult.

**What is being done to address the LIBOR issue?**

While the potential for LIBOR to go away is well known in the market, many questions remain as to how LIBOR-based securities will be impacted. We believe that legacy LIBOR-based securities could be redeemed at par, tendered, or repurchased on the open market as a way for issuers to reduce their exposure to older securities. However, one of the difficulties in dealing with older securities (such as those involving fixed-to-floating rate preferreds and/or long-duration debt securities) is that 100% agreement among all the participants is required before any changes to the prospectus can be made. This makes it unlikely that existing documents can easily be amended to reflect a new market accepted rate, although individual opportunities to exchange old LIBOR-based securities for new securities backed by an alternative reference rate could arise.

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). Additionally, there is some possibility that a small subset of banks continue to provide LIBOR quotes in an effort to fulfill the requirements of the fall back provisions we highlighted earlier. It is our understanding that the ARRC is considering the possibility of a legislative solution to this issue. As most of the documents were based on New York State Law, ARRC is considering the possibility of petitioning the New York State Legislature to allow a change from LIBOR to SOFR in the existing documents as a kind of "fix-all' alternative. However, as this alternative is likely to raise a number of other legal issues, we do not presently view it as a viable alternative. However, this process is still relatively new and in its early stages of development.

**Conclusion**

Given the uncertainties surrounding LIBOR-based securities, we believe it is 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 future of LIBOR is in doubt. Investors unwilling to tolerate the uncertainty surrounding the LIBOR issue should review their positions.

**Disclaimers**

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.

A fixed-to-floating rate security pays a fixed rate for a specific period of time, than a floating rate until the security is called by the issuer. If the fixed-to-floating security is not called at the end of the initial fixed rate period, then the new coupon would float at a pre-defined rate over a floating rate benchmark (typically 3-month LIBOR). Preferred securities are subject to interest rate and credit risks. Interest rate risk is the risk that a security will decline in value because of changes in interest rates. Because preferred securities are long-term instruments, they are subject to a high degree of interest rate risk.

Bank loans are subject to interest rate and credit risk. They are generally below investment grade and are subject to defaults and downgrades. These loans have the potential to hedge exposure to interest-rate risk but they also carry significant credit and call-risk. Call risk is the risk that the issuer will redeem the issue prior to maturity.

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