Plans to Replace LIBOR Are Nearing Completion

Update from T. Rowe Price on the USD LIBOR transition.

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KEY INSIGHTS

- Financial authorities aim to complete their replacement of USD London Interbank Offered Rate (LIBOR) with new alternative reference rates (ARRs) by mid-2023.
- For U.S. dollar-denominated assets, the ARR that is set to replace LIBOR is the Secured Overnight Financing Rate.
- T. Rowe Price's dedicated working group has completed our exposure analysis and firmwide transition plans with the aim of minimizing any disruption to our clients' investments.

The Financial Conduct Authority (FCA) first announced its intention to end the London Interbank Offered Rate (LIBOR) in July 2017. Since then, T. Rowe Price has monitored the situation closely as we formulated our strategy for managing the transition. In November 2019, our working group produced an article on the topic, explaining that the decline in interbank borrowing and reduced trust created the need for a new benchmark rate for a wide array of financial products. Later, in June 2020, we highlighted five important changes expected to result from the cessation of LIBOR, including proposed new alternative reference rates (ARRs) in each key market, and we subsequently revised this information in June 2021.

In this latest article, we provide a further update for clients as we approach the final year of the LIBOR transition process.

1 What Is Replacing USD LIBOR?

In the U.S., the planned ARRs for dollar-denominated assets is the Secured Overnight Financing Rate (SOFR), which is based on overnight loans in the U.S. Treasury repurchase (repo) market. The Alternative Reference Rate Committee (ARRC), a group of market participants convened by the Federal Reserve System and the Federal Reserve Bank of New York, has been leading the plans for the switch to SOFR.

The U.S. remains the last market to fully transition from LIBOR to the new ARRs. Coming into effect at the end of 2021, the UK market switched to using the Sterling Overnight Indexed Average (SONIA) as the LIBOR replacement, while the Euro Short-Term Rate (ESTER) was adopted in the eurozone. Elsewhere, the Swiss Average Rate

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U.S. LIBOR values will cease being computed.

Overnight (SARON) is now being used for Swiss francs and the Tokyo Overnight Average Rate (TONA) for the Japanese yen.

2 What Is the Impact on Different Asset Classes to Date?

Regulators, such as the Federal Reserve and the FCA, strongly discouraged any new LIBOR issuance after the end of 2021. As a result, overall exposure in the markets is declining.

More broadly, a lot of attention in the transition plan has been devoted to "tough legacy" instruments—securities where governing documents do not establish clear fallbacks[1] in the event of a permanent cessation of LIBOR and that are also difficult to amend to incorporate fallbacks. Passage of state and federal legislation that introduce the ARRC-recommended fallbacks into tough legacy contracts has helped to alleviate this concern.

Leveraged loans: In many areas of the loan market, recent loan documentation incorporates language developed by the Loan Syndications and Trading Association (LSTA) and other trade groups that incorporate ARRC-recommended fallback language. Many leveraged loans also typically include built-in alternative rates that may apply if LIBOR cannot be determined. However, these rates are often not appropriate as permanent LIBOR replacements. Because of these alternatives to LIBOR in the contracts, such instruments would be out of scope of the abovementioned legislation as they already contain fallbacks that are not based on LIBOR. Administrators of the leveraged loans will be working throughout the remaining period prior to June 2023 to amend loans and remove references to LIBOR for many of the loans.

Floating rate notes and asset-backed securities: Existing floating rate notes (FRN) and asset-backed securities present a challenge as they often require the consent of all holders to change the underlying benchmark interest rates. In addition, the power to initiate such amendments typically lies squarely with the issuers and not the bondholders. The process of addressing the differences between LIBOR and the new ARRs should help smooth the transition for existing securities referencing LIBOR. Bonds should benefit from the introduction of federal-level LIBOR legislation. Meanwhile, new FRN bond issues priced after the end of 2021 are only referencing the new ARRs directly.

Certain derivatives: The market has been generating a liquid derivatives market for hedging exposures to the new ARRs. The International Swaps and Derivatives Association (ISDA) protocol to incorporate the fallbacks into existing contracts has been open for adherence since January 2021 and has been widely accepted by market participants.

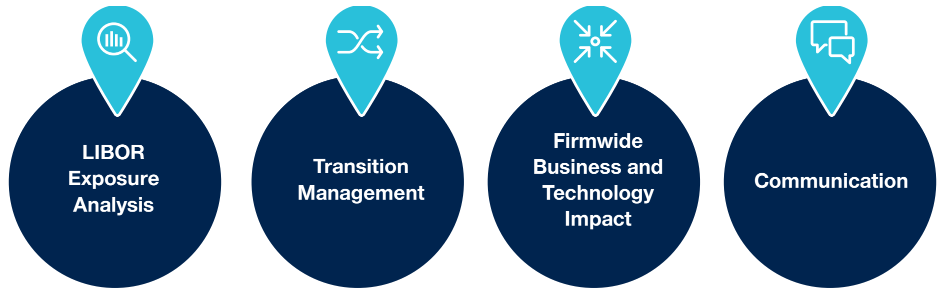
3 Have the Previous Challenges Regarding the Depth of Derivatives Markets, and the Creation of SOFR Term Rates Been Overcome?

The markets based on the ARRs are less mature than LIBOR—which has been in use for well over 30 years—but they are developing swiftly now that new LIBOR securities are no longer being issued. For the U.S. dollar market, the ARRC continues to work toward building market liquidity for SOFR. The ARRC has shown that activity data from cash and derivatives markets have been building at a strong, sustained pace. SOFR swaps, for example, have accounted for approximately 80% of interest rate risk traded in the swaps market. Additionally, SOFR futures volumes and open interest continue to increase relative to Eurodollar futures and the overall futures market.

[1] A fallback rate is a rate of interest that can be used if the reference rate for a contract is unavailable.

Planning for a Smooth Transition

Focusing on four key areas



Source: T. Rowe Price.

The absence of a term SOFR market was a hindrance to many investors when contemplating the adoption of SOFR in the U.S. However, last year, the ARRC formally recommended exchange provider CME Group's forward-looking SOFR term rates for one-, three-, and six-month tenors and just recently added the 12-month tenor also. This advancement has removed the problem of issuers not knowing their interest expense in advance of the payment date.

4 What Is T. Rowe Price Doing to Prepare for the Transition?

Our primary aim is to keep any disruption to our clients' investments to a minimum. To this end, T. Rowe Price's dedicated working group, consisting of senior members from across the firm's business units, is focusing on the following:

LIBOR exposure analysis

Work has been completed to determine the extent of exposures to investments referencing LIBOR or other interbank offered rates across all T. Rowe Price-managed portfolios.

We have reviewed all legal agreements on investments in LIBOR-referencing securities. This information is helping us gauge how a change in the underlying interest rate will impact markets, down to the level of individual holdings.

In addition to our in-house analysis, we contracted outside legal counsel to provide a third-party assessment of T. Rowe Price's exposure and potential risks for certain securities.

We continue to update our exposure numbers to account for potential transactions of LIBOR-based securities in the secondary market and reduce exposure when leveraged loans are amended to eliminate LIBOR language.

Transition management

Our main priority is to pursue the best outcome for our clients during the transition, while also minimizing potential disruption to their long-term investments under the new ARRs. On the derivatives side, T. Rowe Price has adhered to the ISDA LIBOR protocol. As a result, any current derivatives exposures that are outstanding at the transition date should benefit from clear fallback provisions.

We continue to monitor and leverage industry activity, as well as industry regulatory bodies, to help ensure a smooth transition.

Firmwide business and technology impact

An enterprisewide impact assessment has been completed. This included operations, technology, and arrangements with third parties. The impact assessment was

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then used to create an implementation plan, which was duly completed in the fourth quarter of 2021.

Communication

Communication and engagement with internal and external partners are key. Our working group is directing external communications with investors, as well as with other market participants, to ensure transparency about the process and the timing of the transition. The group is in frequent contact with regulators to stay informed about the formulation of the ARRs and other industry changes precipitated by the cessation of LIBOR.

Certainly, the transition represents significant change, and with change comes uncertainty. However, T. Rowe Price has dedicated resources and an action plan in place to help ensure that client portfolios are well positioned to adjust to changes arising from the replacement of LIBOR.

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

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