LIBOR Is Changing: Five Things You Need to Know

T. Rowe Price's working group considers the implications of the transition away from LIBOR.

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KEY INSIGHTS

- Financial authorities are planning for the phaseout and replacement of the London Interbank Offered Rate (LIBOR) after the end of 2021 with new alternative reference rates.
- The transition to a new benchmark rate would impact a wide range of global assets. Close coordination among different institutions aims to minimize disruption.
- T. Rowe Price has created a dedicated working group to assess our portfolio exposures to LIBOR and help smooth the transition of our clients' investments to new benchmark arrangements.

Global financial markets are preparing for the replacement of the London Interbank Offered Rate at the end of 2021. For decades, LIBOR has served as a benchmark rate for a wide array of global financial products in five major currencies. The planned transition to new benchmark interest rates could significantly impact market pricing and processes in several asset classes, with estimates of total LIBOR exposure globally running in the hundreds of trillions. T. Rowe Price's working group on the LIBOR transition answers some important questions on the transition and how we're managing it.

Q. Why is LIBOR being replaced?

Jeff DeVack: There are a number of reasons why markets are transitioning away from LIBOR, including the following:

- **Declining Rate of Interbank Borrowing:** LIBOR is set based on the average rate at which major global banks lend money to one another on a daily basis. Since the global financial crisis, actual lending between banks has fallen, with the effect that LIBOR is now based on an increasingly small number of real-world transactions.
- **Falling Market Trust:** Incidences of LIBOR manipulation, while small in number, have generated controversy in recent years. Only a select group of banks is responsible for reporting the rates at which they lend to one another on a daily basis. The controversy related to instances where some banks intentionally misreported the rates, which impacted the level at which LIBOR was set and weakened the market's trust in it as a benchmark.

New Benchmarks Are Set to Replace LIBOR

The ARRs feature key differences to LIBOR

What is LIBOR?	What will replace LIBOR?
Benchmark interest rate used in wide range of global financial products	New alternative reference rates (ARRs) as soon as 2021
Requires major global banks to self-report the rate they would make short-term loans to other banks	ARRs will be based on real-world, verifiable transactions
Set daily in five major currencies across a range of maturities	Different rates planned for major currencies: USD–Secured Overnight Financing Rate (SOFR) GBP–Sterling Overnight Indexed Average (SONIA) EUR–Euro Short-Term Rate (ESTER) CHF–Swiss Average Rate Overnight (SARON) JPY–Tokyo Overnight Average Rate (TONA)

- **LIBOR Sustainability in Question:** Regulatory bodies have subsequently increased scrutiny of LIBOR-reporting banks. Many banks have been less willing to continue to submit interbank lending rates amid the shifting regulatory environment, committing only until the end of 2021. As there is no obligation for them to continue after this time, LIBOR may simply not be available from the beginning in 2022.

Q. What will replace LIBOR?

Mike McGonigle: Central banks and financial regulators are focusing on constructing alternative rates to replace LIBOR. The plans are to shift to overnight and risk-free benchmark rates, known as alternative reference rates (ARRs), in each of the five currencies currently covered by LIBOR. The priority is to ensure that the ARRs comply with International Organization of Securities Commissions (IOSCO) standards. This means the new rates must be based on real-world, verifiable transactions rather than more subjective quotes that could potentially be manipulated.

In the U.S., the planned ARR 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. UK authorities have identified the Sterling Overnight Indexed Average (SONIA) as the LIBOR replacement, while the Euro Short-Term Rate (ESTER) is the planned replacement for the eurozone. Elsewhere, the Swiss Average Rate Overnight (SARON) rate will be used for Swiss francs and the Tokyo Overnight Average Rate (TONA) will be used for the yen. The specifics governing these ARRs will be important to understand how different asset classes and individual securities will be impacted by the transition.

Q. How will the transition from LIBOR impact markets?

Doug Spratley: Of the roughly USD 340 trillion[1] worth of assets based on interbank offered rates, securities that are priced against the LIBOR benchmark rate will be directly impacted. In addition

[1] Source: U.S. Federal Reserve research.

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>
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to developing the ARRs, global central banks in conjunction with industry groups are working on a credit spread to help markets calculate the bank credit premium, which is a component of LIBOR but not of the ARRs. Applying this premium would help ease the conversion of existing LIBOR exposures to ARRs to avoid market disruption and pricing discrepancies.

Specific asset classes will require different steps to ensure securities do not become untradeable or experience high degrees of pricing volatility:

Loans: In many areas of the loan market, recent loan documentation often incorporates language being developed by the Loan Syndications and Trading Association and other trade groups. Many leveraged loans also typically include built-in alternative rates. However, many of these are intended for periodic outages of LIBOR rather than a permanent cessation.

Bonds and Asset-Backed Securities: Existing bonds and asset-backed securities form a challenge as they often require the consent of a majority of holders to change the underlying benchmark interest rates. These asset classes may require case-by-case negotiations and solutions on alternative rates.

Derivatives: LIBOR is used in the pricing of, and as a reference rate in, a wide range of derivatives contracts. Authorities are working to generate a liquid derivatives market for hedging exposures to the new ARRs. In addition, the International Swaps and Derivatives Association (ISDA) is changing the applicable definitions for interest rate derivatives currently referencing LIBOR and other interbank rates to create a fallback to the ARRs in the event LIBOR is discontinued permanently. We expect that derivatives contracts that pre-date the new ISDA definitions will be amended by market-wide ISDA protocols.

Q. What are the challenges to the transition?

Predrag Rogic: Significant work still needs to be done due to the high volume of global assets that reference LIBOR with new issuance ongoing. Any uncertainty regarding the new ARRs could result in pricing volatility during the transition process, which would mean significant value transfers across global markets.

Central banks, regulatory bodies, and other financial institutions globally are working to encourage the adoption of the new ARRs ahead of time to ensure market participants understand the new system and trust it as a reliable benchmark. However, the lack of an international central authority could make coordination difficult.

In addition to providing benchmark rates for five major currencies, LIBOR is available in seven different maturities, creating a curve for markets to use as a benchmark out to 12 months. Therefore, authorities are considering constructing forward-looking term rates based on the ARRs. A liquid curve based on real-world transactions is an important tool to help prevent volatility during the transition.

Newly issued securities will need to include recommended language that reflects the new benchmark. All changes also need to be clearly and widely communicated to market participants both large and small.

Q. What is T. Rowe Price doing to prepare for the transition?

Mike McGonigle: Our primary aim is to keep any disruption to our clients' investments to a minimum. T. Rowe Price has set up a dedicated working group to manage the shift from LIBOR to the new ARRs. The working group

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> *Director of Credit Research*

consists of senior members from across T. Rowe Price's business units and is focused on the following:

1. **LIBOR exposure analysis:** Work is underway to determine the extent of exposures to investments referencing LIBOR or other interbank offered rates across all T. Rowe Price-managed portfolios. The group can then assess how the transition from LIBOR to ARRs could impact clients' investments in different portfolios.

   We are reviewing all legal agreements on investments in LIBOR-referencing securities. This will help us gauge how a change in the underlying interest rate will impact markets down to the level of individual holdings.

2. **Transition management:** Planning is in progress to ensure a successful transition from LIBOR to the ARRs. As the new framework for the ARRs emerges, the group will implement its plan for navigating the shift. This includes managing and adjusting exposures to investments affected by the new ARRs as well as updating legal agreements to reflect the new post-LIBOR protocols. We are also aware of LIBOR risks embedded in any new deals and have incorporated these transition risks into our investment selection process. Overall, we will prioritize pursuing the best outcome for our clients during the transition while also maintaining our focus on their long-term investments under the new ARRs.

3. **Communication:** Communication and engagement with internal and external partners are key. Our working group is directing external communications with investors as well as other market participants to ensure transparency about the process and the timing of the transition. The group is in contact with regulators to stay informed about the formulation of the ARRs.

Investors need to be prepared for a post-LIBOR era in a little more than two years' time. T. Rowe Price has dedicated resources and an action plan in place working to ensure client portfolios are well positioned to adjust to the impending LIBOR replacement developments.

WHAT WE'RE WATCHING NEXT

We have dedicated research groups looking at how the LIBOR transition will impact each individual asset class, including leveraged loans, collateralized debt obligations, securitized products, corporate bonds, and municipal bonds. The research groups will report on developments of new ARRs as well as the fallback legal language. Based on these findings, the teams will devise plans on how we can mitigate risks and prepare for the transition on a portfolio-level basis.

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