



LIBOR Is Changing: Five Important Updates

T. Rowe Price's working group explains the LIBOR transition.

July 2020

KEY INSIGHTS

- Financial authorities continue to plan to replace LIBOR after the end of 2021 with new alternative reference rates (ARR).
- Investors should be aware of key differences between the ARRs and LIBOR that authorities are addressing to alleviate potential disruption.
- T. Rowe Price's dedicated working group has made progress in our exposure analysis and firmwide transition plans with the aim of protecting our clients' investments.

The London Interbank Offered Rate (LIBOR) is due to be phased out at the end of 2021. T. Rowe Price's working group explained in an article in November 2019 that the decline in interbank borrowing and reduced trust created the need for a new benchmark rate for a wide array of financial products. Although market attention through the first half of 2020 has been focused on the global impact of the coronavirus, the UK's Financial Conduct Authority (FCA) reaffirmed that the shift away from LIBOR remains on track for the end of 2021. Our working group has continued to monitor the situation as it formulates our firm's strategy for managing the transition.

What is going to replace LIBOR?

Plans remain to replace LIBOR with overnight and risk-free benchmark rates,

known as alternative reference rates (ARR). As the UK's Financial Conduct Authority will not require banks to submit their interbank lending rates after the end of 2021, we expect authorities and market participants to implement different ARRs as the key reference rates for securities priced in the five major currencies that are currently covered by LIBOR.

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. The Alternative Reference Rate Committee (ARRC), a group of market participants convened by the Federal Reserve Board and the Federal Reserve Bank of New York, has been leading the plans for the switch to SOFR.

In the UK, authorities have identified the Sterling Overnight Indexed Average (SONIA) as the LIBOR replacement

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New Benchmark Rates Will Replace LIBOR

Key features and differences of the ARR and LIBOR

	Benchmark Rate	Currency	Administrator	Tenor	Secured/Unsecured	Underlying Transaction
Planned Phaseout After December 2021	LIBOR	\$ USD £ GBP € EUR ¥ JPY ₣ CHF	ICE Benchmark	Overnight, 1 week, 1 month, 2 months, 3 months, 6 months, 12 months	Unsecured	Money Market
New ARRs	SOFR	\$ USD	Federal Reserve Bank of New York	Overnight	Secured	U.S. Government Repo Market
	SARON	₣ CHF	Swiss National Bank and SIX Swiss Exchange		Secured	Swiss Franc Repo
	ESTER	€ EUR	European Central Bank		Unsecured	Money Market
	SONIA	£ GBP	ICE Benchmark		Unsecured	Money Market
	TONA	¥ JPY	Bank of Japan		Unsecured	Money Market

As of July 1, 2020.

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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 (TONA) rate for yen.

The priority is to ensure that the ARRs comply with the 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.

2 What are the key differences between the new ARRs and LIBOR?

LIBOR is set based on the average rate at which major global banks lend money to one another on a daily basis. We believe the most important differences that markets and investors need to understand about the new ARRs are the following:

- Tenor:** The new ARRs are overnight rates based on real-world verifiable transactions of government securities. However, LIBOR is available in seven different maturities, creating a curve for markets to use as a benchmark out to 12 months.

To address this difference, 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.

- No Credit Premium:** SOFR, the proposed rate for the U.S. dollar market, is a secured rate backed by underlying government assets. Conversely, LIBOR is based on the cost of unsecured funding in the London interbank market, which means it incorporates the underlying credit risk of the financial institution involved in the trade. Without this additional credit premium, the new ARRs are generally lower than LIBOR.

“We believe it is essential that investors understand their exposure and the inherent risks in their investments.

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Regulators, in conjunction with industry groups, are working on creating a credit premium to help ease the conversion of existing LIBOR exposures to the ARRAs to avoid market disruption and pricing discrepancies. In the case of SOFR for the U.S. dollar market, the ARRC proposed in April that the premium be equivalent to the historical five-year median difference between LIBOR and the SOFR fallback rates and is currently collecting feedback.

SARON, the proposed ARR for the Swiss franc market, faces a similar situation in that it is secured against underlying government securities. The ARRAs planned for the British pound, euro, and yen markets are unsecured rates. However, since they are overnight rates, there is very little credit premium incorporated into the rates as credit risk increases with longer maturities.

3 How will the transition impact different asset classes?

Roughly USD 340 trillion worth of assets are based on interbank offered rates. Securities that are priced against the LIBOR benchmark rate will be directly impacted.

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

- **Leveraged Loans:** In many areas of the loan market, recent loan documentation often incorporates language being developed by the Loan Syndications and Trading Association (LSTA) and other trade groups. Many leveraged loans also typically include built-in alternative rates, which may apply if LIBOR cannot be determined. However, these rates are often not appropriate as permanent LIBOR replacements. Consequently, the ARRC has published recommended fallback language for

syndicated loans incorporating the new ARRAs. New loans should start incorporating the new language.

- **Floating Rate Note Bonds and Asset-Backed Securities:** Existing bonds and asset-backed securities form a challenge as they often require the consent of at least a majority of 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 ARRAs should help smooth the transition for existing securities referencing LIBOR.

Newly issued securities will need to include recommended fallback language for the transition to the new ARRAs. Current recommendations for the U.S. dollar market are that new floating rate note (FRN) bond issues priced after the end of this year should reference the new ARRAs directly. Other markets will also be expected to begin pricing new issues directly off the new ARRAs rather than LIBOR.

- **Certain 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 ARRAs. 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 ARRAs in the event LIBOR is discontinued permanently. We expect that derivatives contracts that predate the new ISDA definitions will be amended by market-wide ISDA protocols.

¹ Source: U.S. Federal Reserve research.

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What are the challenges that still need to be addressed?

Central banks, regulatory bodies, and other financial institutions globally continue to work to encourage the adoption of the new ARRAs ahead of time to ensure that market participants understand the new system and trust it as a reliable benchmark. However, while most market participants are preparing for their implementation at the end of 2021, some participants may not be convinced that the ARRAs are appropriate replacements or they are concerned that the new rates will behave differently to LIBOR during times of market stress. Any uncertainty regarding the new ARRAs could result in pricing volatility during the transition process, which could mean significant value transfers across global markets.

The markets based on the ARRAs are also less mature than LIBOR, which has been in use for well over 30 years. For the U.S. dollar market, the ARRC continues to work toward building market liquidity for SOFR. Other industry-led working groups are focused on the ARRAs to replace LIBOR rates in other currencies. However, the lack of an international central authority could make coordination difficult. With banks not required to submit LIBOR rates after the end of 2021, the LIBOR phaseout is likely to begin as soon as one or more banks withdraw from the panel, regardless of how much progress is made on coordinating the transition.

While we believe that most key concerns regarding the transition can be addressed ahead of time, differing views regarding the new rates will have to be incorporated into pricing and trading of securities referencing the ARRAs. Investors need to understand that, to some degree, market forces will impact the transition.

We believe it is essential that investors understand their exposure and the

inherent risks in their investments. This applies to both the transition at the end of 2021 as well as afterward as market functionality with the ARRAs may not be exactly the same as under LIBOR. All changes and plans need to be clearly and widely communicated to market participants both large and small.

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. T. Rowe Price's dedicated working group, which consists of senior members from across the firm's business units, is focused on the following:

1 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. The group is now assessing how the transition from LIBOR to the ARRAs 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 each individual holding. We are also assessing the feasibility of amending legal documents, especially older contracts, to incorporate fallback provisions.

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

2 Transition Management: As more details around the new ARRAs and the transition process emerge, the group continues to implement its plan for navigating the shift. This includes managing and adjusting exposures to investments affected by

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the new ARRAs as well as updating legal agreements to reflect the new post-LIBOR protocols.

Throughout this process, the working group has been sharing its findings with portfolio managers and analysts to help them prepare and make decisions for the client portfolios and multi-asset products they manage.

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 achieving the best outcome for our clients during the transition while also seeking to protect their long-term investments under the new ARRAs.

3 Firmwide Business and Technology Impact Analysis:

We are also looking at how the transition will impact other areas of the firm, including quantitative research, trading, client operations, technology, accounting, and reporting. Our aim is to assess the range of different exposures the firm faces across different groups and departments globally and work to mitigate any risks.

Ahead of the transition, we are working diligently to ensure that our systems are fully capable of valuing, managing, and reporting products based on the new ARRAs with minimal disruption.

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

The group plans to produce a detailed implementation plan later this year. Investors need to be prepared for a post-LIBOR era in a little more than 18 months. T. Rowe Price has dedicated resources and procedures in place to help ensure that client portfolios are well positioned to adjust to the impending LIBOR replacement developments.

WHAT WE'RE WATCHING NEXT

We are looking for increased certainty on the specifics of the transition to the new ARRAs. In the coming months, we expect authorities to start a Request for Proposal process to establish forward-looking term rates and a credit premium for the new ARRAs and then recommend the forward-looking rates sometime in the first half of next year. It will be important to gauge market reaction to these developments to understand how the transition at the end of 2021 will proceed.

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