Bond Blog

November 13, 2020

LIBOR'S FINAL COUNTDOWN

By Gary Horbacz, CFA, Principal, Structured Products,
and Jason Pan, CFA, FSA, Vice President, Structured Products

The transition from USD LIBOR to an alternate interest rate has been a focus of regulators and market participants worldwide since at least July 2017 and a smooth transition is essential to avoiding market disruptions given the volume of impacted contracts. In the U.S., the Secured Overnight Financing Rate (SOFR) has been identified as an appropriate replacement index by the Alternative Reference Rate Committee (ARRC). Given the importance of the conversion, the following provides our assessment of its progress, hurdles that remain, and our approach to the transition.

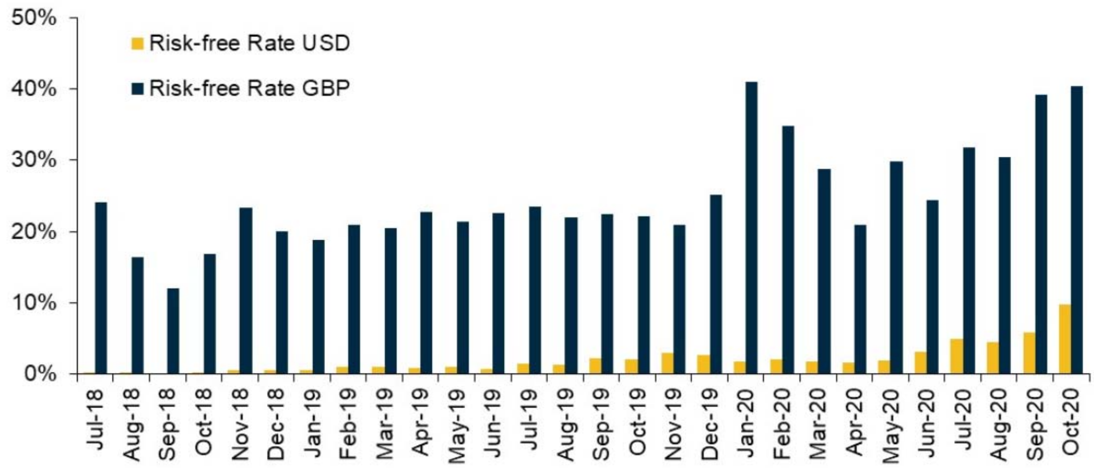
Our Take on the Transition

Despite some confusion amongst market participants, we continue to believe that USD LIBOR will be published through year-end 2021 after which index cessation is likely. The UK LIBOR regulator (Financial Conduct Authority) has indicated that, by year-end 2020, it will likely determine that USD LIBOR will not be representative of borrowing costs on a prospective basis. Such an announcement would not alter our expected LIBOR timeline, but would provide certainty to the market regarding the ultimate demise of the index.

While the adoption of SOFR in the U.S. lags the UK's adoption of its alternate rate (SONIA), we remain confident that the transition from LIBOR to SOFR for new transactions is proceeding according to plan and will be fully transitioned by December 31, 2021. The transition for certain legacy LIBOR transactions remains uncertain.

We expect SOFR derivative (swaps and futures) activity to accelerate in the near-term given a recent switch in discounting of legacy swaps from Fed Funds to SOFR. According to ISDA, in October approximately 10% of USD interest rate derivative activity referenced SOFR versus over 40% in the UK that referenced SONIA (Figure 1).

FIGURE 1: SOFR DERIVATIVE ACTIVITY IN THE U.S. IS INCREASING



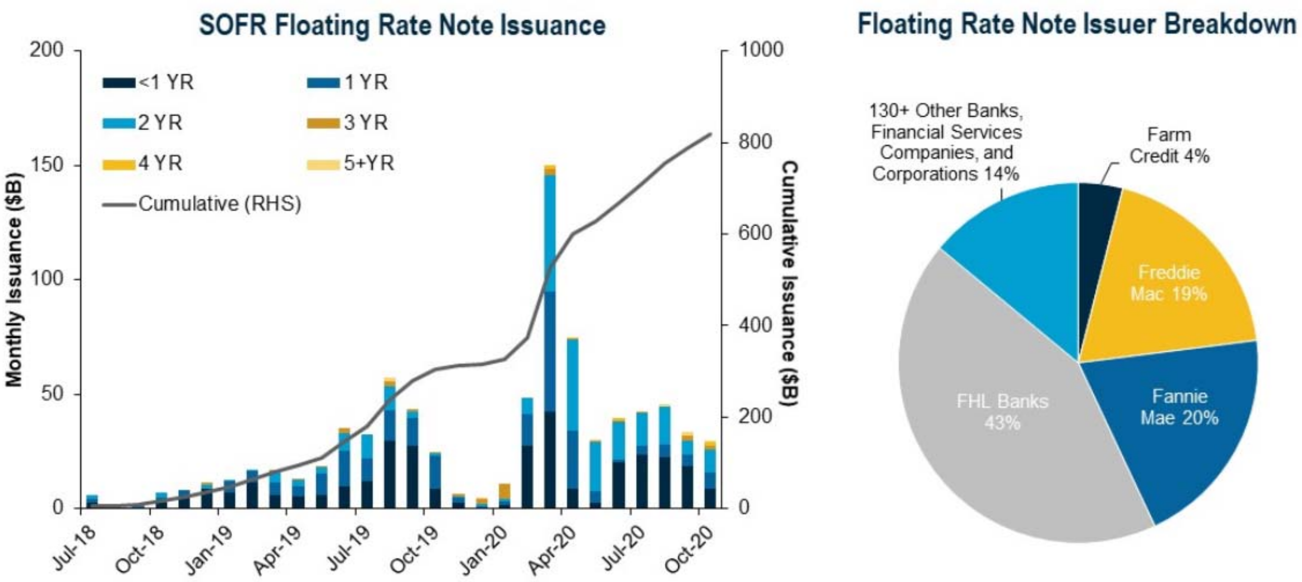
Source: ISDA as of October 2020

For Professional Investors Only. All Investments involve risk, including the possible loss of capital.

Use of SOFR in Cash Products

Despite likely LIBOR cessation in less than 13 months, LIBOR-based financial products continue to be issued. Thus far, the corporate bond market has led other markets in adopting SOFR, with nearly $800 billion of issuance since 2018. This compares to less than $9 billion of issuance in SOFR-based securitized products over the same time period. Business loans have lagged even further, with only a handful of SOFR-based transactions to date (Figure 2).

FIGURE 2: THE CORPORATE BOND MARKET HAS LED, BUT MARKETS HAVE GENERALLY BEEN SLOW TO ADOPT SOFR



Source: Bloomberg as of October 2020

The U.S. structured products market, aside from GSE SOFR usage in a few multifamily and single-family securitizations, has thus far resisted SOFR-based issuance and instead continues to rely on USD LIBOR transactions with clearly defined LIBOR fallback provisions. Much of the resistance perhaps results from an inability to agree on a standard use of a SOFR (overnight rate) to compute a coupon for a longer tenor (e.g., 1-month, 3-month). We believe that the market will gravitate towards a simplistic "compounded-in-advance" model until a SOFR term curve is endorsed by the ARRC.

Addressing Inadequate Fallback Provisions in "Tough Legacy" LIBOR Transactions

Unfortunately, LIBOR-based cash product transactions issued prior to 2019 often lack the fallback provisions necessary to instruct counterparties to establish a floating rate coupon following LIBOR cessation. In 2019, the ARRC addressed this problem by publishing recommended fallback provisions for each sector within cash products on a forward looking basis, but transactions issued prior to 2019 remain problematic. Unlike the derivative market that accomplished a "bulk amendment" of legacy transactions, cash product transactions (aside from leveraged loans) cannot be easily amended given the need for 100% bondholder approval. Without a solution, the floating rate coupon for nearly $5 trillion "tough legacy" bonds and consumer loans will be uncertain post 2021. As a result, liquidity may be affected and court action is likely.

The ARRC has recommended legislation that, if passed, would permit transaction parties to ignore problematic provisions and instead use the ARRC-recommended fallback provisions (SOFR plus a spread adjustment). The ARRC has focused its efforts on New York State given that most bond contracts are governed by New York law, but it has also begun to discuss a potential federal legislative solution.[1]

While legislation is a simple and elegant solution to tough legacy contracts, progress has been slow and somewhat hampered by the COVID pandemic. We believe that, while New York state legislation would solve most of the issues surrounding tough legacy securities, a federal solution would provide further clarity for both bonds and consumer loans that are issued under state laws other than New York.

PGIM Fixed Income’s Approach to the LIBOR-to-SOFR Transition

PGIM Fixed Income represents Prudential Financial as a member of the ARRC and has been active in crafting standardized fallback language for new transactions, recommending appropriate parameters for defining the LIBOR/SOFR credit spread adjustment, and pursuing potential solutions to LIBOR cessation including legislative efforts.

The transition from LIBOR is an unprecedented milestone affecting huge swathes of the fixed income markets. As the final countdown to LIBOR cessation begins, we’ll continue to monitor the progress for a smooth transition while continuing to take the following steps:

- Maintaining a market-leading position in the transition from LIBOR to an alternative reference rate and continuing to recommend potential solutions
- Requiring issuers to incorporate improved fallback language for new transactions that reference LIBOR
- Continuing to evaluate potential outcomes for tough legacy LIBOR holdings through a deal-by-deal prospectus review to capture and categorize potential fallback outcomes
- Continuing to highlight potential transition risks to key stakeholders

[1] Draft legislation which is expected to be introduced by U.S. Representative Brad Sherman (D-CA), member of the United States House Committee on Financial Services where he serves as Chairman of the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets.

This material reflects the views of the authors as of November 13, 2020 and is provided for informational or educational purposes only. Source(s) of data (unless otherwise noted): PGIM Fixed Income.

Important Information

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. Registration as a registered investment adviser does not imply a certain level or skill or training. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Netherlands B.V. located in Amsterdam; (iii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; (iv) the public fixed income unit within PGIM (Hong Kong) Ltd. located in Hong Kong; and (v) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore ("PGIM Singapore"). PFI of the United States is not affiliated in any manner with Prudential plc, incorporated in the United Kingdom or with Prudential Assurance Company, a subsidiary of M&G plc, incorporated in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. All investments involve risk, including the possible loss of capital. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or an y investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: PGIM Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM Fixed Income and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM Fixed Income and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Fixed Income's personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Fixed Income's clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2A of PGIM Fixed Income's Form ADV.

In the European Economic Area ("EEA"), information is issued by PGIM Limited or PGIM Netherlands to persons who are professional clients as defined in Directive 2014/65/EU (MiFID II). PGIM Limited's registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority ("FCA") of the United Kingdom (Firm Reference Number 193418). PGIM Netherlands B.V. is authorised by the Dutch Authority for the Financial Markets (Autoriteit Financiële Markten – AFM) as an alternative investment fund manager with MiFID top up service capabilities under registration number 15003620. PGIM Limited and PGIM Netherlands are authorized to provide services or operate with a passport in various jurisdictions in the EEA. In certain countries in Asia, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co. Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is provided by PGIM (Hong Kong) Limited, a regulated entity with the Securities & Futures Commission in Hong Kong to professional investors as defined in Section 1 of Part 1 of Schedule 1 (paragraph (a) to (i) of the Securities and Futures Ordinance (Cap.571). In Australia, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the FCA (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In South Africa, PGIM, Inc. is an authorised financial services provider – FSP number 49012.

© 2020 PFI and its related entities.

留意事項 2

※本資料はPGIMフィクト・インカムが市場動向に関する情報提供としてプロの投資家向けに作成したものです。PGIMフィクスト・インカムは、米国SECの登録投資顧問会社であるPGIMインクの債券運用部門です。

※本資料は情報提供を目的としたものであり、特定の金融商品の勧誘又は販売を目的としたものではありません。また、本資料に記載された内容等については今後変更されることもあります。

※記載されている市場動向等は現時点での見解であり、これらは今後変更することもあります。また、その結果の確実性を表明するものではなく、将来の市場環境の変動等を保証するものでもありません。

※本資料に記載されている市場関連データ及び情報等は信頼できると判断した各種情報源から入手したものですが、その情報の正確性、確実性について当社が保証するものではありません。

※過去の運用実績は必ずしも将来の運用成果等を保証するものではありません。

※本資料は法務、会計、税務上のアドバイスあるいは投資推奨等を行うために作成されたものではありません。

※当社による事前承諾なしに、本資料の一部または全部を複製することは堅くお断り致します。

※"Prudential"、"PGIM "、それぞれのロゴおよびロック・シンボルは、プルデンシャル・ファイナンシャル・インクおよびその関連会社のサービスマークであり、多数の国・地域で登録されています。

※PGIMジャパン株式会社は、世界最大級の金融サービス機関プルデンシャル・ファイナンシャルの一員であり、英国プルーデンシャル社とはなんら関係がありません。

PGIMジャパン株式会社
金融商品取引業者 関東財務局長（金商）第392号
加入協会 一般社団法人日本投資顧問業協会、一般社団法人投資信託協会
PGIMJ76916