PERSPECTIVES

# Preparing for a Possible Post-LIBOR World

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Mark Boyadjian, CFA
Senior Vice President, Director, Floating Rate Debt Group
Franklin Templeton Fixed Income Group®

Reema Agarwal, CFA
Vice President, Director of Research, Floating Rate Debt Group
Franklin Templeton Fixed Income Group®

Even though they may not know it, many global consumers have at least one loan tied to the London Interbank Offered Rate (LIBOR). Yet, LIBOR's regulator is calling for an end to the rate by the end of 2021. Here, Franklin Templeton Fixed Income Group's Mark Boyadjian and Reema Agarwal explain why they believe replacing LIBOR won't be easy. They also share some concerns about the new-issue loan market as the market waits for a possible LIBOR replacement.

For decades, the financial world placed its trust in the London Interbank Offered Rate (LIBOR) as a reference interest rate for a wide range of financial instruments across the globe. The common view was LIBOR would represent the average interest rate a panel of leading London banks would charge each other for a loan. As LIBOR moves, so do the interest payments for some $350 trillion in financial securities.

However, scandals have eroded trust in LIBOR over the past five years. In 2012, regulators in the United States and Europe unveiled a plot by some banks to manipulate LIBOR for profit. By the end of 2016, 12 banks had paid about $10 billion in penalties.

Now, the UK's Financial Conduct Authority (FCA) is calling for an end to LIBOR as a benchmark by the end of 2021. In July, the LIBOR regulator said it was concerned about the lack of liquidity in the underlying market. In addition, the FCA expressed concerns about material panel bank membership turnover.

As a result, the FCA said it expects the market to transition to an alternative benchmark in the next four years. Banks agreed to submit rates to sustain LIBOR on a voluntary—as opposed to mandatory—basis until the end of 2021 to ease the transition to a new benchmark.

**LIBOR's Uncertain Future**

At this time, it's too early to tell if the FCA's 2021 deadline is set in stone, but we think the likelihood of LIBOR discontinuation is high. Past scandals and the lack of actual unsecured lending among banks have reduced the credibility of a LIBOR quote. At the core of the problem, in our view, is LIBOR depends on the opinions of industry insiders about what rates interbank lending should be, instead of actual trading levels.

We believe a change from LIBOR to an alternative benchmark would be significant. Global lenders use LIBOR to set interest rates for a variety of financial products, including interest rate swaps, student loans, mortgages, collateralized loan obligations (CLOs) and floating rate loans. A change would require amendments to the contracts and credit agreements, underlying trillions in global assets.

The interest rates on many of these contracts and agreements are set based on LIBOR plus a spread. If the alternative benchmark does not copy the compensation provided by LIBOR, it will likely result in a resetting of the spreads lenders charge and borrowers are willing to pay for these assets.

**A US Alternative to LIBOR?**

In June of this year, the Federal Reserve Bank of New York-sponsored Alternative Reference Rates Committee (ARRC) proposed an alternative to LIBOR, a broad Treasury repo financing rate (BTFR). The rate will be published daily starting in the first half of 2018.

The BTFR is different from LIBOR in many ways. It is a secured rate, which implies lower risk for an investor, and hence is typically lower than the unsecured LIBOR rate. The BTFR is an overnight rate. Meanwhile LIBOR is produced for five currencies and has seven different maturities—overnight, one week and one, two, three, six and 12 months. There would have to be an adjustment for the difference in tenors of these rates.

In the institutional loan market, there is some concern CLOs and floating-rate loans will offer less appeal as floating-rate assets given the uncertainty surrounding the replacement of LIBOR. These assets may no longer provide investors the desired or expected interest-rate protection in a rising-rate environment. That's a key differentiator of the asset class from fixed-rate credit, notably high-yield bonds.

That said, it's unclear what benchmark could replace LIBOR. The replacement process is in its infancy and the outcome is highly uncertain. We believe it is too early to form any concrete theories as to what rate or methodology will replace LIBOR, how smooth such a transition will be, and what the impact will be on markets that depend on this benchmark.

**What Happens Now?**

There is a full four-year period before the FCA deadline is upon us. Given the continuously callable feature of loans, our view is that most loan issuers will address changes to LIBOR as part of the refinancing process by amending their credit agreements well before then, and they will be able to incorporate replacements as they crystallize.

However, we have some more immediate concerns. We have seen attempts to dilute investor rights with regard to the reference benchmark (LIBOR) in the absence of full information about the future of the LIBOR benchmark.

Specifically, we have seen some companies add language to new-issue loan credit agreements that allow them to choose a replacement rate for LIBOR, *without consent from all lenders.* In our opinion, it's a cardinal rule of lending that each affected lender should consent to a proposed reduction in the interest rate of a loan.

We think this is an alarming trend. Consenting lenders could take actions, based on other considerations, which are not in the interest of non-consenting lenders. These considerations could be other business from the issuer, future business opportunities or ownership in other parts of the capital structure that incentivize them to reduce compensation for the senior secured loans.

More egregiously, we have also seen provisions in new-issue loan credit agreements that permit the issuer to change the reference rate from LIBOR, *without any lender approval.* Also, this language was not in draft documentation sent to investors. It was added to final executed versions of credit agreements.

The legality and underhandedness of inserting such a provision are debatable, but we are taking a proactive approach to this development. We are watching for this language in draft credit agreements of any new-issue transactions we are considering investing in. As a condition of investing, we are requiring approval of any changes made to the LIBOR or reference benchmark rate.

In this environment, we still favor investing in the secondary market versus at new issue. Historically, the secondary market has presented us with the greatest opportunities. Now, it also appears to take away uncertainties from a documentation perspective.

It is entirely possible that we could walk away from otherwise attractive new-issue investments due to these egregious provisions. We would rather err on the side of caution, and protect our investors from one-sided credit agreement provisions and unforeseen changes in rules that adversely affect the return profile of the investment. We firmly believe that, as has been the case in the past, the leveraged-loan market will ultimately prove resilient in the face of changing regulations.

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**Franklin Floating Rate Daily Access Fund**

All investments involve risks, including possible loss of principal. Investors should be aware that the fund’s share price and yield will fluctuate with market conditions. The fund should not be considered an alternative to money market funds or certificates of deposit (CDs). The floating-rate loans and debt securities in which the fund invests tend to be rated below investment grade. Investing in higher-yielding, lower-rated, floating-rate loans and debt securities involves greater risk of default, which could result in loss of principal—a risk that may be heightened in a slowing economy. Interest earned on floating-rate loans varies with changes in prevailing interest rates. Therefore, while floating-rate loans offer higher interest income when interest rates rise, they will also generate less income when interest rates decline. Changes in the financial strength of a bond issuer or in a bond’s credit rating may affect its value. The fund is actively managed but there is no guarantee that the manager’s investment decisions will produce the desired results. These and other risks are discussed in the fund’s prospectus.

*Investors should carefully consider a fund’s investment goals, risks, sales charges and expenses before investing. Download a prospectus, which contains this and other information. Please carefully read a prospectus before you invest or send money.*

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