Episode 20

LIBOR: A transition unlike any other

The world is preparing to leave LIBOR behind. We walk through the ins and outs of this massive undertaking.

Kara O'Halloran (00:06):

Welcome back to FireSide, a podcast from FS Investments. My name's Kara O'Halloran, and I'm a Director on our Investment Research team here. And before we get into today's episode, we want to hear from you. If you've tuned into FireSide before you've probably heard from Lara Rhame, our Chief U.S. Economist. We bring her on regularly to share her insights and outlooks, but now we want to know what you want to know. So if you have a question about anything relating to the economy or markets, send us an email at research@fsinvestments.com, and we will sit down to answer them all.

Kara O'Halloran (00:38):

And now to today's topic, the world is leaving LIBOR behind at the end of this year. A transition that markets had been preparing for years. Over the last year and a half, our team here at FS has, in partnership with KKR, published a series of research pieces thoroughly chronicling the transition. Those are all available on our website, fsinvestments.com. But I'm excited today to bring you a conversation between Andrew Korz, a member of our research team here, and one of the foremost experts on the LIBOR transition, Tal Reback. Andrew, I'll let you take it from here.

Andrew Korz (01:09):

Thanks for leading, Kara. My name is Andrew Korz. I work in our investment research department here at FS Investments, focusing on macro commentary among other things. I'm joined today by Tal Reback, a principal at KKR, where she focuses on the firm's credit portfolios, leads the development of credit content, and most importantly for this episode, leads the firm's global LIBOR transition effort. Tal also serves as a member on the Federal Reserve Board and the New York Fed's Alternative Reference Rates Committee, which is the public/private working group helping to ensure a smooth transition from LIBOR in the U.S. Tal, welcome.

Tal Reback (01:44):

Thanks so much, Andrew, for having me.

Andrew Korz (01:45):

Sure. So let's jump right in. So I want to start from the very highest level. Folks have been hearing about LIBOR going away for years now. The ARRC, which again, you serve as a member on, was formed in 2014 to address LIBOR's issues. Since that time, the topic of the transition has popped up in the press intermittently when there have been milestones hit or new developments, but by and large, I think your average market watcher probably doesn't have a great handle on this long and winding journey. The process of weaning the global financial system off LIBOR has been incredibly complex as you well know, and I'm sure we could sit here for hours dissecting it, but from a very high level, can you set the stage for us? Where do things

stand in the move away from LIBOR right now – first globally, and then in the U.S more specifically?

Tal Reback (02:32):

Yes. So we are at the precipice, I would say, of the transition. So from a global standpoint, we are less than two months away from the cessation of all non-USD LIBOR currencies. And that would be GBP, Euro, Frank, and the Japanese Yen. You know, what we've really been seeing is an acceleration of people really knowing now that this is top of mind, especially as multicurrency facilities are remediating their documentation, or repricing, into the successor rates. You know, if you take a step back, like you mentioned, this is something that many market participants have been working on for a very long time, although some would be call it behind the scenes. And where we are, why I say we're at the precipice, is because everything is coming together similar to our Rubik's cube. It has continued to morph and change with different developments, different twists and turns.

Tal Reback (03:27):

And as all non USD shifts over to their successor rates, we're starting to see SOFR loan issuance in the U.S, which is awesome. I would also say that the U.S is on the precipice as well because being two months away, or less than rather, of no new origination in LIBOR, starting in the new year. And that's a really big deal because that's a completely different mindset than what you've ever operated in. And although the dollar has a tail that goes until June 30th, 2023, that's only from a legacy perspective. So what I think we're going to see is that this become a very topical discussion across anyone who has any lIBOR exposure. And I think one of the things that people underestimate is the breadth of which this rate has really been used and kind of consumed across all different types of market segments.

Tal Reback (04:18):

And so where I believe we need to go, call it in the next sub 50 days, is really the time to act and have a dialogue and lean [inaudible 00:04:27] is really now. I really encourage people if they haven't been participating, or in the know, to pick up the phone and learn more about it, because this is something that everyone's going to have to deal with in some shape or form. It's a pretty big market moving event. And so I think one of the things that gives me some sleep at night,, comfort, is that there's been a lot of work and there's a lot of tools out there to help people navigate through this. But taking the first step is really having the dialogue, which I think we are definitely at that point.

Andrew Korz (04:58):

Yeah, definitely. And just as you were talking there, I was kind of thinking about a sort of an iceberg analogy; where people are kind of seeing the tip of the iceberg right now, but what they haven't seen over the past four, or five years has been all of the arduous work that's gone into this from so many corners of the financial markets. I want to pull on one thread, you mentioned there, which was SOFR, or the Secured Overnight Financing Rate, which is the preferred replacement for LIBOR in the United States. And I want to dig a little deeper there. Can you walk us through what SOFR is, how it differs from LIBOR, and why the regulators and the ARRC have really honed in on SOFR as really the ideal replacement for LIBOR?

Tal Reback (05:43):

Yeah, it's a great question. So I think in order to answer that effectively, we need a little bit of history to set us up. And so if you recall, LIBOR really came into question around the Global Financial Crisis when it became known that the rate was manipulated. And since the GFC, not only has the world dramatically changed, but markets have dramatically changed and how

banks fund themselves have dramatically changed. And so LIBOR was really the representation of credit risk amongst the group of panel banks. And quite honestly the reason why it all came into a question is that it was susceptible to manipulation and collusion. Where we are today is that the quantum of transactions that actually take place to really get LIBOR quotes is sub $500 million a year in total volume. That's probably even shrinking as we speak.

Tal Reback (06:38):

And it really heavily relies on something called expert judgment. And I think there was definitely a big mobilization globally to reform the rate when the decision was ultimately made by regulators that the rate would go away. They knew this would take like monumentous architecting and that we would never want to be in a situation like this again. So what were the key pillars and principles that they needed to scope out to identify a successor rate, and what the Fed really concluded was that you needed a breadth of transactions. You needed a very robust rate. You needed to preserve liquidity. You needed to be able to really back into the numbers and have true black and white transparency on how a rate was derived. And that is how essentially those key components are what prevailed SOFR to be the regulator's choice for U.S Dollar LIBOR, because it is essentially the overnight rate collateralized by U.S Treasuries. The volume at this point reaches close to a trillion of volume a day.

Tal Reback (07:44):

And if you look at a trillion daily volume versus potentially a max of 500 million in annual transaction, it's quite a big difference. It's a rate that is risk free, where LIBOR was something known as an unsecured rate with a credit component. I.e. measuring the risk in the system, via panel banks. And so intrinsically when you look back at the two rates, they are a little bit of apples and oranges. They are completely one overnight rate. Now we have a term structure with SOFR, which is awesome, but SOFR, at its core, is an overnight rate.

Tal Reback (08:22):

Collateralized by us treasuries, LIBOR has a term structure that is derived mostly on expert judgment through the panel banks. The panel banks are on contract until LIBOR ceases for dollar on June 30th, 2023. And they will stop quoting the rest of the non dollar currencies at year end. And it essentially, it became, I think when you look at the canvas from afar, you have to zoom out and say, what did we need to ensure financial stability and health of markets and price discovery, and a rate where people, when they need liquidity most, would have that. And that is how they got to SOFR as that choice.

Andrew Korz (08:58):

Right. Okay. So clearly, as we were looking to replace LIBOR, regulators really put a high priority on the robustness of the underlying market. SOFR is a relatively new rate and it's one thing to create a rate based on a robust underlying market. It's a whole nother beast to try to, sort of, implement it into financial markets and get liquidity in derivatives in loans and bonds. So really kind of stepping through that process of ingraining SOFR into the markets, the most efficient way to introduce SOFR to markets quickly was via derivatives, which are largely centralized and formulaic. The harder part was always getting borrowers and lenders in the cash market comfortable using the rate, especially in the leverage loan market, which has historically been one of the most significant and largest users of LIBOR. Over just the past few weeks, we've seen multiple leverage loans referencing SOFR finally come to market after waiting months and months to see issuance there. Talk to us about some of the conversations you're having and what you expect to see as that year end deadline approaches and the transition gets more and more real for a lot of market players.

Tal Reback (10:13):

Absolutely. You know, it's funny, I feel like everyone wants to talk about this now, which is great, but there are a lot of questions. And so, like you said, derivatives really kind of drove the initial roadmap of how you implement a new rate into the market given the notional size, the loan market, the cash products. However, the complexity of loans, I would say outweighs the 200 trillion notional of OTC derivatives. With that being said, different market participants have come into this transition at different points in time from different angles. The conversations that I'm really having today are very much centered around leverage loans. They're very much centered around: how do you price and look at new issue? How do we think about risk pricing in a so called quote unquote risk free rates? And what does that mean on a go forward basis where interest rates are at all time, lows spreads are at all time type?

Tal Reback (11:12):

We could see the feds start hiking. We have all kinds of macroeconomic, different twists and turns in the background. You have a LIBOR going away. And yet LIBOR has also been at historic lows for about 20 months. And I think what a very high touch item that comes up often is how do I think about the two rates, their relationship, and how do I think about my existing potential assets and liabilities that need to convert? And how do I think about new issue? And that is truly the blending of multiple different methodologies. And I would say different touch points of where this transition has ebbed and flowed over the years. And so I think the market has done a good job at understanding and digesting fallbacks. We've seen that that's been implemented over the last 15 months.

Tal Reback (12:00):

What we haven't, what's new is new issue. And I think we are seeing a fair bit amount of price discovery in the market, which is healthy. I think what we need to increase is the dialogue and the education amongst different market participants, borrowers, and lenders alike. And really start to think about the world in a non LIBOR context, meaning there's a lot of comparing SOFR to LIBOR and the differential of the spread, which is a couple of basis points on spot spread basis. But when LIBOR goes away and there's no new origination in the new year, my question to many people has been, how/why would you compare new forward looking risks to something that is being phased out and presumably will become much more a liquid. And so that's a very high topic that a lot of people have been asking questions about.

Tal Reback (12:49):

People are thinking about what is my loan look like in a SOFR in the market that is super volatile potentially, and is SOFR based. And that's where you would see a behavioral difference between LIBOR and SOFR. Historically LIBOR was known to react to stress in the system and rise, where risk free rate and what we saw in March, 2020 when the set stepped in was the opposite of, SOFR decreasing. LIBOR actually did the same thing, which was a very big indicator to everyone that we were at the right time of the transition and things were not working the way they were supposed to. But I think it comes down to now back to fundamentals, thinking about how do we think about risk? How do we think about managing our basis? What are we doing when we have a mixed bag, a mixed portfolio, as you know, CLO collateral pools are changing over at different points in time.

Tal Reback (13:43):

Those are high topics that people ask about a lot. I mean we've talked about how CLOs make up 65 plus percent of the leverage loan market. They have a fun game of managing their assets and their liabilities in an ever changing market, plus many legacy vintages that we'll have to think about that too. Ultimately my thought is that people opt to be more proactive next year because I think the world becomes infinitely more complex as we navigate these waters. But I

think people are figuring that out very quickly. And that's why this is all very important to have the dialogue, have everyone have a seat at the table, and especially for non-financial corporates, who have to think about their capital structures and what the world looks like in a very different lens. Those are the types of conversations I'm encouraging everyone to have now.

Andrew Korz (14:37):

Absolutely. So you kind of mentioned that the last roughly seven weeks, or so, of 2021 as we're recording here on November 11th, are really going to be what we call the, the crescendo. Right. Of the transition where markets are finally realizing, oh, shoot, this is real. I need to really start to think about my risk in a SOFR perspective. And we're really starting to see some issuance in the loan market based on SOFR. And SOFR derivatives are really increasing in terms of liquidity. I know the SOFR futures market is now about the same size as the Fed Funds futures market, which is a pretty significant milestone. So we're really in this rush to year end right now. Let's say we get to year end, usage of SOFR has increased meaningfully. And now LIBOR, as of January 1, is no longer allowed to utilized in new loans, bonds, derivatives, any new financial contracts, you kind of alluded to it earlier, but walk us through quickly what 2022 is going to look like.

Tal Reback (15:37):

Yeah. My crystal ball that does not exist tells me that 2022 will be very active. I think that people are go-like I do think productivity and proactivity are going to be top of mind, and that there's going to be a gravitation towards wanting to opt in to SOFR earlier to repri, to refi, to think about how new issuance, and that digest in the market pairs with legacy loans. My thought, also, is that the tail of assets and liabilities that are left by June 30th, 2023, are really those that don't need to be touched, meaning that they have fallback language and they can convert at their will, or they're being paid down, or they're being taken out. But I do think anyone who's actively managing a portfolio, looking through their capital structure, working through the market, is going to want to be on SOFR sooner rather than later.

Tal Reback (16:36):

That's just my sniff test of how I think people will think about the world. So, that leads us to a very busy first half of the year. I also think, as I mentioned quickly earlier, we don't know what liquidity and LIBOR will look like in a couple of quarters. And so I think you could potentially see that spin out and you could see in the liquidity, the premium come in. Pricing of swaps could start to change. That could spill over into the cash markets. You know, there's a little bit of the domino effect here too, which is what made this thing so complicated is that it's a rate that's everywhere. It's super integrated all over. Most people didn't pay attention to it before, but now that you have to face it out, that unwind is much more work than many had anticipated.

Tal Reback (17:22):

And by virtue of that, there's always going to be knock-on and net effects. And so I think proactivity will be something that people will gravitate to. That's certainly how we have been thinking about it and how I have been thinking about it. And quite honestly, as risk managers, that's where our heads should be in my opinion. And we all have lived through a bunch in the last almost 21 months. And I think it's taught us that you never know what could happen, and markets are susceptible to different changes. And there is probably still some fragility in the system, albeit lots of support through the Fed, stepping in. But I don't know that you want to have this hanging out and be an outstanding item. In my view, you'd feel a lot better if you knew it was taken care of.

Tal Reback (18:10):

And to me, that just means being proactive in the first half of the year, seeing where the market goes, see how the market digests it. We could have some little fits and starts quite honestly, as CLOs get up to speed as new issuance and SOS derivative liquidity is deepening. You're going to have people switching over their curves, right now. But there's still a little bit of that. We've got to digest and work it through the ecosystem. And so that to me just says be ready, be active, have those conversations, have a dialogue, ask questions. It's amazing that this is actually quite complicated, but it can be distilled very, I think pretty easily at this point, given the amount of resources and education and tools that Official Sector has put out there globally. And so that's what my fake crystal ball tells me.

Andrew Korz (19:00):

Well. Yeah. I like it. It sounds like we're going to have a pretty active first half of 22, but I think I speak for everybody in that if the most complicated fly of letter acronym in 2022 is LIBOR instead of COVID. I think that's a step up from the last two years. Okay. So Tal, we're going to jump into a quick lightning round, if that's okay with you. I'm going to ask you a couple questions. I want a quick answer, 20 seconds or fewer. Are you good with that?

Tal Reback (19:28):

I'm good. I just didn't bring my umbrella. So let's move quickly.

Andrew Korz (19:32):

Let's do it quick. All right. Number one. So hearing you speak, it seems like the market at least knows what needs to get done at this point up until the end of the year. And then in the first half of 22, what's the biggest risk to the average investor that you see over the next 20 months or so?

Tal Reback (19:47):

I think the biggest risk honestly, is complacency and thinking that someone else is going to figure it out for you, and then it's going to fix itself. I think the devils and the details in this. Absolutely. I would be remiss if I didn't reiterate that being proactive, knowing your portfolio, knowing your docs, asset liability management is going to be critical, any hedges, any swaps that you have on all of that needs to come together. It's truly a connected dots type of exercise, but being complacent, I would say, would be an Achilles heel in this situation.

Andrew Korz (20:19):

Yep. There's no shortcuts here. Number two, a lot of people are eyeing up that June 2023 date as the time when all legacy contracts must officially move off LIBOR. However, we know that many in the market expect to switch to SOFR much sooner. So you've kind of spoken to this a bit, but how proactive do you expect market participants to be in terms of refining or otherwise closing out existing LIBOR exposure in 2022, instead of waiting for that 2023 deadline?

Tal Reback (20:47):

I think you probably skewed more towards being more active in 2022, just because oftentimes issuers are thinking about their capital structures. Something else may be happening. It may make sense for them to nip everything in the bud. I do think as more dialogues are happening across the table between borrowers and lenders, this is a very natural conversations to have. And unless there's a really good reason to let something go off into, to run off quite honestly, or reaching maturity, I think you're a little bit incentivized to be proactive. And obviously this is contingent on market inertia and how everything unfolds, but I'd imagine that it skews more heavily towards activity in 22 versus waiting until 2023.

Andrew Korz (21:31):

Sure. So obviously we've mentioned that LIBOR sort of has tentacles that reach into pretty much every corner of the financial system. What one part of the market will you be watching most closely up until the end of the year and then into next year?

Tal Reback (21:46):

I'm heavily watching the CLO leverage loan market. That's my playground, if you will. And so I think as call it one of the slower segments of the market to adopt the rate and albeit also a very complex and nuanced area, there are many things that I'm going to keep my eyes on there. And so that's where I'll be watching going to year end.

Andrew Korz (22:10):

Sure. So we haven't touched on this really quite yet, but some listeners may have heard of some other alternatives to LIBOR in the U.S. There's been Ameribor there's BSBY, which is published by Bloomberg. I think there's an ICE Bank Yield Index and maybe a couple other less known ones. And these rates tend to act in a similar fashion as LIBOR, in that they have a credit sensitive component, but they also have much less robust underlying market than SOFR. Do you see any significant usage of any of these rates, any of these sort of what we call credit sensitive rates, that could steal some market share away from SOFR?

Tal Reback (22:45):

Yeah, I think, one of the phrases that I really gravitate to, is know your reference rate. I think markets are super efficient. Market participants have the ability to make decisions that support their investments, or products, or business needs. So I think all of that supports a really healthy ecosystem. I find it hard to envision a market that is majority led by these alternative rates, given the regulatory backdrop. Plus the underlying composition of these rates does look very different than SOFR. So I think it's really going to lay in the hands of the beholder if you will. So I see it being used, but not in a majority stake fashion. And not really. I don't see the institutional loan market gravitating to that direction.

Andrew Korz (23:31):

Sure. All right. Last question. Let's skip big picture. This transition has been incredibly arduous and taxing for many institutions and certainly many people. I don't think I need to tell you that. Has it all been worth?

Tal Reback (23:43):

That's the trillion dollar question.

Andrew Korz (23:47):

[Laughs 00:23:47].

Tal Reback (23:48):

Yes, it's been a ton of work. There's been a lot. There's been so many people involved, many, many years of compounded history behind this, but at the end of the day, I think the financial system in the markets will probably be better for it. I think we, as students of history, always have to look back and realize if there's something that we can drive our destiny with and help control a better outcome and better environment that's worth the effort and the work. The markets have certainly done that since post the financial crisis. And this is probably just one of the longer tail items on that list. And so in the future state, we probably all forget about it that we ever went through this whole thing. And I think that's an important thing for people to remember. We don't want to go through another type of benchmark transition type of event. And so it's really important to be thoughtful throughout all of this.

Tal Reback (24:37):

And so long winded way of saying, yeah, it's been a lot of work. I think it will be worth it. Everything takes time. Everything is an evolution, but as soon as it's history, it's on us to kind of to take the driver's seat here.

Andrew Korz (24:50):

Yeah, absolutely. It's one of those subjects, sort of like supply chains, where if you're not talking about it eventually, it probably means it was successful.

Tal Reback (25:02):

So that's right.

Andrew Korz (25:03):

That's a great overview, Tal. Congratulations. You made it through the lightning round gauntlet. Not many do, but you succeeded, so congratulations. [laughs 00:25:11]

Tal Reback (25:11):

Thanks, thanks. Do I get a t-shirt?

Andrew Korz (25:13):

Oh yeah. We'll send you a FS Investments t-shirt yeah, absolutely. [laughs 00:25:17]

Tal Reback (25:17):

Okay, great. Awesome.

Andrew Korz (25:20):

Anything else you want to add before we end?

Tal Reback (25:22):

I would just say that I really encourage people to start asking questions and having dialogues if they haven't. There's still-I think it's important to lean in now before year end and that there are resources available.

Andrew Korz (25:35):

Absolutely. So obviously given the format and time constraint, we weren't able to dive into the weeds on some of the more complex and nuanced topics regarding the transition. Again, I'll remind our listeners that FS and KKR have co-authored a series of research notes on this topic, including a brand new one, hot off the presses just this week. That goes into these topics in some more detail and lays out our core views for what investors can expect over the next 20 months, or so. Tal, thanks again. We really appreciate you joining us on the podcast. I will say I hope you put your mind at ease and stop thinking about short term interest rates for at least a couple days around the holidays. I know that's probably unrealistic, but I'm sure you can dream, right?

Tal Reback (26:18):

I'm sure I can. Maybe Santa will bring me something.

Andrew Korz (26:19):

There you go.

Tal Reback (26:20):

Thank you, Andrew.

Andrew Korz (26:21):

Well, thanks again Tal for your partnership. And again, for joining us today, it was a lot of fun.

Kara O'Halloran (26:32):

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