GRANT'S
INTEREST RATE OBSERVER®

Vol. 37, No.03d 233 Broadway, New York, New York 10279 • www.grantspub.com FEBRUARY 8, 2019

Out with the old

If all goes according to plan, Libor—the London interbank offered rate—will vanish at the end of 2021, superseded by a new money-market interest rate. The changeover will make no headlines, disappoint no market participant. Equitable and seamless, the transition will be the money market's own version of the anticlimactic, year-2000 computer-clock changeover, Y2K.

That is, if the Alternative Reference Rates Committee, a Federal Reserve-led technical body now at work, does its job as well as its technically proficient members say they intend to do it. The risk, which *Barron's* highlighted on Jan. 19, is that technical issues and clashing vested interests of borrowers and lenders may leave the holders of trillions of dollars of Libor-referenced securities without a relevant reference interest rate.

We write to describe the problem, the work in progress to fix it and the risks confronting the holders of the kind of fixed-to-floating-rate preferred shares about which we have written approvingly, including the General Electric Co. Series D perpetual preferreds (*Grant's*, Nov. 16, 2018). In preview, we judge—or, rather, venture to speculate—that the Y2K analogy will prove to be the applicable one.

You'll recall that fixed-to-floating securities come into the world paying a fixed dividend. They are callable five years after issuance. If not called, they convert to a dividend that floats with a standard reference rate, that rate being three-month Libor. And if there were no Libor and no reasonable facsimile of Libor? It's not impossible that, in a few years' time, the investor could be stuck with a fixed-rate security, not the floating-rate paper that he or she signed up for; or stuck with a floating-rate security tied to a reference rate that was seemingly invented to deny him or her a fair yield.

Libor is an unsecured rate; it's what London-based institutions charged when they trusted each other enough to make uncollateralized interbank loans. The U.K.'s Financial Conduct Authority requires several major banks to provide daily quotes to Libor's administrator, the Intercontinental Exchange, and it's from these once-scandal-plagued quotes that Libor is calculated. The problem these days is not the integrity of the quotes but the paucity of transactions from which to calculate them. Anyway, the FCA will stop requiring banks to provide quotations after 2021.

"Let us say that Libor indeed ceases to exist, and the GE Series D preferreds are still outstanding in January 2022," colleague Fabiano Santin ruminates. "The rate charged on three-month U.S.-dollar loans between prime London-based banks would become the new benchmark. Otherwise, the rates on dollar loans charged by New York banks to European banks would serve the purpose. Or, if not even that were feasible, the borrower would be required to update its coupon based on the last printed three-month Libor rate. Such, at least, is standard practice, as we read the documents."

For his part, Mr. Market is seemingly betting on the aforementioned ARRC to produce a new, fair, Solomonic floating interest rate—or, perhaps, the elderly gentleman refuses to focus on a contingency three years into the future. In any case, the *Barron's* story has made no price waves.

The Committee is writing documents to facilitate the migration of credit instruments to the secured overnight financing rate (SOFR) from Libor. Boilerplate contract language with respect to new issues is expected within weeks. The knottier problem concerns the trillions of dollars of legacy securities.

James Bianco, the Chicago rates guru, has light-heartedly dubbed SOFR "New Coke." Whatever its other merits and demerits, SOFR is a secured rate, which, by its nature, should always be lower than the uncollateralized Libor.

"Circumventing the problem by amending old bond indentures for the use of SOFR could be troublesome because unanimous consent from security holders would be required," Santin points out. "The Trust Indenture Act of 1939 requires 100% consent solicitation whenever registered indentures are amended with an interest rate lower than the prevalent one. The case is different for preferred securities, typically considered to be equity for legal purposes, which would be governed by a combination of state law and underlying corporate documents, such as the fine print published in the prospectus."

The worst case would not be so disruptive for an institutional investor. For a price, the big money can purchase interest-rate swaps to convert a fixed-rate instrument into a floating-rate one. No such workaround is feasible for the nonprofessional. Then again, says Ian Walker, legal analyst at Covenant Review, the Fitch-owned credit-research firm, there could be a legal fix.

"One potential solution might be legislation that clarifies that a transition to SOFR plus an appropriate spread adjustment would not result in a reduction of interest," says Walker. "This would mean that unanimous-consent requirements would not apply and contracts with bad fallbacks could be more easily amended."

One particular set of preferreds issued by Citigroup contains unusual language that fixes the coupon to the Libor rate that was in effect when the securities were issued during ZIRP—instead of the most current Libor. Michael Verdeschi, Citigroup Treasurer, noted in the bank's Jan. 24 earnings call:

> We are very focused on this language in the subset of our preferred securities and are actively evaluating alternatives to address it. Each potential path forward, whether we address the issue through an exchange or an amendment or some other means, has different considerations, which is what we're currently working through. Also, we want to be thoughtful and aligned with [the] industry's best practices to make sure any decisions we make in the near term will not be inconsistent with the ongoing work we're doing with the rest of the industry.

Maybe a bet on the good will of the contracting parties is not so outlandish after all.

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News from GE is taking on a cheerier cast, as asset dispositions accumulate and the settlement of a Department of Justice complaint proved no costlier than the reserves set aside to meet it. The unconventional absence of terrible news has likewise lifted spirits.

Since the Nov. 15, 2018 nadir, the Series D preferreds have rallied by 25%, to 89 from 71, and GE common by 28.4%. Priced to yield 11.4% to the January 2021 call, the preferreds still strike us as good value, the uncertain future of Libor notwithstanding.

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