GUGGENHEIM

The Transition Away from Libor

Goodbye Libor

July 2023

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We are confident that our portfolios and systems are prepared for the range of market outcomes that have accompanied the end of Libor.

The publication of all U.S. dollar Libor tenors ceased on June 30, 2023, marking the end of a years-long transition away from the troubled London Interbank Offered Rate, or Libor. This process began a decade ago, when the Financial Stability Oversight Council (FSOC) in 2013 declared that the financial system's reliance on Libor posed a significant threat to U.S. financial stability.

By now, every market participant should be well-acquainted with the reasons for seeking a replacement for Libor. The rate, based on estimates of inter-bank lending rates provided by a small number of leading banks in London and not actual transactions, made it vulnerable to manipulation by the rate-setting banks and unreliable during times of market crisis. Preparing for the transition away from Libor has been an enormous undertaking for market participants, corporations, and regulators alike, with far-reaching consequences for households, businesses, investors, and financial intermediaries. Libor had been used as a reference rate for an estimated $200 trillion worth of financial contracts in the United States alone, including derivative instruments that hedged Libor, consumer and business loans, bonds, and structured credit securities. Withdrawing from such a pervasive feature of the financial system could have been a hugely disruptive process, but significant advance planning and cooperation from all stakeholders helped to make it a relatively smooth one.

The Alternative Reference Rate Committee (ARRC), the private-market participant group convened by U.S. financial regulators in 2014 to identify risk-free alternative reference rates for U.S. dollar Libor, chose the Secured Overnight Financing Rate (SOFR)—an overnight Treasury repo rate created in 2018 by the Federal Reserve Bank of New York and published daily—as the rate that represents the best practice for use in new U.S. dollar derivatives and other financial contracts.

The vast majority of fixed-income market participants have made the switch to SOFR, but there are still some loose ends to the transition. Many contracts and securities are still tied to Libor: While some contracts will transition when their current Libor interest period ends, other contracts have been slow to transition due to the changing interest rate environment. For example, after Dec. 31, 2021, when U.S. dollar Libor no longer could be used in new contracts, it was expected that existing contracts using Libor would be refinanced and an alternative reference rate would be selected for new contracts before the June 2023 deadline. But after a strong refi start in January 2022, refinancings dried up over the rest of 2022 and the beginning of 2023 as inflation, rising interest rates, and economic concerns took their toll.

Interest rate sensitivity may have temporarily muted the switch from LIBOR to SOFR through refinancings, but the lack of suitable fallback language for some leveraged loans will likely present another challenge. Over half of the loans in the Credit Suisse Leveraged Loan Index have appropriate fallback language or don't require lender approval to switch from Libor to SOFR or an alternate reference rate. But complications in choosing a new benchmark rate are likely to arise among the minority of loans in which contractual terms can pit buyer against seller or where there is no Libor succession language at all. In some contracts, if borrowers and lenders can't come to terms on a reference-rate switch, these loans could revert to the prime rate. While these small frictions will persist for a while, they will be settled over time.

At Guggenheim Investments, we have been monitoring the evolving environment carefully. In a series of reports starting in 2017 (here, here, here, and here), we have been keeping clients abreast of market developments in the transition away from Libor as well as our preparations as a Firm and within portfolios we manage for our clients. As we conclude this series of reports on this major market event, we are confident that our portfolios and systems are prepared for the range of market outcomes that have accompanied the end of Libor.

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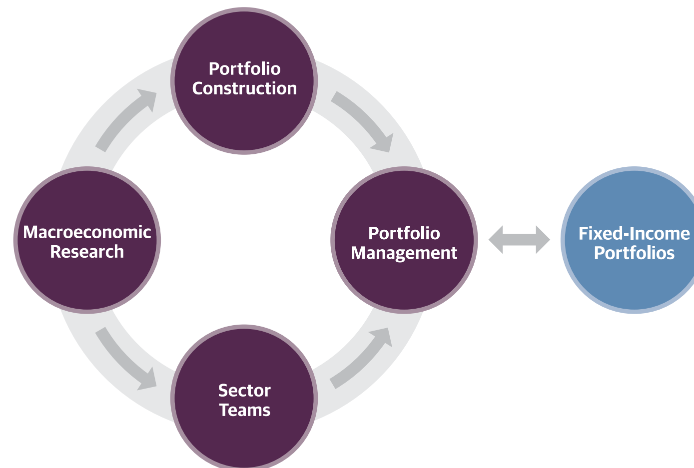
Guggenheim's Investment Process

Guggenheim's fixed-income portfolios are managed by a systematic, disciplined investment process designed to mitigate behavioral biases and lead to better decision-making. Our investment process is structured to allow our best research and ideas across specialized teams to be brought together and expressed in actively managed portfolios. We disaggregated fixed-income investment management into four primary and independent functions—Macroeconomic Research, Sector Teams, Portfolio Construction, and Portfolio Management—that work together to deliver a predictable, scalable, and repeatable process. Our pursuit of compelling risk-adjusted return opportunities typically results in asset allocations that differ significantly from broadly followed benchmarks.



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About Guggenheim Partners

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