

Preferred Securities in a Post-LIBOR World

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Executive Summary

We expect the London Interbank Offered Rate (LIBOR) to be phased out at the end of 2021, though the COVID-19 pandemic could affect the schedule. Markets are slowly transitioning to alternative benchmarks, but uncertainties remain, as a clear path forward on the transition has not yet been reached among the many stakeholders.

The transition has important bearing on preferred securities, because many have LIBOR-based payment resets. Notably, contingency “fallback” language that would take effect in the event LIBOR ceases to exist varies across preferreds, with some securities offering more favorable terms, and others including language that could put investors at a disadvantage. While pitfalls exist, our sense is that issuers are likely to support their investors by adopting best market practices rather than allowing poor outcomes. However, investors must focus on these complexities and price the uncertainties.

SOFR as a Likely Successor Rate

LIBOR is scheduled to be phased out by the end of 2021, carrying far-reaching implications for securities and derivatives that have payment resets, including many preferred securities. Signs point to the Secured Overnight Financing Rate (SOFR) as the likely successor, which has advantages over LIBOR in terms of reliability and liquidity. However, since this rate is based on Treasury-collateralized borrowing, it lacks the credit sensitivity of LIBOR, which prices in bank counterparty risk. A proposed solution is a static spread added to SOFR (“SOFR+”) to account for the risks that LIBOR priced in. But this static spread would result in weaker protections in risky markets than LIBOR, which

is dynamic. As such, it should warrant higher up-front credit spreads, in our view. Assessing the appropriate compensation is integral to our investing.

New Preferreds Addressing the Need for LIBOR Contingencies

Recent issuance of preferred securities has started to include explicit fallback provisions, such as indicating specific benchmark replacements or bypassing LIBOR and going straight to SOFR+. In other cases, new securities have moved away from short rates entirely with spreads based on five-year Treasuries. To date, the various new forms do not offer successor rates that are as credit sensitive and dynamic as LIBOR, requiring an understanding of the potential risks.

How Will Older Preferreds Work Post-LIBOR?

Many preferreds issued before 2017 have weak LIBOR fallback provisions, with coupons that could effectively convert to fixed rates, either based on a spread to an old LIBOR fixing or the original coupon rate. This could be positive or negative depending on the specific security and current market factors. For securities with unfavorable language, issuers wishing to avoid harming their investors may simply offer an exchange into new securities with better, more up-to-date documentation. Other solutions being explored include more sweeping statutory changes that could supersede issue-specific documentation.

Conclusion: Complexity Creates Opportunity

The transition from LIBOR to a new floating-rate benchmark adds an extra layer of complexity to preferred investing, underscoring the importance of knowing the contingencies and fallback provisions at the security level. This analysis remains integral to our investment process, creating additional opportunities for Cohen & Steers to potentially enhance returns and manage risks.

SOFR as a Likely Successor Rate

LIBOR's Demise

Developed in the 1970s, LIBOR has long served as the most widely used benchmark for setting rates on hundreds of trillions of dollars of fixed income securities and derivatives. Like other interbank benchmarks, LIBOR represents an average of unsecured short-term bank-to-bank lending rates submitted by panel banks.

In the wake of the global financial crisis, transaction volumes underpinning these submissions declined significantly, in part due to regulatory and market changes that led to less interbank lending. This caused panel banks' submissions to rely increasingly on expert judgments (educated guesses) rather than solely on actual transactions. This weakened the quality of the benchmark and made it more susceptible to manipulation.

Over the past decade, there have been wide-ranging investigations into potential manipulation of LIBOR. These concerns led to greater government oversight and, in 2017, to the U.K. Financial Conduct Authority announcement that it will no longer compel banks to submit rates for the calculation of LIBOR after 2021. Even today, panel banks perceive litigation risks with these submissions.

It is likely that panel banks will cease reporting LIBOR as soon as they are able to, effectively phasing it out as of 2022; however, the LIBOR transition might be extended. The official sector appears resistant to adjusting deadlines but there may be more pressing demands on regulators and companies stemming from COVID-19. If there is a delay, we would expect it to be relatively short as officials remain committed to the eventual phase-out of LIBOR.

Why the Phaseout Matters to Preferred Securities

Approximately two-thirds of the securities in the \$1 trillion global preferred market have payments that reset periodically, many of which use LIBOR as the reference rate. These securities typically fall into one of three categories:

- **Floating rate:** Coupons reset monthly or quarterly, usually at a spread over LIBOR (for example, LIBOR+3%).
- **Fixed-to-floating rate:** Coupons are fixed for a specified number of years, after which the security converts to a floating rate with a LIBOR-based reset.
- **Fixed-to-fixed rate:** Coupons are fixed for a specified number of years, after which the security resets to a new fixed rate based on a spread over 5-year swap rates, which are underpinned by LIBOR.

Due to this dependence on LIBOR for payment resets, the phaseout adds an element of uncertainty to future cash flows of affected preferred securities, which can impact risk premiums. As a specialist manager of preferred securities, we assess the associated risks and compensation for each security in which we invest, as represented by both the contract language and the issuer's intent.

The SOFR Solution

In 2014, the U.S. Federal Reserve convened the Alternative Reference Rates Committee (ARRC) together with industry participants, with the mission to guide the transition from U.S. dollar (USD) LIBOR to a more robust reference rate. In considering the weaknesses of LIBOR, the Fed focused on formulating a new benchmark with a high number of observable inputs based on actual transactions. The new proposed successor rate is the Secured Overnight Financing Rate (SOFR), representing the best practice for use in certain new USD derivatives and other financial contracts.

The ARRC published its transition plan with specific steps and timelines designed to encourage adoption of SOFR. Reference rate reform is an international effort, so to the extent possible, the ARRC's recommendations seek to coordinate with similar groups in the U.K., Switzerland, Japan and the Euro area.

SOFR has emerged as a 'best practice' replacement for LIBOR, with implications for the majority of preferreds with resets

The development of SOFR has been instrumental to solving the issue of a LIBOR sunset, offering a benchmark that is far more robust and reliable. However, SOFR is quite different from LIBOR and is not a perfect substitute (Ex. 1).

Liquidity. The average daily trading volumes of SOFR index components regularly exceed \$900 billion, more than 1,800 times the estimated \$500 million average daily trading volume for unsecured bank trades underlying USD LIBOR tenors.

Tenors. SOFR is an overnight rate only, whereas LIBOR is produced in various tenors—including overnight/spot, one week, one month, two months, three months, six months and one year—all of which are used in the market. The Federal Reserve recently proposed publishing SOFR of various tenors based on a compounding in arrears methodology that would align the cash and derivatives markets.

This SOFR in arrears (or lookback) methodology is different from the forward-looking nature of LIBOR. The ARRC has proposed that a private administrator could construct a forward-looking term rate based on the SOFR derivatives market once there is enough liquidity.

Collateral and credit pricing. LIBOR is a survey-based, unsecured interbank lending rate. By contrast, SOFR is a lending rate based on transactions that are secured by U.S. Treasury collateral (repo transactions). Since LIBOR includes a meaningful credit component, it is typically higher than SOFR (Ex. 2). Furthermore, the spread between LIBOR and SOFR is prone to widen in times of market stress (Ex. 3).

The differences between LIBOR and SOFR raise some important questions:

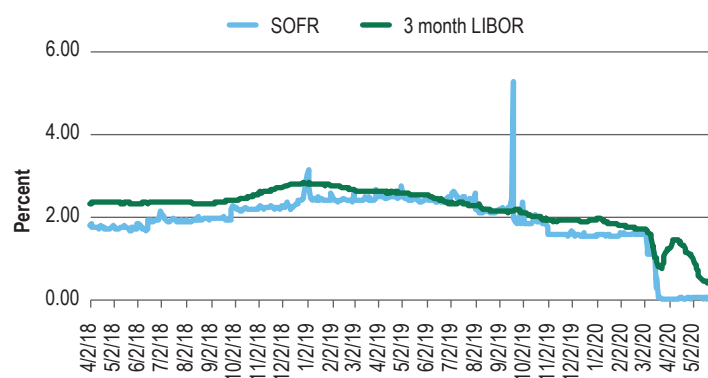
- Will SOFR be translated into something more akin to LIBOR, and will any new adjusted SOFR be widely adopted?
- How will existing securities with LIBOR-based resets or maturities beyond 2021 operate? Are the governing documents good enough, or will they have to be changed?
- If documents will be altered, how will that be done? Will such securities be redeemed or replaced?

Exhibit 1: Reference Rate Comparison

	LIBOR	SOFR
Liquidity (Avg Index Component Daily Trading Volume)	\$0.5 billion	\$900+ billion
Tenors	Overnight, 1W, 1M, 2M, 3M, 6M, 12M	Overnight rate only
Collateral	Unsecured	Secured with U.S. Treasuries
Dynamic Credit Component	Yes	No

At March 2020. Source: JPMorgan Chase, Cohen & Steers. See back page for additional disclosures.

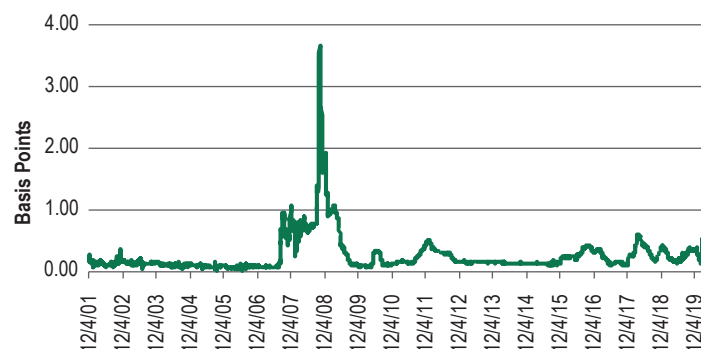
Exhibit 2: SOFR Solves Some Issues with LIBOR, but It Is Not a Perfect Substitute



At May 31, 2020. Source: Bloomberg and Cohen & Steers.

Exhibit 3: The LIBOR/SOFR Spread Tends to Widen in Times of Market Stress

3-Month LIBOR Minus SOFR Proxy (Effective Federal Funds Overnight Index Swaps)



At May 31, 2020. Source: Bloomberg and Cohen & Steers.

SOFR+ Brings SOFR Closer to LIBOR

Bridging the gap between LIBOR and SOFR has been a priority. The International Swaps and Derivatives Association (ISDA) has sought to quantify this credit adjustment, recommending a “historical mean/median approach,” whereby the spread adjustment would be based on the mean or median spot spread between LIBOR and the adjusted risk-free rate (i.e., SOFR), calculated over a static lookback period (e.g., 5 or 10 years).

ISDA's recommended adjustment would rely on SOFR's limited history and use a single, static (rather than dynamic) adjustment. The ARRC's spread recommendations, like that of ISDA, also use static adjustments, as dynamic spread adjustments would be based on the same unsecured and thinly trading funding markets that underpin LIBOR.

Bridging the gap between SOFR and LIBOR will likely be accomplished by adding a static credit spread adjustment—but this raises questions about pricing credit risk during periods of market stress

If the adjustment were to be static, then the new rate—which has come to be known as “SOFR+”—would still fall short of replicating LIBOR. Accounting for the credit differential with a static spread relationship cannot replicate LIBOR in periods of market stress. This is an important factor in pricing credit risk, as we witnessed during the financial crisis and more recently during the COVID-19 pandemic, when the basis between LIBOR and T-Bills widened meaningfully as the cost of bank credit risk was recalibrated. The spread between LIBOR and SOFR widened from 35bp in early 2020 to a wide of 144bp in late March 2020 because of reduced liquidity and increased perceptions of credit risk. This lack of credit sensitivity is one reason why there has been a tepid embrace of SOFR in parts of the funding markets.

In periods of stress, expected cash flows to investors would be lower with SOFR+ than with LIBOR. The Fed appears supportive of efforts to find a credit sensitive alternative to SOFR+, but it is uncertain if such a rate will exist. In his February testimony to congress, Fed Chair Powell noted that “SOFR will be the main substitute for LIBOR” but the Fed is working with “regional and some of the larger banks too about the idea of also having a credit sensitive rate.” In the quest to have a knowable and not-easily-manipulated replacement for LIBOR, it seems likely, at least at present, that a static spread will be adopted to translate SOFR to LIBOR.

This is a thorny issue for preferred investors.

Financial institutions (mainly banks) are the largest issuers of preferreds. LIBOR, as an interbank lending rate, made sense as a preferred security reset benchmark, providing extra credit cushion by baking in general credit conditions. Resetting coupon rates based on a static-spread SOFR+ would mean weaker protections, warranting a higher up-front credit spread to adjust for the higher risks and potential lost cash flows in a stressed scenario.

The degree of spread widening in such a scenario would likely vary by security. Discounting the expected cash flows, securities with long terms before resetting would likely be less negatively affected than those with shorter terms, and those with higher reset spreads may be less at risk.

New Preferreds Addressing the Need for LIBOR Contingencies

As issuers prepare for LIBOR to sunset, recent transactions of preferreds with resettable rates have taken three distinct forms, none of which offer the dynamic credit-sensitive resets that LIBOR does.

- **Fallback language.** These securities base resets on LIBOR for now, but include specific language indicating a benchmark replacement following LIBOR cessation. This is consistent with the recommended floating-rate note fallback language published by the ARRC in April 2019. These documents are often complicated, encompassing a waterfall of potential replacement rates, such as forward-looking term SOFR, SOFR compounded in arrears, an alternate rate determined

by a government body and an ISDA-determined rate used in derivatives markets. In each case, a credit adjustment would be added to the replacement rate, with the exact adjustment to be determined in the future. These documents leave the investor with some uncertainties, and perhaps the most likely outcome from this waterfall is, in fact, SOFR+ with a static credit spread.

- **SOFR+.** Some recent preferred issues skip LIBOR and go straight to SOFR+ using a static spread. These transactions have simply listed the static spread to translate SOFR to SOFR+ as approximately 25 basis points, as implied by the recent historical SOFR-LIBOR basis at the time of issue. That spread adjustment is locked at the time of issuance regardless of future changes in the secured/unsecured funding relationships.
- **Long-term rate benchmarks.** Other new issues move away entirely from short-term rates, basing resets on longer-dated Treasuries. These securities typically reset once every five years in a fixed-to-fixed format, with resets determined by spreads to 5-year Treasury yields. This type of reset benchmark would not help protect investors should the security reset in a stressed market environment. However, resetting over the mid-point of the curve may present some benefits relative to resetting over short rates, as the yield curve is normally upward sloping.

Considering that these various structures do not offer successor rates that are as credit sensitive and dynamic as LIBOR, they are all inferior in the event of market stress. However, investors can demand higher up-front spreads as compensation. In addition, an active manager can seek to reduce reset risk by identifying preferreds with strong prospectus language and investing in issues with adequate reset spreads.

How Will Older Preferreds Work After LIBOR?

Many preferreds issued before 2017 have weak LIBOR fallback provisions, as their documentation generally accounts for a scenario in which LIBOR is temporarily unavailable rather than permanently discontinued. LIBOR contingency plans in these documents vary by issuer, and sometimes even vary among securities from the same issuer.

If issuers were to follow the contractual language following LIBOR cessation, the coupons could convert to fixed rates. Fixed-rate calculations vary by security, usually set as:

- Fixed at a spread over the last available LIBOR
- Fixed at the original coupon
- Fixed at a spread over LIBOR at the time the security was issued

In some instances, the outcome can be positive. For instance, for many legacy securities, the original fixed coupon is quite high and well above levels offered by more recent issues. However, if the coupon is based on the LIBOR spread at the time of issuance, investors face the risk that the benchmark could be struck at a low rate. The attractiveness of the fallback rate will depend on specific security and market factors, including the current levels of short and long rates, as well as credit spreads relative to the specific reset spread.

While these elements are important to consider, issuers' postures toward their outstanding securities are likely to matter as well. We expect many issuers will not want to harm their dedicated investor base over an event that was not contemplated when the securities were created. Hence, some issuers that have securities with materially unfavorable fallback language may choose to extend better terms. At least one large bank, Citigroup, has indicated as much, publicly stating it would look to new market standards as it considers options for its older issues. Clearly, for investors in older transactions, it will be important to pay attention to issuers' intentions as well as the document language.

Many legacy securities would likely convert to fixed rates—but for those with unfavorable contract language, issuers may extend better terms to avoid harming their investor base

Exchanging Old Securities for Better Ones

One possible solution for older securities with poor language is document amendments. However, the legal requirements of a super-majority—or even possibly 100% investor consent—for document changes stands as a significant roadblock. Hence, changing the language directly may be too high and costly a hurdle.

The ARRC has proposed a legislative solution that would establish its recommended benchmark replacement as a reasonable substitute for LIBOR, override existing fallback language and provide a safe harbor from litigation for the use of the recommended benchmark replacement. While this could be an elegant fix, there could be conflicts between such legislation and federal law contained in the Trust Indenture Act of 1939 (TIA). Holders of notes that are subject to the TIA may argue that modifications require unanimous consent under the statute.

One area in which a more sweeping change could well materialize involves fixed-to-fixed reset issues that reset over swaps, which are themselves underpinned by LIBOR. In this case, there appears to be a good likelihood of sweeping industry/regulatory changes effectively fixing the issue, as swap rates themselves are recast over some version of SOFR+. Derivatives have uniform contract language that are governed by one document, the 2006 ISDA master agreement, which makes a sweeping change a relatively easy fix.

If a legislative solution is not possible, we believe the most probable path forward is security exchanges. Issuers wishing to avoid harming their investors may simply offer new securities with better, more up-to-date documentation. In this case, investors could choose whether to accept the new securities or continue to hold the older ones. Such security exchanges would likely involve tax and accounting considerations that would need to be addressed.

Conclusion: Complexity Creates Opportunity

The high income rates offered by preferred securities compensate investors for credit and complexity risks. The LIBOR phaseout is an example of complexity risk that the market will have to price. We expect the transition to a successor rate will be a smooth one for the most part. However, some securities will be more vulnerable than others, and should market misunderstandings occur, opportunities may emerge.

Despite the strides toward alternative benchmarks such as SOFR or SOFR+, these are fundamentally different rates from LIBOR, creating uncertainties for older and newer securities alike. Considering that a large majority of the global preferred market—including a meaningful amount of exchange-listed issues—depend on a fair system for pricing rate resets, the need to carefully assess contingencies and fallback provisions in preferred prospectuses is more important than ever, in our view.

For investors in preferred exchange-traded funds, assessment of these complexities is simply not in the scope of passive investment vehicles. By contrast, this analysis plays an integral role in our active investment approach as we price risks and rewards and strive to add value for our clients.

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