

After LIBOR: Pricing Benchmark Convention for Fixed Rate ABS

Market Survey Request and Key Takeaways from SFA Roundtable

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Survey Request

Securitization Issuers, Investors and Broker-Dealers: **Your Input is Needed. This survey seeks your view on the benchmark convention that should be used for pricing and quoting relative value of fixed rate asset-backed bonds in the primary and secondary markets after the market transitions away from the LIBOR Swap Curve.**

Background

The impact of the LIBOR transition on new and legacy *floating rate* structured finance products has been the primary focus of our market. **However, LIBOR's end will also bring a significant change to *fixed rate* structured finance products which are priced and quoted primarily off a swap rate curve that's derived from LIBOR-based future contracts.** Thus, it is imperative for the market to come together as it has in the transition of floating rate LIBOR products to build an agreed market consensus solution. **Without market consensus around a replacement pricing benchmark, the market could experience initial confusion. And, if sustained, this confusion could negatively impact liquidity and pricing levels in both the primary and secondary markets.** This is a particular concern for the ABS market which has become increasingly fixed rate. In 2012, fixed rate ABS contributed 63% of that year's new issuance. By years 2020 and 2021, fixed rate ABS represented 96% of total new issuance, according to Deutsche Bank Securitization Research.

Key Takeaways: SFA Roundtable

SFA members convened over 100 members including investors, issuers, broker-dealers for a December 28th roundtable to discuss this needed market transition away from the LIBOR Swap Curve. The roundtable featured an interactive and robust dialogue on a number of important topics related to the transition of pricing and valuing structured finance bonds in the primary and secondary markets. Below we highlight the key considerations discussed across the following areas:

1. Potential benchmark replacements for the LIBOR Swap Curve
2. Need for a single consistent benchmark replacement
3. How the interpolation convention will work for the replacement benchmark
4. Timing of transition away from the LIBOR Swap Curve

1. Potential Benchmark Replacements for the LIBOR Swap Curve

Not surprisingly, the main issue discussed **was what benchmark should replace the LIBOR Swap Curve** used today to price the vast majority of fixed rate structured finance bonds. Market participants offered their perspectives on three alternative benchmarks: (1) On-the-Run Treasury Securities, (2) Treasury Securities Interpolated J-curve and (3) SOFR Swap Curve.

- **Treasury Securities (On-the-run Treasuries or Interpolated Treasury J-curve)**

Yields on Treasury securities are in theory free of credit risk and are often used as a benchmark to evaluate the relative value of most non-Treasury bonds. Asset-backed bonds are one of the few historical exceptions. One of the most common pricing benchmarks for non-ABS bonds are “on-the-run” Treasuries which reflects the most recently issued bonds or notes of a particular maturity. When the maturity or weighted average life of a bond does not coincide exactly with the maturity of a specific on-the-run Treasury bond – such as almost all amortizing ABS bonds – benchmark pricing curves are constructed using the yields of the underlying on-the-run bonds with maturities from three months to 30 years.

Many market participants of the roundtable, expressed interest in considering the use of Treasuries as the pricing benchmark replacement for fixed rate ABS bonds. Key takeaways on the advantages and potential drawbacks of Treasury securities raised during the roundtable were:

- Allows for better clarity around yield changes due to changes in credit risk of the ABS bond as the benchmark is risk-free.
- Reflects a benchmark used by the broader fixed income market allowing for simpler comparison to other fixed income products.
- Increases selling potential to crossover buyers as pricing off swap curve is “unique” for non-ABS fixed income investors.
- Provides straightforward hedging for certain products.
- Some market participants also raised potential concerns to the use of a Treasury Securities benchmark including:
 - Lower liquidity of Treasuries further out the curve, especially beyond 5 years – which would introduce another component to the benchmark, a liquidity premium, that isn’t largely present in today’s LIBOR Swap Curve.
 - Practicality of using Treasury Benchmark for the such varied weighted average lives of amortizing securitization bonds.
 - Heightened sensitivity of Treasuries to technicals such as interest rate movements, inflation and economic growth which could causing a “noisier” benchmark vs. a SOFR Swap Curve (i.e., more day-to-day volatility).

- **SOFR Swap Curve**

Similar to the LIBOR swap curve, the SOFR swap curve plots the swap rates across various periods to detail the market's expectations for where future short-term floating SOFR rates will set in one year, two years, three years and so on. Given the liquidity and large size of the LIBOR swap market where new swaps with standard maturities are issued on a daily basis, the LIBOR swap curve provided what the market considered a liquid forecast horizon. Likewise, many roundtable participants noted they believed the SOFR swap curve, once it achieves a significant level of liquidity, should be the benchmark curve used for pricing and quoting fixed rate asset backed bonds. Key takeaways on the advantages and potential drawbacks of using the SOFR swap curve raised during the roundtable were:

- Provides a risk-free curve.
- Affords greater stability during periods of market volatility.
- Represents minimal change to the benchmark convention used in the securitization market today (provided the similar liquidity builds for SOFR swaps as existed for LIBOR swaps).
- Some market participants raised potential concerns to the use of the SOFR Swap Curve benchmark, including:
 - Applicability to medium and longer-dated structured finance bonds.
 - Whether the SOFR swap curve can achieve the same sharpness that the LIBOR swap curve provides today.
 - Requires significant increase in liquidity and trading swap volumes – which is generally expected to occur quite quickly as all new swap trades must move away from LIBOR.
 - Likely the only fixed income sector to use the SOFR Swap Curve as a benchmark.

2. Need for a Single Consistent Benchmark

There was generally universal agreement across roundtable participants that there needs to be consensus across the issuers, investors and broker-dealers for a universal benchmark used across the structured finance market.

- A number of issuers emphasized that their main priority was achieving market consensus with the goal of supporting maximum market liquidity and eliminating any market confusion that could reduce the liquidity the market benefits from today.

3. Opened Questions on How Interpolation Convention Will Work

There was consensus across the roundtable participants that there needs to be further market discussions around the interpolation conventions that would be used for each of the alternative benchmarks being seriously considered. This was especially emphasized for the Treasury benchmark alternatives where the intent was to mimic the US Investment Grade market's use of on-the-run Treasuries and apply it to amortizing securitization deals without precise 1, 2, 3, 5 year maturities.

4. Transition Timing

Another key topic of discussion was the timing of transition. Market participants explored if there is a requirement or need to immediately transition to a new benchmark on January 3, 2022, or could the

LIBOR swap curve continue to be used for some period of time while market participants assess the optimal new benchmark and convention including allowing time for the SOFR Swap Curve to build further liquidity. Main takeaways surrounding this topic were:

- **Most market participants felt a “light-switch” approach to turn off the use of the LIBOR Swap Curve at year-end 2021 would raise critical risks to the market.**
- Broker-dealers expressed that they **need to consider the supervisory guidance to end use of LIBOR by December 31, 2021** other than for trades related to risk management of existing positions – and how that guidance applies to the use of the LIBOR Swap Curve for benchmarking ABS.
- Some roundtable participants noted that **any transition period would likely need to be relatively short anyway** given concerns that the LIBOR Swaps Curve may become more volatile and less reliable as new LIBOR trades are ceased.

5. Next Steps

As a next step, we agree to seek market participants’ benchmark preferences via a [survey](#) – and use that information to guide our future discussions on the benchmark conventions. Please provide your input to the [survey](#).

We look forward to continuing work with SFA membership on the transition away from the LIBOR Swap Curve to help ensure as seamless transition to a new benchmark as possible for the structured finance market. If you’d like to join future market discussions, and haven’t already registered, you can do so [here](#).

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