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SFA LIBOR Symposium

Key Takeaways

The September 11, 2019 SFA LIBOR Symposium was at full capacity, bringing together more than 150 engaged participants and covering issues critically important to the forthcoming transition away from LIBOR. Participant feedback was overwhelmingly positive and included requests for additional symposia. We look forward to continued work with SFA membership, regulators and policymakers on LIBOR transition to help ensure it is as seamless as possible for the structured finance market.

Summary

- SFA convened over **150 members, regulators, and policymakers** for a LIBOR Symposium on September 11, 2019. The Symposium featured interactive and robust dialogue on a number of important topics related to the LIBOR transition, facilitated by discussion leaders with relevant expertise and experience. The key issue at hand, however, was **how to solve the "legacy problem";** i.e., given that it is nearly impossible to amend a key cashflow term in structured finance securities, how will the market deal with transactions with insufficient fallback language upon the occurrence of a LIBOR trigger.
- Attendees also heard from **Congressman David Scott (D, GA-13)** and **CFTC Commissioner Rostin Behnam**, both of whom provided guidance on navigating the policy environment as it relates to the LIBOR transition.
- Earlier in the day, market participants focused on the following key areas:
  - The extent to which the LIBOR fallback language recommended by SFA and the Alternative Reference Rates Committee (ARRC) has been adopted in **new securitizations**
  - The **magnitude** of the legacy securitization problem
  - Overview of securitization as a funding mechanism and its inherent complexities, including the **shortcomings of existing fallback language** and **obstacles to deal amendment**
  - **Perspective of consumer advocacy groups** and how to minimize impact on consumers
- Following detailed level-setting of the problem and an **update from the Federal Reserve's Senior Associate Director David Bowman** and **ICE Benchmark President (IBA) Tim Bowler**, participants engaged in rigorous discussion around **potential solutions**:
  - The maintenance of LIBOR for a few years beyond 2021

- The creation of a synthetic LIBOR based on SOFR
- A legislative solution

- The day ended with a discussion on how best to approach changes that will accompany the transition away from LIBOR, including the need for standardization across the market. The need for "**crowdsourcing**" was a key point – such that industry participants should be able to leverage one another's work to identify differences in fallback language for all outstanding structured finance securities and other risks related to the LIBOR transition. We understand from market participants that Bloomberg has initiated an analysis of fallback language across key sectors.

Policymaker Remarks

- **Representative David Scott (D, GA-13)**, a longstanding member of the House Financial Services Committee, joined Symposium participants in the morning and provided his perspective that the LIBOR transition is one of the most significant challenges facing the financial system today and could have "monumental impacts" on the U.S. financial system in particular. He noted four key hurdles with LIBOR transition:
  - General unfamiliarity with SOFR and lack of related historical data;
  - Concern around legacy contracts;
  - Litigation risk; and
  - Tax uncertainty
- Rep. Scott urged market participants to **seek regulatory guidance** where appropriate and to view **Congress as an advocate** for the industry as it navigates through the transition. He believes that Congress has an important role to play whether it be to ask important questions of regulators and/or to hold hearings. He also suggested that Congress consider ways to provide relief for market participants facing litigation as a result of the LIBOR transition. He closed by urging the industry to work with Congress on a **bipartisan basis**.
- In the afternoon, **CFTC Commissioner Rostin Behnam** shared his thoughts on the LIBOR transition via a Q&A session with former SFA Head of Policy, Sairah Burki. He opened with a statement that efforts related to LIBOR's transition should be motivated by broad, systemic solutions where possible. He agreed that the availability of **term SOFR rates is important, but noted the "chicken/egg" problem** that currently exists; i.e., issuers balk at participating in deals until term SOFR rates are available, but the absence of SOFR deals is holding back overall SOFR liquidity and, therefore, the development of term rates.
- He agreed with Rep. Scott that it is important for the industry to engage with Congress, but added that there is education needed and potential bipartisan implementation concerns that may need to be addressed.

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- The Commissioner stated that consumer advocacy and education is the best way to encourage Congress' involvement in this issue. He also urged **the industry to demonstrate that it has done everything within its power to effectuate change before seeking any legislative intervention.**

Adoption of Standardized Fallback Language

- The importance of standardized fallback language in new deals figured prominently throughout the day. Participants debated the appropriate approach from very prescriptive provisions to more flexible provisions with calculation agent discretion, as well as the need for alignment across products and within deal structures.
- Most investors emphasized the **need for as much standardization as possible**, advocating that issuers try to hew as closely as possible to the ARRC fallback language.
  - Investors are already deploying teams of analysts, machine learning, and other artificial intelligence tools to identify LIBOR-related provisions in legacy deals. Any significant issuer customization in new deals would exacerbate this problem, require "an army of technologists", and likely be reflected by diminished liquidity in the secondary markets.
  - Investors also stressed that discretion on the part of any one deal participant could lead to value transfer upon LIBOR cessation.
  - Finally, some investors signaled significant interest in new deals with fallback language close to the ARRC template as it helps them test their systems' readiness to incorporate new types of floaters.
- Issuers also indicated their preference for **prescriptive language** where possible, noting that **discretion opens the door to potential liability.**
  - Some issuers noted the need for issuer/calculation agent discretion at the bottom and/or other steps of the fallback waterfall to cover the remote possibility that an appropriate SOFR benchmark might not be available, given that no third-party seemed willing to take on that decision-making role. However, other issuers believe that the absence of SOFR (or another regulatory-recommended rate, with respect to the bottom of the waterfall) is so remote that there might not be the need for such discretion.
- A number of issuers also raised a few **operational considerations**:
  - If using a compounding in arrears option for calculating SOFR, it might make sense to start accruing interest 5 days in advance in order to mitigate the risk that a 5 day lock-out at the end of the accrual period poses (i.e., magnification of the interest rate over this time period).
  - Delaying the switch from LIBOR to SOFR until the end of an accrual period in order to avoid having to account for both benchmarks in a single accrual period.

- Investor and issuer participants alike stressed the importance of a **term SOFR** and a **value-neutral adjustment spread** between LIBOR and SOFR upon the former's cessation.

Quantifying the Legacy Problem

- SFA provided data, sourced from ARRC's Second Report, on current legacy outstandings for securitizations and underlying collateral, as well as the estimated decrease in outstandings until 2040. **Please see the Appendix.**

Securitizations, Derivatives, & Business Loans: Comparing the Challenges

- During this session, attendees discussed overarching LIBOR cessation themes related to securitizations, including derivatives and underlying loans indexed against LIBOR. It was noted that the LIBOR transition would likely have **only a limited ratings impact**, even with the introduction of basis risk, given sufficient credit enhancement in most deals. However, it was noted that the rating agencies are still very much in the process of evaluating the risk across the structured finance market.
- Following a discussion on the extensive work that ratings agencies are doing across sectors to identify fallback language and risks related to the LIBOR transition, Symposium attendees coalesced around the need to **crowdsource this work; i.e., findings from this type of analytical work should be shared across markets**. Participants noted that Bloomberg had done a similar exercise for Volcker implementation and, as indicated in our above Summary, has initiated a fallback analysis for legacy LIBOR deals.
- Identifying where fallback deficiencies exist is just the first step in trying to manage the legacy problem. Attempting to amend deals is even more difficult given current bondholder voting infrastructure across the DTCC, custodians and investor systems. In most cases, **in the U.S., 100% noteholder consent is required to make a benchmark change**, but it is (a) nearly impossible to reach all noteholders for functions beyond disbursement of funds and (b) communication to the appropriate noteholders is not auditable.
  - Participants noted that, in the U.K., executing deal amendments is somewhat easier since 100% noteholder consent is not required and, following an initial attempt, subsequent required quorums become increasingly smaller.
- Participants also focused on consumer impact and perspectives, and how to ensure that consumers understood how their LIBOR-indexed debt will be adjusted. Educated consumers who understand that a **successful LIBOR transition would be one with minimal value transfer** would reduce the risk of litigation. Furthermore, market participants should adopt replacement rates as soon as possible in order to minimize opportunities for arbitrage.

- Servicers were identified as most likely acting as the front line in terms of fielding questions and concerns, but that **some consumers would also likely look to navigate the process via support from government entities like the CFPB**. Some participants encouraged the CFPB to start posting LIBOR transition information as early as possible.

Legacy Deals: Fallback Language

- Before trying to identify solutions for legacy deals, participants discussed fallback language in typical securitization deals as well as in the underlying collateral. In many deals, the fallback language waterfall is as follows: if LIBOR is unavailable on the appropriate Bloomberg/Reuters screen, poll London banks; then poll NYC banks; and then fix the transaction at the last posted LIBOR rate. However, it was also noted that there are many variations of fallback language throughout structured finance transactions, including: (1) utilizing another index, such as Prime, (2) obtaining at least one LIBOR rate from a defined bank, (3) obtaining the vote of 100% of noteholders; and (4) fixing the transaction at the LIBOR rate at the time of deal closing.
  - While some participants believe that precisely executing a transaction's fallback language would eliminate **litigation risk**, others disagreed (e.g., noting that litigation may be a possibility where investors in a floating rate deal found themselves suddenly with a fixed rate note in contradiction to the security being sold as a floating rate note as documented on the actual note itself.) It was also noted that many participants believe the "*last posted*" rate fallback language was only meant to cover temporary disruptions of LIBOR and not intended for LIBOR's cessation, which was never contemplated.

Options for Legacy Cash Products

- The heart of the Symposium discussion centered on **potential solutions** for legacy transactions: **keeping LIBOR temporarily outstanding; creating a synthetic LIBOR;** and **developing a legislative fix**.
- **Federal Reserve Board Senior Associate Director David Bowman** provided the **official sector view**. Bowman disputed the notion that regulators are forcing the market to move on from LIBOR; rather, he stated that LIBOR would have failed much earlier had the official sector not compelled panel banks to continue providing LIBOR quotes until the end of 2021. He also shared that compelling panel banks to commit to the end 2021 was the best that the Financial Conduct Authority (FCA), the regulatory body that governs LIBOR, could do to ensure LIBOR remained viable for the foreseeable future.
- Bowman also tried to dispel the notion that LIBOR could remain outstanding beyond 2021 for a few more years. He noted the FCA's statement that it **believes it is highly likely additional banks would withdraw from the LIBOR panel by 2022**, which could make the benchmark even

less "representative." He noted the problems with continuing to reference a rate that had been officially declared to be inaccurate in the event the FCA were to find LIBOR to be no longer representative, and asked participants not to ignore the official sector's warnings as to the most likely paths for LIBOR. **Tim Bowler, IBA President, however, shared they are working with panel banks to see if a significant number would continue to provide LIBOR post-2021** and that IBA is now in constructive dialogue with all of the panel banks. Once a clear framework is available, IBA will communicate immediately with the FCA and the other members of the official sector. Bowler also strongly noted multiple times that he could not currently provide any assurances that any panel banks would be willing to continue to post LIBOR, or that even if they were willing to provide submissions, the FCA would allow LIBOR to continue to be published. He stressed, therefore, that institutions and individuals should plan accordingly.

- Bowler's discussion also resulted in a few key questions:
  - If LIBOR were produced but no **longer considered "representative"** under Europe's Benchmarks Regulation (BMR), could it still be utilized for <u>legacy</u> deals?
    - If rates were considered "non-representative," the IBA would certainly be hesitant in publishing them, but could be compelled to do so by the FCA. (BMR would not have to formally issue a waiver for **LIBOR to be published for legacy deals** since it would only prohibit new use, but it would need to be clear about what it considered to constitute new use.)
    - However, it is also completely unclear what would transpire in the U.S.
- Symposium participants also discussed the possibility of using "**synthetic" LIBOR** in legacy deals, where LIBOR would be defined as SOFR plus a spread depending on tenor.
  - While synthetic LIBOR could be helpful from an operational perspective, this option faced similar concerns raised with LIBOR being temporarily extended, with the additional risk that synthetic LIBOR may not actually be considered legally LIBOR under current contracts.
- Finally, Symposium attendees discussed the **use of legislation to address the legacy problem**. Lary Stromfeld, partner with Cadwalader and engaged by the ARRC as counsel to lead the analysis into potential legislative relief, provided an overview of this approach.
  - Under the ARRC's ongoing evaluation of a legislative approach, Stromfeld noted they have considered first looking to New York State given that the vast majority of securities, including securitizations, are governed under New York law. The ARRC may also consider whether to approach other states. He also noted that the potential statute would have to define what it would mean for LIBOR to be "unavailable" – likely modeled after the triggers for cash and derivatives recommended by the ARRC and ISDA for new transactions. Perhaps most importantly, the statute would also have to take into account

the Constitutional mandate that contracts may not be altered/impaired unless there were a justified public policy reason to do so.

  - Stromfeld then provided examples of how, upon LIBOR's cessation, such a statute might work in practice under different contractual circumstances:
    - If there were no fallback language present, the statute could mandate replacement with ARRC rate plus spread (the legislation would not be overriding any existing requirements under the contract).
    - If a contract directed participants to poll banks/or use the last posted LIBOR, the legislation could override the contract and specify the ARRC rate plus spread.
    - If a contract specified a non-LIBOR replacement rate, the legislation might not be applicable.

- Finally, some discussion participants noted that the best solution may be **to combine some of these options**, potentially pairing a synthetic LIBOR option with a legislative solution.

Conclusion

- SFA is pleased that the LIBOR Symposium participants found the day to be useful. Many have requested that this type of event be repeated on a regular basis. SFA will continue to work with its membership, regulators, and policymakers to ensure all stakeholders are well-versed in key LIBOR developments. We will also remain active leaders engaged with our membership, the ARRC, policymakers, regulators, and consumer groups to evaluate any new alternatives and issues related to the LIBOR transition as they arise. **Please join our** [LIBOR Task Force] **to engage with other members of the industry as we continue to tackle this monumental and historic transition.**

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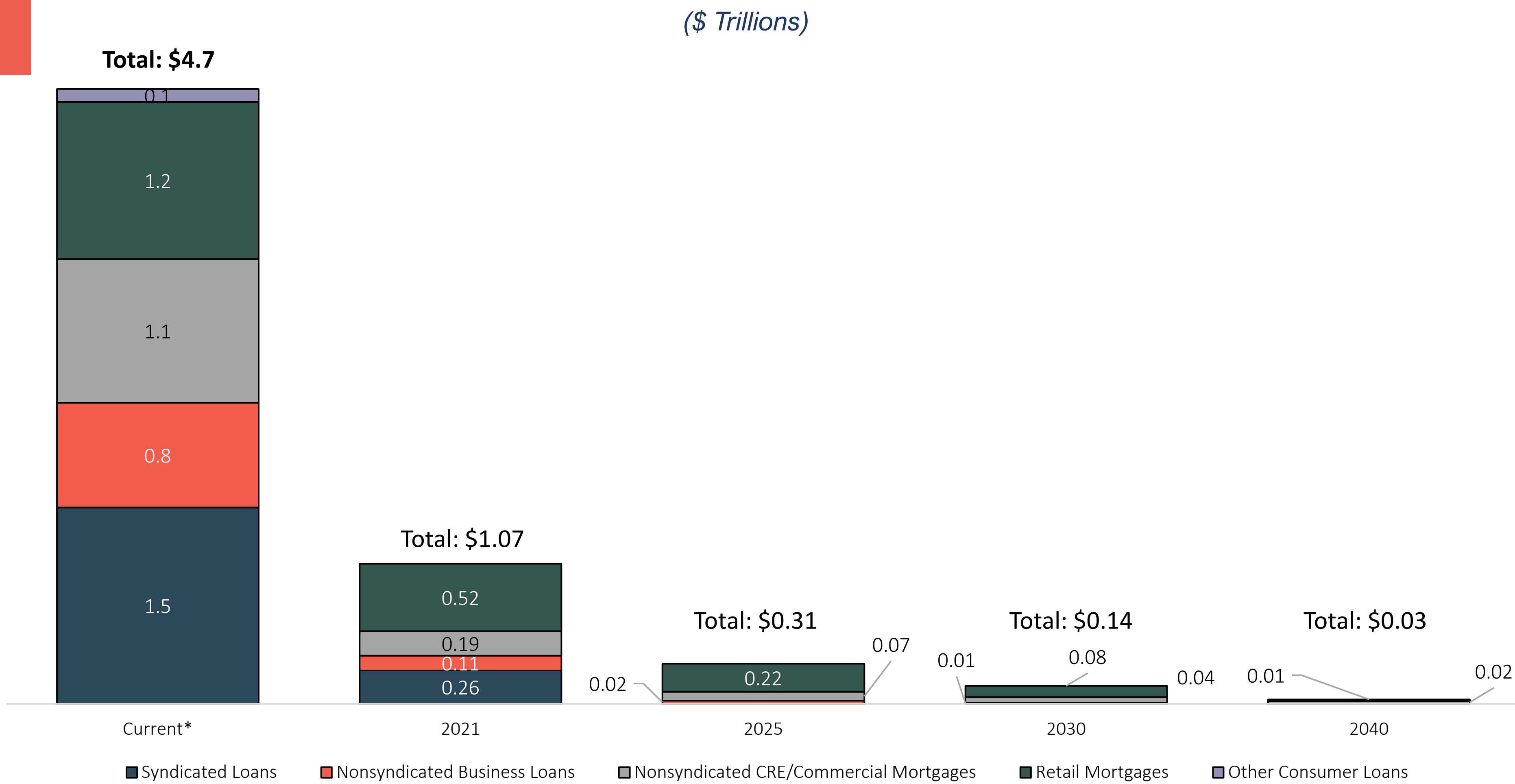
Outstanding Legacy LIBOR Loans



Source: Second Report of the ARRC
*As of year-end 2016

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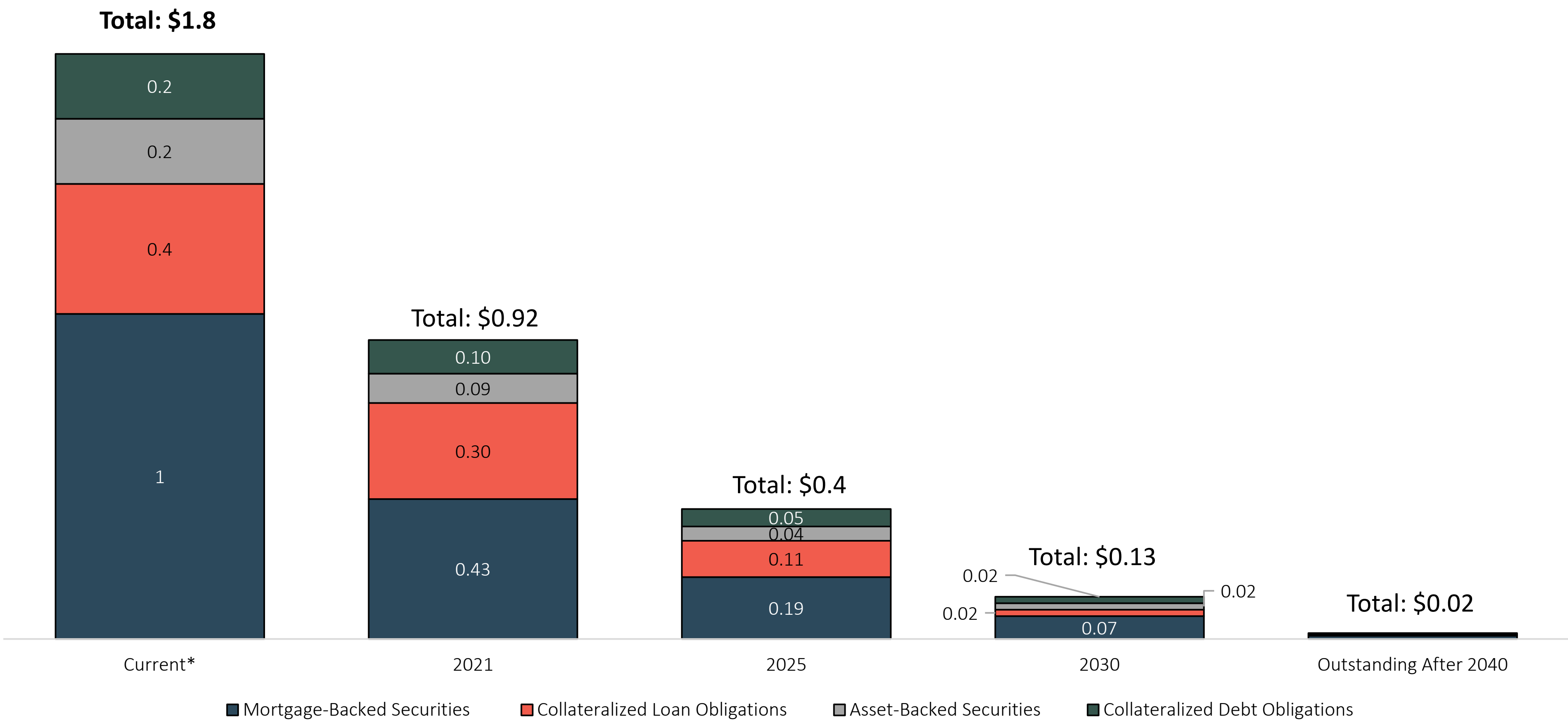
Outstanding Legacy LIBOR Securities

($ Trillions)



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