



Libor Litigation Risks

Securitization Market Legacy
Vehicles and Instruments

December 4, 2019

Agenda Preview

1) Libor Litigation Risks: Securitization and Market Legacy Vehicles and Instruments

- Libor Transition – Brief Background
- Legacy Deals: Fallback Language
- Example of Fallback Language Ambiguity
- Libor Exposures in Securitization Market
- Notable Recent Developments
- New Transactions: Use of New Fallback Language

2) Appendix: Three Approaches to Libor Transition

- Overview of three potential transition solutions for legacy instruments
 - Extension of Libor beyond 2021 for legacy instruments
 - Replacement rate (e.g., SOFR, SOFR *plus a credit sensitive supplement*, or a synthetic LIBOR)
 - Legislative action
- Potential Legal Claims and Defenses

Libor Transition - Background

- In July 2017, the UK's Financial Conduct Authority (FCA) announced that by the end of 2021, it will no longer compel panel banks to submit estimates for LIBOR.
- Regulators state that while they are not forcing the market to move on from LIBOR, reliance on LIBOR can no longer be assured beyond 2021 and firms should plan for permanent cessation
- An estimated \$200 trillion of contracts, mostly linked to derivatives, reference LIBOR (~\$190T derivatives notional; ~\$10T cash market instruments)
- Cash market instruments may be particularly difficult to amend, presenting unique challenges and risks.
- Litigation risk is likely to correlate directly with the extent the LIBOR transition – whatever path it may follow – is perceived to change the economics of an instrument.

Legacy Deals: Fallback Language

“When you looked at the underlying contracts that used LIBOR, they didn’t provide very well for LIBOR simply disappearing. . . . This is a DEFCON 1 litigation event if I’ve ever seen one.”

– *NY Fed Exec. VP and General Counsel Michael Held (Feb. 2019)*

Legacy Deals: Fallback Language

- Fallback language is often ambiguous, absent, or fails to contemplate permanent cessation of LIBOR, raising the possibility of contractual disruption or frustration.
- Fallback language in structured finance transactions varies, including for example language that directs parties to:
 - Utilize another index, such as Prime,
 - Poll London/NYC banks,
 - Obtain at least one Libor rate from a defined bank,
 - Obtain the vote of 100% of noteholders
 - Fix the transaction at the Libor rate at the time of deal closing (or the last posted Libor.)
- Some disagree that precisely executing fallback language would eliminate litigation risk. For example, for securities sold as a floating rate note (as documented on the actual note itself) and a “last posted” rate fallback, investors may suddenly find themselves with a fixed rate note.
- Some believe that the “last posted” rate fallback language only contemplated temporary disruptions and was not intended for permanent cessation of LIBOR.

Example of Fallback Language Ambiguity: Fannie Mae Form Adjustable Rate Note

ADJUSTABLE RATE NOTE

(LIBOR One-Year Index (As Published In *The Wall Street Journal*))—Rate Caps)

THIS NOTE CONTAINS PROVISIONS ALLOWING FOR CHANGES IN MY INTEREST RATE AND MY MONTHLY PAYMENT. THIS NOTE LIMITS THE AMOUNT MY INTEREST RATE CAN CHANGE AT ANY ONE TIME AND THE MINIMUM AND MAXIMUM RATES I MUST PAY.

4. INTEREST RATE AND MONTHLY PAYMENT CHANGES

(A) Change Dates

The interest rate I will pay may change on the first day of _____, _____, and on that day every 12th month thereafter. Each date on which my interest rate could change is called a "Change Date."

(B) The Index

Beginning with the first Change Date, my interest rate will be based on an Index. The "Index" is the average of interbank offered rates for one-year U.S. dollar-denominated deposits in the London market ("LIBOR"), as published in *The Wall Street Journal*. The most recent Index value available as of the date 45 days before each Change Date is called the "Current Index," provided that if the Current Index is less than zero, then the Current Index will be deemed to be zero for purposes of calculating my interest rate.

The Index:
LIBOR

The Trigger

If the Index is no longer available, the Note Holder will choose a new index which is based upon comparable information. The Note Holder will give me notice of this choice.

Fallback

(C) Calculation of Changes

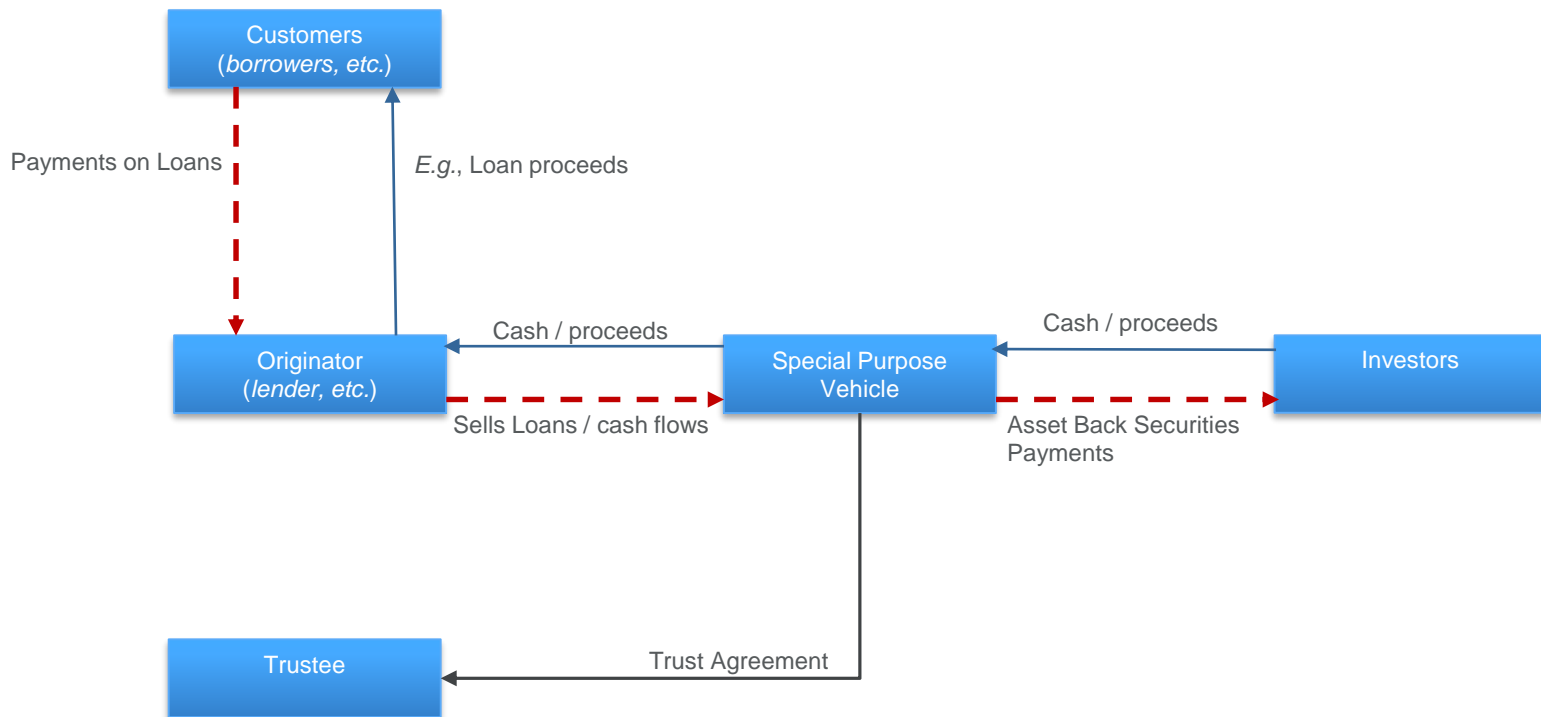
Before each Change Date, the Note Holder will calculate my new interest rate by adding _____ percentage points (_____ %) (the "Margin") to the Current Index. The Note Holder will then round the result of this addition to the nearest one-eighth of one percentage point (0.125%). Subject to the limits stated in Section 4(D) below, this rounded amount will be my new interest rate until the next Change Date.

Margin/
Spread

The Note Holder will then determine the amount of the monthly payment that would be sufficient to repay the unpaid principal that I am expected to owe at the Change Date in full on the Maturity Date at my new interest rate in substantially equal payments. The result of this calculation will be the new amount of my monthly payment.

Libor Exposures in Securitization Market

- Libor references in Asset Backed Securities
- Libor references in underlying assets (e.g., Loans) creating asset pool



Notable Recent Developments

- October 3, 2019, reported by Politico – Financial Stability Board Chairman Randal Quarles (who is also Vice Chair for Supervision at the Federal Reserve) made two important observations, focusing on LIBOR transition from the perspective of financial stability:
 - Observed that risk-free benchmarks may not be appropriate for all lending products (implying that the Fed is at least evaluating the possibility of a RFR, like SOFR, along with a “credit sensitive element” or supplement)
 - Implied that for certain legacy instruments, the extension of some form of Libor may be needed
- On September 17, the secured overnight finance rate (or “SOFR”) rose to a record 5.25%, according the Federal Reserve Bank of New York, pulled by a jump in borrowing rates for overnight repurchase agreements, or repos.
- The move is viewed as being due to an aberrational period of volatility in the repo market.
- SOFR had been in a range between 2.1% and 2.75% for more than 3-months prior.

New Transactions: Use of New Fallback Language

- To alleviate concerns about LIBOR transition for new securitizations, some market participants are adding fallback language to new deals that will implement the transition from LIBOR to SOFR:
 - The ARRC proposed new language – which includes defining trigger events for LIBOR cessation – and a waterfall of replacement rates that may be used to replace LIBOR
 - SFA also developed proposed language for use in new securitizations that is very similar to the ARRC’s recommendations.
- Despite the existence of recommendations that were developed by a broad representation of market participants and that reflect different perspectives across the market – investors, issuers, and trustees – the adoption of this new language has been slow.
 - In cases where it is used, it is not perfectly consistent with the existing recommendations and has been customized to meet the particular requirements of an issuer and/or structure.
 - Investors prefer that fallback language is as consistent as possible across transactions
 - Issuers prefer that the language is as prescriptive as possible but acknowledge the need to adopt language that allows for operational implementation as well as optionality to accommodate the potential development of “market standard” rates that are not yet contemplated
- SFA is working toward a middle ground where both sets of concerns are addressed in order to promote broader adoption of fallback language for new securitizations



Appendix: Three Approaches to Libor Transition

Three Approaches - Overview

1) Extension of Libor beyond 2021 for Legacy Instruments

- ICE Benchmark Administration (IBA) is working with panel banks to see if a significant number will continue to provide IBOR estimates beyond 2021

2) A replacement rate is used (multiple variations)

- SOFR plus a spread depending on tenor; this is the Alternative Reference Rates Committee (ARRC)'s preferred alternative to LIBOR
- SOFR plus a credit sensitive supplement
- Synthetic Libor

3) Legislative Relief

- ARRC is exploring options for seeking legislative relief, but has not made any decision on whether to move forward with such efforts
- Statute could mandate replacement, e.g., with ARRC rate plus spread, where there is no fallback language present; or statute could declare that replacing a benchmark with a new rate does not amount to an interference with the continuity of contract

Extension of Libor beyond 2021 for Legacy Instruments

Pros

- If panel banks continue to submit estimates and the continued rates are considered sufficiently “representative,” this approach potentially poses the least risk for contractual disruption/frustration
- Precedent in San Francisco Federal Home Loan Bank determination to continue publishing Cost of Funds Indices beyond original scheduled cessation period.

Cons

- Disconnect between Fed/FCA and IBA
 - Federal Reserve Board Senior Associate Director David Bowman has dismissed the idea that LIBOR could remain outstanding beyond 2021 for a few more years; but see Quarles remarks
 - FCA has stated that it believes it is highly likely additional banks would withdraw from the LIBOR panel by 2022
 - IBA, however, is working with panel banks and is in constructive dialogue to see if a significant number would continue to provide IBOR estimates

Extension of Libor beyond 2021 for Legacy Instruments – Litigation Risks

- Counterparties may assert that the published LIBOR rate has become “non-representative,” and, on that basis, assert that the agreement is breached, notwithstanding the fact that the rate continues to be published
- Challenges related to compliance with EU’s Benchmarks Regulation (BMR):
 - For example, the IOSCO Principles for Financial Benchmarks require that a benchmark reference a certain number of underlying transactions; if that is not possible for certain tenors of LIBOR, the benchmark could be viewed as non-compliant
 - A non-compliant benchmark may be viewed as being “subject to manipulation”

A replacement rate, such as an RFR or synthetic Libor, is used

Pros

- RFRs: ARRC/SFA have pushed the market to adopt SOFR as the replacement rate to LIBOR
- RFR plus a credit sensitive supplement – potentially appeals to ARRC and market desire for credit component of rate
- Synthetic LIBOR: Potentially less disruptive transition

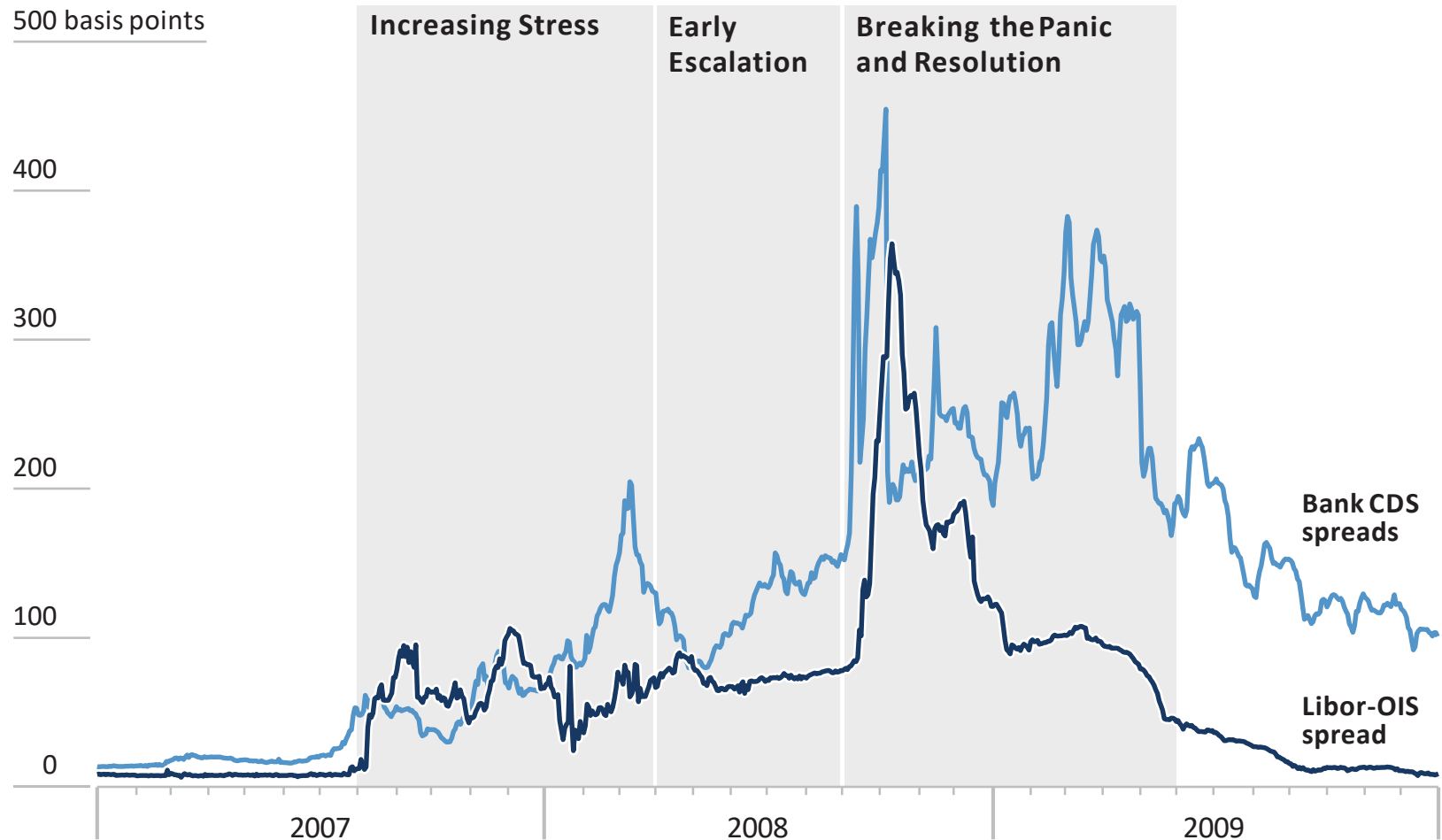
Cons

- SOFR is overnight secured; LIBOR is unsecured (i.e., includes a credit component) and is calculated for multiple different terms
- Attempts to create a synthetic LIBOR alternative (for example, SOINA plus a fixed spread) may not readily fit within the existing contractual language, for example for contracts that define LIBOR by reference to a particular Reuters or Bloomberg screen.
 - Fixed spread, or
 - Dynamic credit sensitive spread?
- Potential intellectual property issues of referring to a “synthetic LIBOR”; in addition, administrators likely would seek comfort of legislative authorization

Risk Free Rates versus Credit Sensitive Rates during the Financial Crisis

(e.g. Evaluating bank credit default swap spreads and Libor-OIS in times of stress)

Arc of the Crisis



Source: Bloomberg. Note: Credit default swap spreads are equal-weighted averages of JPMorgan Chase, Citigroup, Wells Fargo, Bank of America, Morgan Stanley, and Goldman Sachs.

A replacement rate, such as an RFR or synthetic Libor, is used – Litigation Risks

- SOFR plus a spread, or RFRs, are not really LIBOR (credit component plus term structure).
- The difference creates a risk of winners/losers, as well as a risk that one of the parties to the contract would assert that the bargain has been frustrated
 - Courts are reluctant to invoke frustration, would likely instead look to fill contractual gaps with a substitute rate.
 - Under NY law, frustration of purpose arises when both parties can perform but, due to unforeseeable events, performance by one party would no longer give the other the results that induced that party to make the bargain in the first place. “To invoke frustration of purpose as a defense for nonperformance, the frustrated purpose must be so completely the basis of the contract that, as both parties understood, without it, the transaction would have made little sense.” *Crown IT Servs. v. Olsen*, 11 A.D.3d 263, 265 (1st Dept. 2004).

Legislative Relief

Pros

- Market-wide coordination through legislation could decrease transition risks, as otherwise a market-driven outcome would result in divergent approaches
- Statute might work as follows under different contractual circumstances:
 - No fallback language present: no override, replacement with ARRC rate plus spread,
 - Fallback language directs participants to poll banks/or use the last posted Libor: the legislation would override the contract and specify the ARRC rate plus spread,
 - Fallback language specifies a non-Libor replacement rate: no override
- Precedent in New York “Euro Conversion” legislation, re: EU currency conversion

Cons

- Potentially violates the Contracts Clause of the Constitution
 - The Supreme Court applies a two-step test, asking: 1) does the law undermine the contractual bargain, interfere with a party’s reasonable expectations, and prevent the party from safeguarding or reinstating his rights; and if so, 2) is the law drawn in an “appropriate” and “reasonable” way to advance “a significant and legitimate public purpose.” *Sveen v. Melin*, 138 S. Ct. 1815, 1827 (2018).
 - Unreasonable when “an evident and more moderate course would serve [the state’s] purposes equally well.” *Sveen v. Melin*, 138 S. Ct. 1815, 1829 (2018).

Potential Legal Claims and Defenses

Impracticability

- An equitable defense that excuses nonperformance, applied when a party's performance is rendered impracticable without the party's fault by the occurrence of an event, the nonoccurrence of which was a basic assumption of the contract.
- In this context, there are a variety of options for parties to include in a waterfall of fallbacks should LIBOR be unavailable. However, for many of these, lenders may claim that the fallbacks are impracticable where LIBOR is permanently discontinued, e.g.:
 - Calculating a Reference Bank Rate successfully for every interest rate period for the remainder of a facility may be impracticable for agents, as panel banks are no longer required to submit estimates
 - Calculations of each lender's cost of funding related to their participation in the loan for a "costs of funds" calculation is burdensome

Force majeure

- A contract provision that relieves the parties from performing when certain circumstances beyond their control arise, making performance inadvisable, commercially impracticable, illegal, or impossible. Under the 2002 ISDA Master Agreement, Section 5(b), a "Force Majeure Event" triggers early termination provisions, which end open trades and provide for the payment of a "close-out" amount.
- Here, the discontinuation of LIBOR may not be a typical force majeure event, but parties may argue that LIBOR's permanent cessation triggers force majeure because if fallbacks fail, it may be impracticable or impossible to calculate payment obligations.

Potential Legal Claims and Defenses (cont.)

Mutual Mistake

- A defense to performance where both parties mistakenly believed a fact was or would be true.
- Here, borrowers may claim that both they and lenders contracted on the mistaken basis that LIBOR would continue to be published through the term of the contract or that it would never be permanently discontinued

Covenants of good faith and fair dealing

- Courts may use these implied covenants to prevent one party from denying the other the benefit of the contract or seizing unanticipated windfalls.
- Here, borrowers may use this claim to challenge lenders who exercise contractual discretion to replace LIBOR with another rate that advantages them over the borrowers; agents and trustees exercising similar discretion may also face such claims.

Securities Act of 1933

- Purchasers of securities may attempt to bring claims for damages or rescission under this Act, arguing that prospectuses for LIBOR-linked securities that failed to disclose the risks of LIBOR being discontinued were materially misleading.
- Such claims are subject to a three-year statute of repose and require a showing of scienter (that defendant acted recklessly, if not intentionally), so the risk of such claims are low.