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SFA Research Corner

March Came in Like a Lion for LIBOR Transition

March 30, 2021

WHAT WE'RE WATCHING

With essentially nine months remaining before issuing securities tied to USD LIBOR creates "safety and soundness risks," regulators, government officials, and market participants strongly re-committed their efforts to a successful LIBOR transition. We highlight the key points of these developments below and track the progress of SOFR adoption in the securitization markets.

- March 24: **The New York State Legislature passed standalone LIBOR transition legislation**, which addresses the impact of LIBOR discontinuation on certain LIBOR based contracts governed by New York law. The legislative proposal, which was initially presented by the Alternative Reference Rates Committee (ARRC), provides a path forward for legacy LIBOR contracts that have inadequate or did not contain any fallback provisions. By providing a safe harbor from litigation for the use of a benchmark replacement, the legislation removes a cloud of uncertainty for many securitizations and is considered a strong positive development for the structured finance market. **The New York State Assembly will next deliver the legislation to Governor Cuomo for his signature**.

- March 23: **In her testimony to the House Committee on Financial Services, U.S. Treasury Secretary Janet Yellen agreed that federal legislation is needed to facilitate a smooth transition away from legacy LIBOR contracts.** In doing so, Treasury Secretary Yellen echoed both SFA's view and that presented by Federal Reserve Chairman Powell at the Committee's February hearing.

- March 23: The ARRC urged market participants "not to wait for a forward-looking term rate for new contracts, but to instead be prepared to use the tools available now." "While trading activity in SOFR derivatives is growing, at this time, the ARRC believes that it is not yet in a position to recommend a term rate with confidence based on the current level of liquidity in SOFR derivatives markets."

- March 22: Federal Reserve Vice Chair for Supervision Randal Quarles specified six key points that Federal Reserve Examiners will be using to assess a firm's readiness for a transition away from LIBOR. These are: 1) a transition plan that is commensurate with a firm's LIBOR exposure, 2) accurately measuring exposure and providing risk assessment, 3) operational preparedness, 4) legal preparedness for new and legacy contracts, 5) communication with customers and counterparties, and 6) oversight.

- March 22: The ARRC issued its Progress Report on the LIBOR Transition. The report compares adoption in the cash and derivatives markets, progress in addressing legacy contracts, and delineates key steps that need to be taken in 2021.

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- March 9: The Federal Reserve issued SR 21-7 as a follow-up to SR 20-27 the Interagency Statement on LIBOR Transition on **November 30, 2020.**

  - SR 20-27 encouraged banks to transition away from USD LIBOR as soon as practicable, warning that new LIBOR-based contracts after **December 31, 2021** would create "safety and soundness risks."

  - SR 21-7 issued guidance to assist Federal Reserve Examiners in reviewing a supervised firms' planning for- and progress in- moving away from LIBOR.

- March 5: ICE Benchmark Administration (IBA) and the UK Financial Conduct Authority (FCA) set specific end dates for the cessation of USD LIBOR as a representative, panel-based rate – officially extending the publication of the most-used USD LIBOR rates to **June 30, 2023**.

  - IBA will cease publication of 1-week and 2-month USD LIBOR on **December 31, 2021**

  - Overnight and 1-, 3-, 6- and 12-month USD LIBOR will cease to be published on **June 30, 2023**

  - Following this announcement, the ARRC confirmed that they considered the IBA announcement a "Benchmark Transition Event" but not a "Benchmark Replacement Date" under ARRC recommended fallback language. If a contract used ARRC recommended fallback provisions, the distinction is important, as a *Benchmark Transition Event* does not trigger an end to the use of LIBOR in the contract. Instead that occurs upon the *Benchmark Replacement Date* which the ARRC noted occurs on the cessation of publication of the specific LIBOR tenor, as outlined above.

    That doesn't make the occurrence of the *Benchmark Transition Event* irrelevant. Principally the *Benchmark Transition Event* triggered the fixing of the SOFR Spread Adjustment, which will be added to the SOFR rate to minimize the difference between LIBOR and SOFR upon the transition to SOFR (which as noted above occurs on the *Benchmark Replacement Rate*).

    It's important for market participants to recognize that not all contracts followed these specific ARRC recommendations so the March 5th announcement may have different implications. Please review and discuss with counsel as needed.

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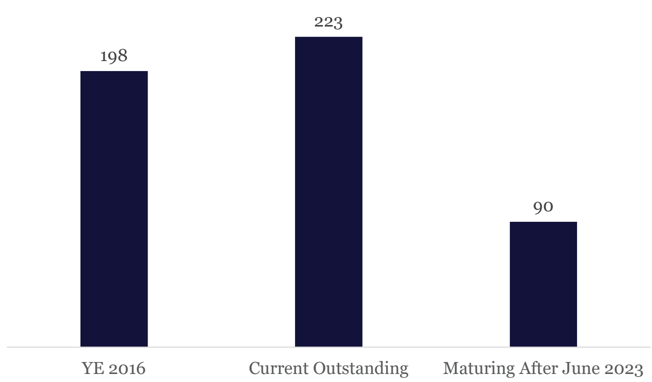
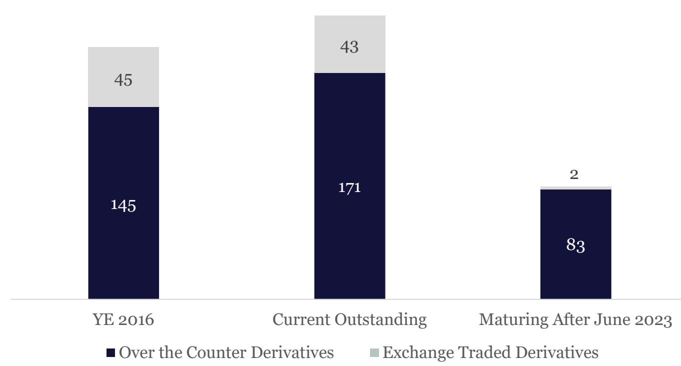
The ARRC estimates that there are currently $223 trillion outstanding contracts exposed to USD LIBOR, an ***increase*** of $23 trillion from four years ago, and despite calls from various officials to cease LIBOR-based issuance. Increases came from the over-the-counter derivatives market, which rose by $26 trillion over this time and comprises over 75% of total market exposure. Other increases came from business loans, which rose by $1.4 trillion, and consumer loans, which rose by $100 billion. Securitization's exposure to LIBOR contracts fell by $200 billion, from $1.8 trillion to $1.6 trillion. While it's expected that other products will see a big drop off in LIBOR-based outstandings by 2023, securitization's exposure, backed primarily by MBS and Student Loan ABS with longer maturities, is expected to see insignificant reduction.

ARRC: LIBOR-Based Contracts Outstanding Has Increased To $223 Trillion in Three Years



Source: ARRC

LIBOR-Based OTC Derivates Contracts Increased by $26 Trillion in Three Years; Set to Fall By 50% by 2023 ($ Trillions)



Source: ARRC

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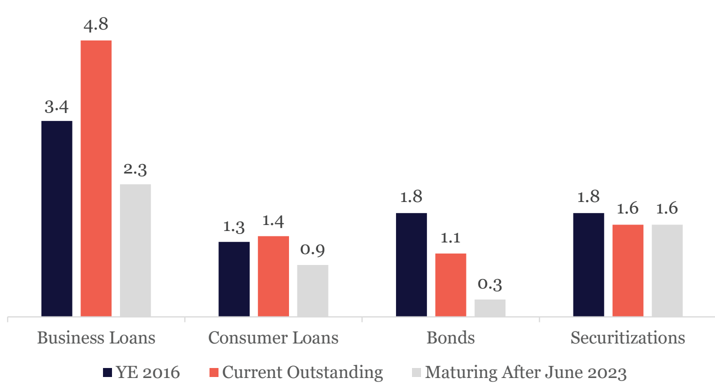
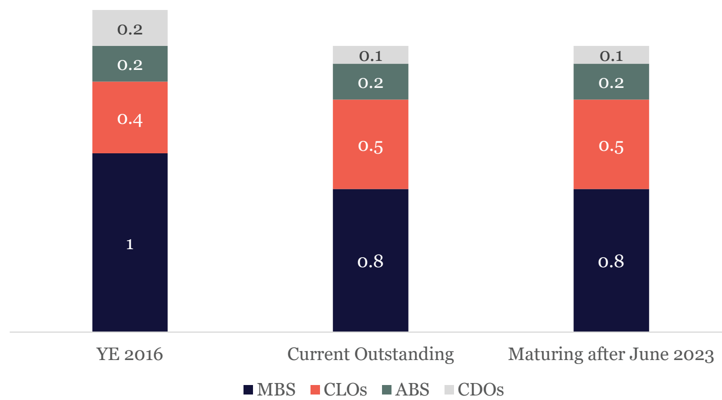
Securitization's Exposure to LIBOR Contracts Fell From $1.8 Trillion to $1.6 Trillion ($ Trillions)



Source: ARRC

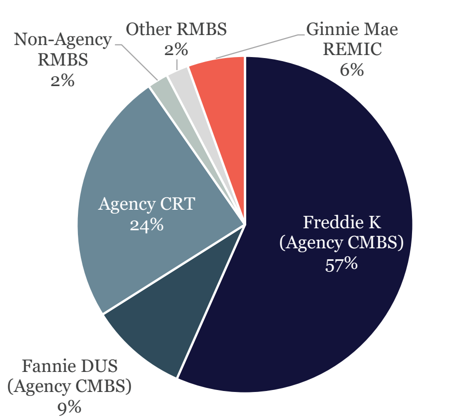
Longer-Dated RMBS and Student Loan ABS Contribute to Persistent LIBOR Exposure Post-2023 ($ Trillions)



Source: ARRC

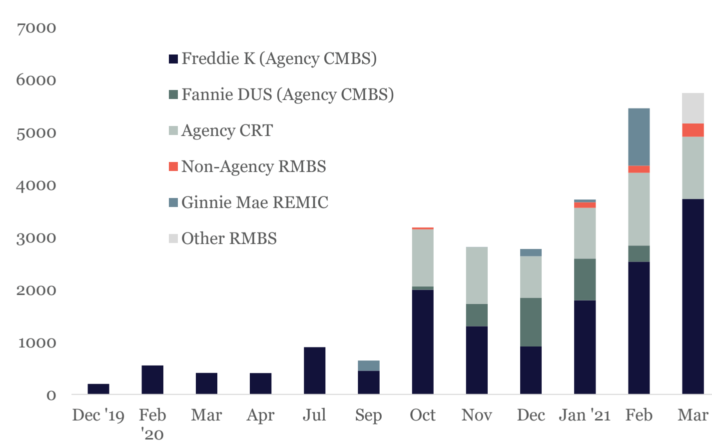
In the meantime, adoption of SOFR has continued apace in the securitization market. Since 2019, $27 billion of structured products issued have been tied to SOFR. Agency CMBS, through the Freddie K and Fannie DUS products, comprise 63% of the issuance total.

SOFR Issuance in Securitizations; Limited to Mortgage Products, Sor Far (2019 to Today: $27 Billion)



Source: SFA, Market Compilation

Led by Agency CMBS, SOFR Issuance in Securitizations Has Grown Steadily, ($ Millions)



Source: SFA, Market Compilation

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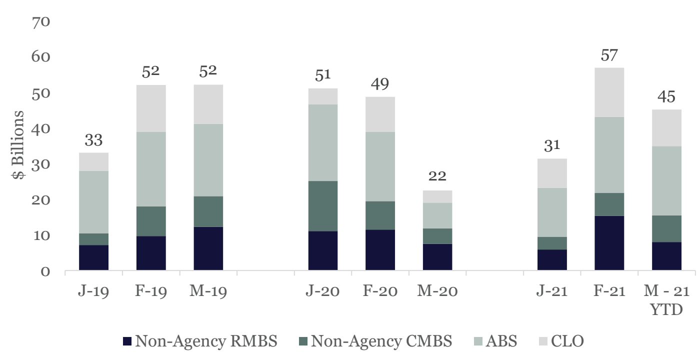
MARKET SUMMARY

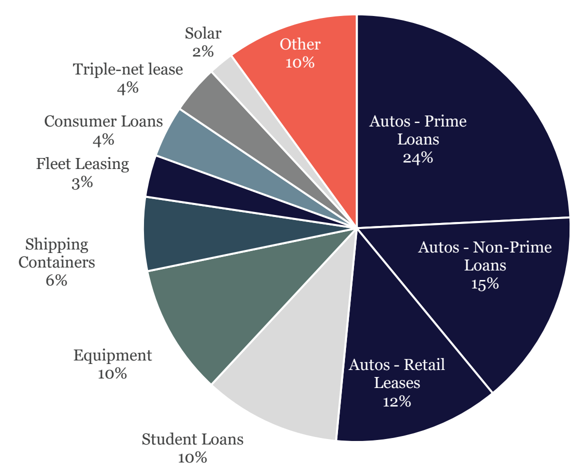
As we near the end of the first quarter, issuance across Non-Agency RMBS and CMBS, ABS, and CLOs now stands at $133 billion. ABS leads with 41% of the market's total, followed by CLOs with 24% and Non-Agency RMBS with 22%. In ABS, 41%, or $22 billion, of the bond offerings are backed auto related loans and leases. Notably this month in ABS has seen the diversity of issuance from the esoteric or "other" category, which combined comprises 10% of today's market. This includes ABS backed by venture debt financings, PACE funding, data center financings, rail leases and whole business financings. Bond pricing, and bid-ask spreads, in the secondary market continue to be range-bound.

Issuance for Non-Agency RMBS and CMBS, ABS, and CLO 2021 YTD ($133 Billion) Versus 2019, 2020



Source: Market Compilation

ABS Only YTD: $54.5 Billion



Other includes ABS backed by aircraft lease, insurance premium, rail lease, tax liens, UK/US credit cards, and litigation funding, whole businesses, timeshare, venture debt, PACE financings, data center financings, and insurance premiums.

Source: Market Compilation

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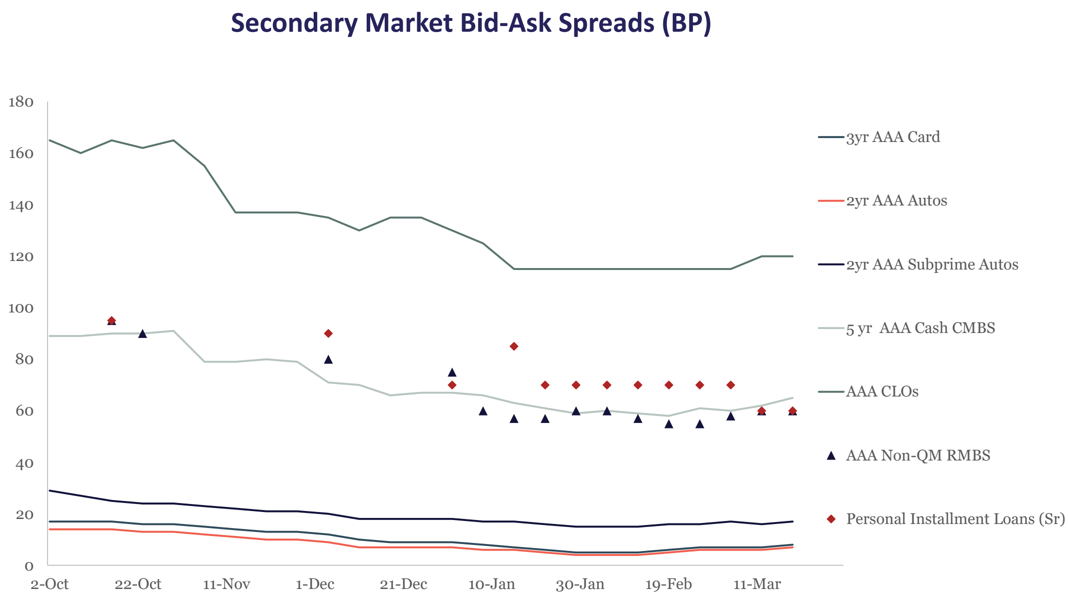

Source: Market Compilation

Secondary Market Bid-Ask Spreads		
(bps)	19-Mar	12-Mar
3yr AAA Card	8	7
2yr AAA Prime Autos	7	6
2yr AAA Subprime Autos	17	16
5yr AAA Cash CMBS	65	62
AAA CLOs	120	120