LIBOR Transition

Legacy Asset Valuation Study

Introduction

The permanent cessation of LIBOR will have the greatest impact on financial assets lacking the ability to amend the documentation. Thousands of securitizations, corporate FRNs, and other assets whose indentures do not contemplate the permanent cessation of LIBOR and lack a process for amending the floating rate determination provisions will find that the language for the temporary unavailability of LIBOR is wholly inadequate for permanent cessation. The result may be a value adjustment when markets incorporate the resulting financial impact of this inadequate fallback language into pricing. Together, this is known as the Legacy Asset Problem.

As with any market structure change, a risk evaluation and examination of alternative actions is an appropriate course. We evaluated a sample portfolio and produced risk distributions of possible price impacts. Further, we developed a mechanized approach to facilitate a contextual reading of critical language and coupled this with a scenario analysis of interest rate effects to create risk metrics and prioritization of securities within portfolios of legacy assets. The Legacy Asset Problem has been a focus of official sector agencies for LIBOR transition in multiple jurisdictions. We will describe the collection of current proposals—grouped as Regulate, Legislate, Litigate—that may provide solutions but may also create a set of consequences.

Problem Statement

Loans, debt securities, and other similar contracts often have fallback provisions to address temporary unavailability of the reference rate ("Fallback"), usually by proscribing alternative rates or assigning responsibility to a third party to choose a rate. Prior to 2017, most Fallback did not address permanent cessation of the benchmark, and very few documents specifically refer to the intended replacement rate, SOFR. For documents such as loan agreements with relatively few known parties, amendment is the routine solution. For securitization indentures, amendments typically require unanimous consent making it impractical. Therefore, the permanent cessation of LIBOR creates significant issues and no corresponding obligation for a responsible party to act to remedy the problem. In fact, the definition of the problem can be an open question itself, because while a specific Fallback may be unsatisfactory to some holders, it does inform the trustee's action. Some holders may perceive it as unfair or inconsistent with the intent of the transaction and seek relief through litigation or other means.

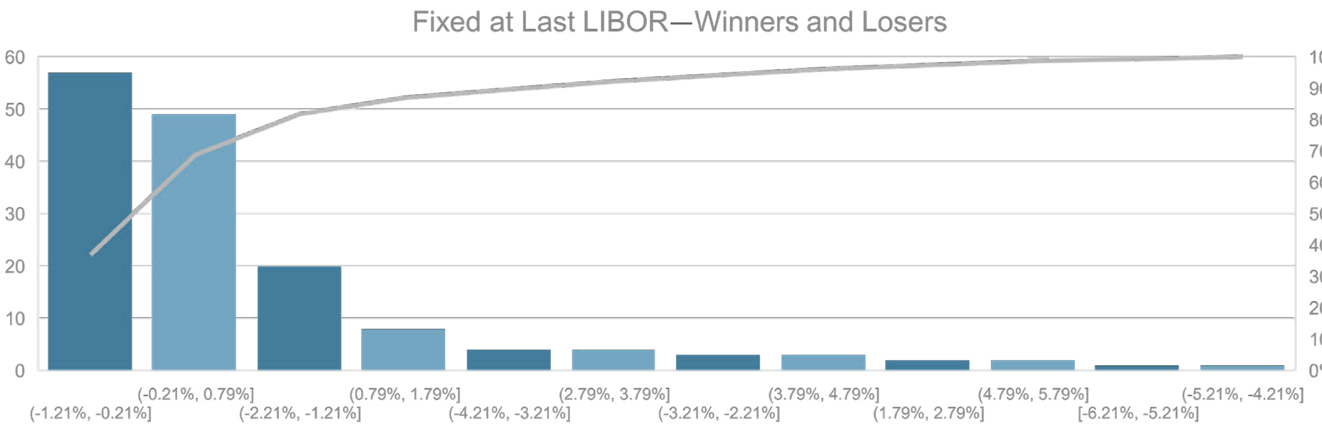
Imagine typical language for a securitization senior tranche, where the Fallback language says, "If LIBOR is not available, use the previous LIBOR." If prevailing short-term rates decrease in the future, the noteholder would benefit, but another class of noteholders would suffer, since the use of "previous LIBOR" essentially converts the floating-rate note to a fixed-rate note at an above-market rate. Conversely, if interest rates move higher rather than lower, the opposite value transfer will result. There are many other typical languages and scenarios that shift value between borrower and lender, or between the senior noteholder and the equity in a structure. However, the owner of a note who has benefitted from cessation is likely to rely on the defined outcomes of the contract, which are available to all in the market to evaluate.

It is simple to argue that the unintended consequence of not considering the permanent cessation of the benchmark is a documentation oversight that should be rectified by a trustee or controlling class. However, the potential liability from that change could expose the agent to lawsuits. This liability is a potential impediment to a remedy for transactions that lack practical amendment processes but have some elements of Fallback language.

Sample Valuation Impacts—Winners and Losers

For this study, we concentrated on securitization notes (which are essentially not amendable) and applied interest rate scenarios corresponding to common Fallback language. The intent was to demonstrate the potential impact on value. We selected a portfolio of more than 170 securities in the CLO, RMBS, TruPS, and other ABS categories with a diverse range of seniority, origination dates, remaining lives, and spreads to LIBOR. After applying the interest rate scenarios to this portfolio, we displayed them in a histogram, revealing the number of securities with price movements that group together within ranges. The left axis is the number of securities and the x-axis is the corresponding range of value change. Blue shows the "losers" where price fell, and green shows the "winners" where price rose.

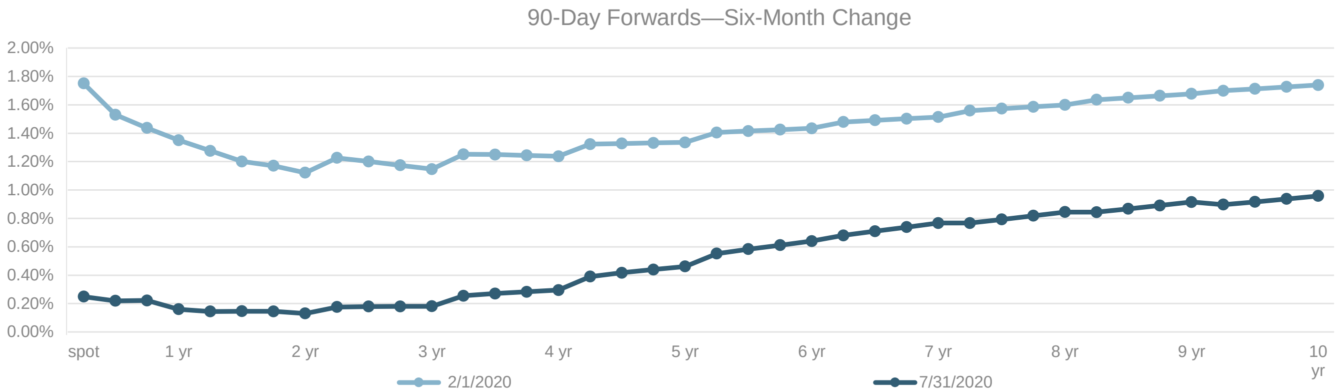
In this diverse portfolio, 62% were impacted by only +/- 1 point (-1.2 to +0.8), while 38% saw price movement of +/- 3 points (on average) in the scenario of "use previous LIBOR." This suggests that a specific reading of each evaluated security is necessary in the context of any individual asset manager's portfolio management and risk responsibilities.



The table shows the same cluster of price effects within different security types, but CLO equity appears to be at greatest risk of price reduction and TruPS appear to have the greatest potential for price increase.

Type	Percentage of Selection	Lower Limit (%)	Upper Limit (%)
CLO	69	-1.7	+1.2
CLO	31	-6.1	-1.7
TruPS	65	-1.1	+1.2
TruPS	35	+1.2	+6.1
General ABS	70	-0.5	+0.5
General ABS	30	-2.5	+3.7

These scenarios are highly sensitive to the shape of the forward curve. The chart below shows the series of forward rates obtainable in the swap market today and six months ago. The study results above would demonstrate significantly more dispersion if the forward curves were not as flat as they are today, particularly from the spot to the four-year area, where much of the remaining duration lies. If the rates markets resume a more normal upward-sloping curve, these results would likely shift dramatically.



Source: Bloomberg.

It is also very interesting to note that the results were both positive and negative within a scenario, indicating that both potential winners and losers can be identified.

Combine Document Understanding With Rate Scenarios

The price impacts above were computed for all notes without regard to the actual Fallback language in the note. To complete this analysis for a portfolio of notes, it is essential to understand and categorize the existing Fallback language. Using machine reading, natural language parsing, and intelligent ontology derivation, we converted the Fallback language to categories, including:

1) Fixed Rates: “Use last LIBOR”
2) Fixed With Transition: “Use last LIBOR” for 12 months, then apply the expected market standard (possibility upon trustee request for injunctive relief)
3) Prime: Loans and some bonds designate the Prime rate without a spread as a replacement
4) SOFR + Spread Adjustment: ISDA and LSTA standard
5) FCA Zombie LIBOR: The rate that may result from legislative or regulatory action

In our study, we generated note prices and then repriced only using rates appropriate to the first scenario. The final step is to select the reprice relative to the Fallback specific to the note and then rank the results in order by price or portfolio effect to determine a priority order or risk metric.

Regulate, Legislate, Litigate

Given the potentially significant price effects resulting from inadequate Fallback language and the range of interest rate environments at the time of cessation, market participants can reasonably expect that current market prices may begin to be impacted as Fallback analysis becomes more widely used.

However, market expectations of price impacts may be significantly affected by announcements from the global official sector in connection with potential systemic remedies for the Legacy Asset Problem. The three proposals are briefly described below, but specific legal interpretation is beyond the scope of this analysis.

1) New York State Legislative Proposal by ARRC: Specific language to provide a safe harbor through legislation for contracts with no Fallback provision
    a. https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Press_Release_Proposed_Legislative_Solution.pdf
2) UK FCA Proposal: A regulatory proposal to create a “LIBOR rate” only for the purposes of legacy assets
    a. https://www.fca.org.uk/markets/transition-libor/benchmarks-regulation-proposed-new-powers
3) EC Commission Benchmark Regulation Proposal: Broad extraterritorial reach redefining LIBOR with potential value transfer implications
    a. https://ec.europa.eu/finance/docs/law/200724-benchmarks-review-proposal_en.pdf

All of these proposals have deficiencies and risks and may subject Trustees and others to litigation for action or potentially defer the timing of a solution until injunctive relief can be obtained.

Conclusion

We will remain at the forefront of potential valuation issues and provide risk evaluation services. Importantly, while the Legacy Asset Problem is most acute in securities, it is a factor in valuation and risk for loans, corporate FRNs, and other contracts where Fallback is ambiguous and an amendment process may not be easily accommodated by all parties. With the potential for significant price impacts, it is incumbent on asset managers to consider impacts as soon as possible—ahead of any repricing that may result from widespread market analysis. While the cost and complexity can be a formidable challenge, the tools of modern machine learning and data analysis can speed up the effort and reduce the cost. The OCIE Risk Alert raises the question that a manager is responsible for the evaluation of the client risk profile, and while this market structure change is a unique event, it remains a potentially large impact that can be measured in advance.

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