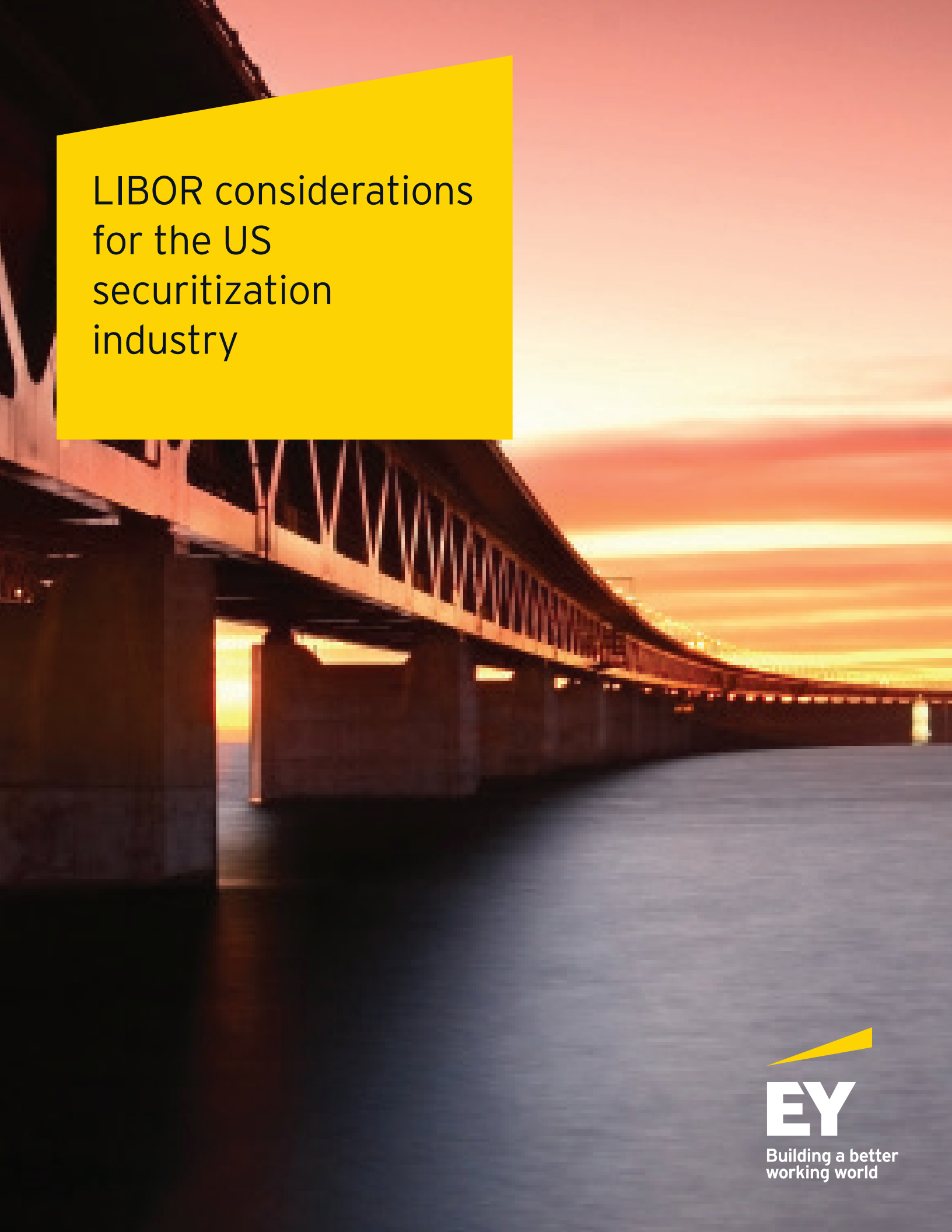
LIBOR considerations for the US securitization industry



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Building a better working world

Increasing emphasis on the likelihood of the permanent discontinuation of the London Interbank Offered Rate (LIBOR) by global regulatory authorities has led the US securitization industry to rapidly mobilize in order to respond to idiosyncratic issues related to their transition to alternative reference rates (ARRs).

Coordinated speeches such as those by the US and UK regulators in July 2018[1] called into question the availability of LIBOR post-2021 and pushed a broader segment of market participants, including those within the securitization industry, to focus on their long-standing exposure to interbank offer rates (IBORs). In January 2019, the Financial Conduct Authority in the UK reiterated there is now wide recognition LIBOR will end and explored different approaches to the final stages of the transition.[2] As of the end of 2016, the total exposure to United States Dollar (USD) LIBOR across cash and derivative products was close to $200t, of which securitizations transactions represented $1.8t.[3]

[1] https://www.fca.org.uk/news/speeches/interest-rate-benchmark-reform-transition-world-without-libor and https://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement071218?utm_source=govdelivery

[2] https://www.fca.org.uk/news/speeches/libor-transition-and-contractual-fallbacks

[3] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report

How the industry is getting ready

In the United States, the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (ARRC) in order to identify leading practices for selecting ARRs, leading practices for contract robustness and to develop an adoption plan to facilitate the acceptance and use of ARRs on a voluntary basis. The ARRC is composed of market participants, and it first met in December 2014. On June 22, 2017, the ARRC identified the Secured Overnight Financing Rate (SOFR) as the rate that represents the best practice to use in certain new USD derivatives and other financial contracts.[4]

The securitizations working group within the ARRC is focused on developing approaches for the securitization industry to transition from USD LIBOR to ARRs.

Industry groups such as the Structured Finance Industry Group (SFIG) and Commercial Real Estate Finance Council (CREFC) have also formed securitization-specific working groups that provide additional guidance and opportunities for collaboration on transition approaches across different currencies and jurisdictions.

A current priority for working groups in the US securitization market is to provide recommendations for fallback contract language to implement SOFR as a fallback for USD LIBOR in new securitization transactions based on feedback from market participants. The language is designed to establish an effective fallback rate in the event that LIBOR is discontinued or is no longer usable. These working groups also consider the efforts of other product-specific working groups for derivatives and cash products to drive consistency in fallback language between asset classes and find solutions that reduce basis risk between the securities and the corresponding underlying collateral as well as any related hedges.

It is anticipated that industry groups will also consider approaches to transition existing securitization portfolios referencing LIBOR and provide guidance to the market on ARRs being used as the reference rate within new securitization transactions.

Structured finance market participants — including banks, issuers, investors, trustees, rating agencies and servicers — should participate in or actively monitor these discussions to the extent appropriate for their exposure to LIBOR-linked products and contracts.

[4] https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/ARRC-faq.pdf

Select industry developments

2018

April 3
Secured Overnight Financing Rate was first published by Federal Reserve Bank of New York

May 7
CME Group (CME) launched SOFR futures

July 12
Financial Conduct Authority (FCA), Commodity Futures Trading Commission, Federal Reserve Board (FRB) regulator speeches highlighting need to prepare for transition

July 18
London Clearing House (LCH) began clearing SOFR swaps

July 26
Fannie Mae issued first SOFR-based floating rate notes (FRN)

July 30
S&P announced SOFR is an "anchor money market reference rate"

August 14
International Bank for Reconstruction and Development (IBRD) issued first Supra Sovereign Agency SOFR-based FRN

August 24
Barclays issued first SOFR commercial paper (CP)

September 20
Triborough Bridge and Tunnel Authority (TBTA) issued first Municipality SOFR-based FRN

October 9
CME began clearing SOFR swaps using SOFR price alignment interest (PAI) discounting

October 22
SFIG responds to the consultation for derivative fallback language from the International Swaps and Derivatives Association (ISDA)

October 25
Financial Accounting Standards Board (FASB) adds SOFR to approved rates for Hedge Accounting

November 8
Freddie Mac issued its first SOFR-based FRN

November 15
Federal Home Loan Bank (FHLB) issued its first SOFR-based FRN

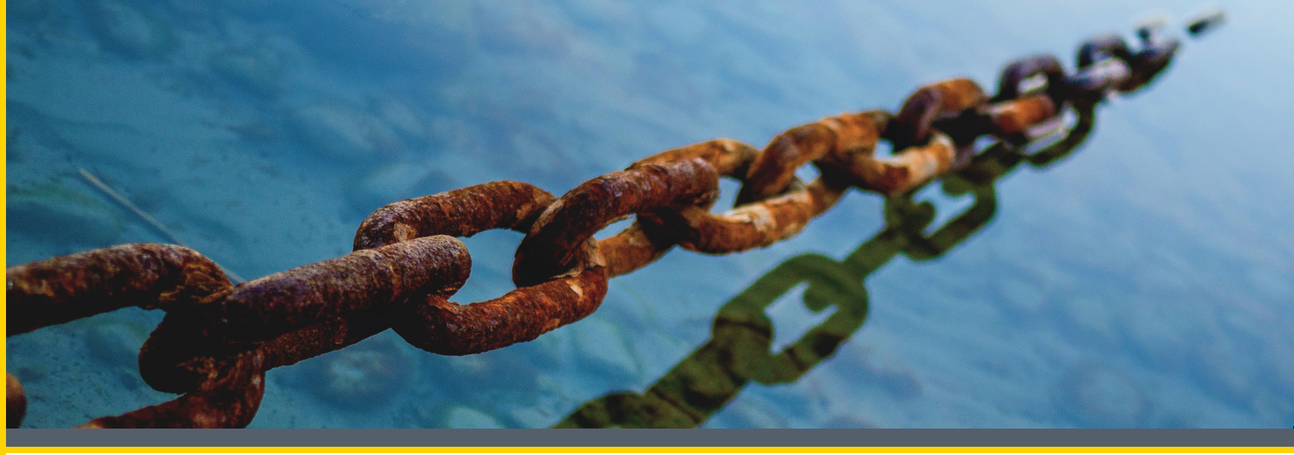
December 7
Alternative Reference Rate Committee released securitization specific consultation relating to fallback language in new-issue securitization transactions

December 18
SFIG released first edition Green Paper recommending leading practices for the transition of new-issue LIBOR-based securitizations

2019

January 28
Financial Conduct Authority regulator speech on final steps in the transition

February 7
SFIG submits response to ARRC securitization consultation on contract fallback language



What are the considerations for securitizations?

The complexity and scale of the transition from USD LIBOR to ARRs is expected to be a significant transformation effort for market participants. The inherent complexities of securitizations further compound the already substantial valuation, legal and reputational, operational and financial reporting considerations associated with the LIBOR transition.

1 Valuation considerations

- Uncertainty around the future liquidity of LIBOR markets and the value of any USD LIBOR-based product following the transition to ARRs or other fallback rates may cause significant changes to the valuation of LIBOR-based portfolios (value transfer).
- Structured finance market participants need to consider the impact of potential mismatches in timing and the fallback language for the securities and underlying collateral of a transaction; for example, asymmetry in either the transition timing or approach may result in additional basis risk or cash coverage challenges that could lead to interest shortfalls or changes to principal paydowns.

2 Legal and reputational considerations

- Different perspectives or interests of the various stakeholders to a securitization transaction increase the risk of litigation, fines or reputational damage related to the transition from USD LIBOR to ARRs.
- Legal and reputational impacts can be mitigated by clear communication between parties to avoid misunderstanding. For example, administrative agents may not want the liability of making the decision on when to move away from USD LIBOR to ARRs and will need to work closely with the issuer of the structured product or originator or servicer of the underlying asset.
- Assessing fallback provisions within legacy products and managing the repapering process will require significant effort due to the volume and complexity of the securitization contracts throughout the lifecycle of the transaction (e.g., asset origination documents, asset purchase/sale documents, securitization documents), particularly where 100% consent from all involved parties is required.

3

Operational considerations

- LIBOR is deeply embedded across the business and technology infrastructure of most securitization market participants, and organizations should be preparing to implement the operational changes required to adopt ARRs.
- The operational impact can be sized by assessing the dependencies to LIBOR within current processes, systems, data and models. For example, considering readiness for servicers to implement overnight SOFR within daily calculations of borrower interest payments using either a compounded SOFR or average SOFR approach.
- Detailed analysis across risk and pricing models is required to understand the depth of impact as models will need to be redeveloped, recalibrated and revalidated for ARRs. For example, the lack of availability of historical time series data on SOFR is also likely to be an issue for risk modeling.
- Preparation for a phased transition or the potential for timing differences between the securities and underlying collateral of a transaction may require operational capabilities to be enhanced to support multi-rate environments (e.g., LIBOR and ARRs).

4

Financial reporting considerations

- Transitioning to ARRs requires firms to analyze accounting treatments that may have a direct impact on an instrument's fair value and related hedging strategies.
- As described in Accounting Standards Codification (ASC) 470, a change in index for a security requires an entity that consolidates the corresponding special-purpose vehicle and holds both the liabilities and assets to consider whether such change is considered a modification or extinguishment to the liability. Similarly, entities often analogize to the guidance in ASC 310-10 to determine whether such a change is considered a modification or extinguishment to the asset.
- As described in ASC 320-10, a change in index related to an investment classified as either trading or available-for-sale results in changes to the fair value of an investment, requiring investors to account for the mark-to-market impacts of the fair value changes due to fallback rates.
- As described in ASC 860, servicing assets and liabilities are initially recognized at fair value. Subsequently, an entity may choose to follow either an amortization approach (with evaluation for impairment and increased obligation based on fair value) or a fair value mark-to-market approach. Where a fair value mark-to-market approach is selected, a change in discount rates may lead to an immediate change in fair value of the servicing asset or liability that will impact P&L.
- The Financial Accounting Standards Board has added SOFR as a benchmark interest rate for hedging purposes. However, several other transition implications are still outstanding that impact the assessment of hedge effectiveness, probability of cash flows, and mismatches in timing of the hedging instrument and hedged item's transition.

What should securitization market participants do now?

The transition to ARRs is expected to be a multiyear effort requiring constant monitoring of market developments and an approach that can evolve as progress is made by the industry. Actions that market participants should undertake include:

- Appointing senior executives to be accountable for assessing, planning and coordinating transition activities
- Mobilizing an enterprise-wide LIBOR transition program office with dedicated resources to own and execute all project activities across lines of business and control functions
- Updating contract documentation for new transactions to include fallback language based on the recommendations from the ARRC and other industry groups
- Conducting an enterprise-wide LIBOR transition impact assessment to inventory LIBOR-linked products, legal contracts, risk exposures, models, business processes and infrastructure
- Developing a LIBOR transition road map based on the results of the impact assessment that describes the prioritized plans, resources and activities required for the adoption of ARRs
- Participating in or monitoring working groups so that the latest market developments, leading practices and market dependencies are reflected within LIBOR transition planning
- Defining and executing a communication and education strategy for issuers, investors and other key parties to increase awareness and help to avoid the perception of conflicts of interest

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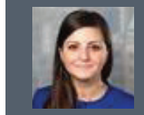

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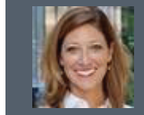

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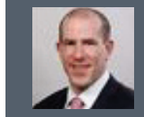

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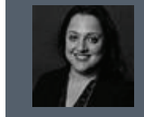

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