What’s the score?

To date, most of the required actions for transitioning have been the responsibility of investors and issuers. However, as it relates to legacy LIBOR-linked securities with inadequate fallback language, the path forward is largely out of investor’s control. Most fixed income investors, including Aegon Asset Management, have exposure to legacy LIBOR-linked securities. Obtaining 100% noteholder approval to change document language is the standard play attempted in the past, but its low success rate likely makes it an unviable option. Synthetic LIBOR is akin to the trick play that every team has in its back pocket, but is never actually called. A legislative solution, which some thought of as a “Hail Mary”, is now looking more viable if executed perfectly. Lastly, as with some of the biggest matchups in sports, sometimes overtime is needed for a definitive outcome. We are now inside of 18 months until the date when panel banks will no longer be required to provide LIBOR submissions. With that window closing, the correct play will need to be called to meet the original LIBOR transition timeline.

Several options being discussed

Once it became clear that LIBOR’s future as the world’s most prevalent floating-rate benchmark was coming to an end, Aegon Asset Management’s primary concern became how the financial markets would handle the approximately $2 trillion in legacy securities that were linked to LIBOR. Most deal documents were constructed to be able to handle a brief disruption to the availability of LIBOR, instructing deal participants to utilize the most recently posted LIBOR rate should LIBOR become unavailable. If the period of unavailability is brief, the economic winners and losers will be small and manageable. However, if LIBOR ceases to exist for the remaining life of the contract, the economic impact could be significant with the potential for big winners and big losers. This begs the question – what are the options for handling legacy LIBOR-linked securities?

Exhibit 1: Potential solutions for legacy LIBOR-linked securities

<table>
<thead>
<tr>
<th>Options</th>
<th>Description</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>100% Noteholder Approval</td>
<td>All noteholders agree to amend document language to incorporate LIBOR fallback language.</td>
<td>Unanimity</td>
<td>Impractical Logistically Difficult</td>
</tr>
<tr>
<td>Synthetic LIBOR</td>
<td>Change how LIBOR is calculated to incorporate risk-free rates. Document language would remain unchanged.</td>
<td>Widespread solution</td>
<td>Litigation Risk Enforcability</td>
</tr>
<tr>
<td>Legislative Solution</td>
<td>State of New York, where most documents are governed, would require widespread changes to legacy documents.</td>
<td>Widespread solution</td>
<td>Legislative timeline Constitutional challenges</td>
</tr>
<tr>
<td>Extending LIBOR</td>
<td>Panel banks will no longer be required to provide LIBOR submissions after 1/1/2022. This could be extended.</td>
<td>More securities &quot;roll off&quot;</td>
<td>Would only be temporary Last resort for regulators</td>
</tr>
</tbody>
</table>
Obtain 100% noteholder approval

Often, 100% noteholder approval is required to make any amendments relating to the coupon of a bond, including providing adequate LIBOR fallback language. The mechanics behind obtaining 100% approval are surprisingly complicated and unreliable. There is precedent for attempting to make widespread changes to deal documents. In 2016, Moody’s and Fitch placed approximately 40% of all Federal Family Education Loan Program (FFELP) asset-backed securities (ABS) on review for downgrade due to the potential for slower-than-expected repayment, which would have caused those bonds to miss their legal final maturity dates. Navient, one of the largest student loan servicers in the United States, attempted to amend the loan documents to extend the maturities. This was a rather non-controversial decision and was supported by most deal participants. However, Navient was able to get less than 20% of the deal documents changed, not because participants opposed the amendments, but because tracking noteholder approval through trustee, custodian, and sub-advisory channels to seek 100% approval was ineffective. Like attempting to kick a field goal without having crossed midfield, amending deal documents is a low percentage solution in a situation that demands a high percentage outcome.

Synthetic LIBOR

If LIBOR ceases to exist, many legacy deal documents ultimately instruct participants to utilize an average of LIBOR submissions requested from several panel banks. If those submissions aren’t available, the most recent LIBOR posting would be used. What if there was a way to change the definition of "LIBOR" within legacy deal documents? In its simplest form, synthetic LIBOR would mean changing the definition of LIBOR to be an alternative risk-free rate plus a spread component. By doing this, many deal documents would not need to be changed and LIBOR could continue to be referenced. In this potential solution, the mechanism for determining LIBOR changes before ever attempting to amend the document language. This option is comparable to a trick play – it’s clever but comes with additional risks. Currently, no regulatory agency would be compelling synthetic LIBOR rates to be posted, unlike traditional LIBOR rates. Additionally, those involved with the construction of synthetic LIBOR rates may be opening themselves up to potential litigation. A proposal in Europe has been brought forward that would give the Financial Conduct Authority (FCA) additional oversight as it relates to a synthetic LIBOR rate, but the potential outcome of this proposal is unclear.

Legislative solution

A legislative solution appears to be gaining traction across the industry and has become the most talked about solution to transition legacy LIBOR-linked securities in the United States. The Alternative Reference Rates Committee (ARRC) has proposed legislation to the State of New York in which documents that are silent on the cessation of LIBOR or do not provide an adequate fallback to LIBOR would, on an industry-wide basis, change documents to provide adequate fallback language. In addition, the proposed legislation would also provide safe harbor for deal participants, meaning those involved could not be sued by other parties for participating in the document amendments. The pros for this solution are clear. A legislative solution could be a widespread solution to an issue that can be very granular in nature and would help remove the dark cloud hanging over legacy floating-rate securities. The inclusion of safe harbor would also help mitigate the risk that deal participants would be opening themselves up to litigation. Once considered to be the “Hail Mary” necessary to successfully transition, a legislative solution is now starting to look like the most likely outcome. However, most recognize that the passing of legislation is not something that happens overnight. The State of New York would need to act relatively quickly as the end of 2021 gets closer and closer.

Winning will take a team effort

With all the uncertainty surrounding which solution will ultimately be adopted, one thing is clear – regulators have doubled down on the cessation of LIBOR occurring by the end of 2021, leaving market participants with less than 18 months to successfully transition away from LIBOR. With that said, the consequences of transitioning prematurely must also be considered. As with many sporting events, overtime is often needed to determine an ultimate winner. The LIBOR transition may prove to be no different. While regulators are against the extension of LIBOR, the pace of the transition will likely need to increase to avoid an extension and ensure a successful transition.
LIBOR TRANSITION: WHAT’S THE GAME PLAN FOR LEGACY LIBOR-LINKED SECURITIES?

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