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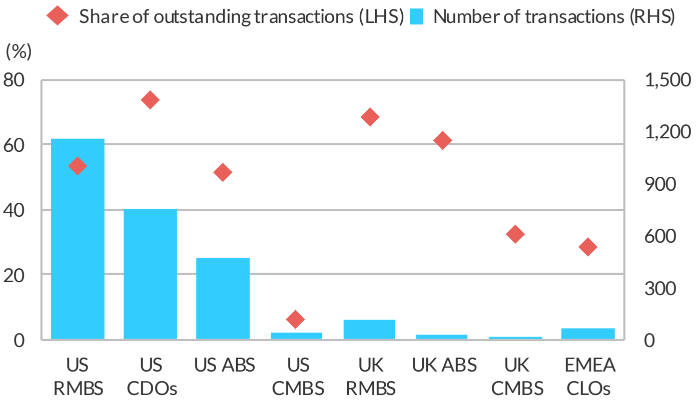
Global

Legacy Libor Exposure Is Significant in US and UK Structured Finance

USD and GBP Libor Transition Plans Still Lack Detail

Fitch-rated Transactions with Legacy Libor Exposure



Note: Transactions that mature after 2021, have any underlying assets or bonds referencing Libor, have the highest rating above 'CCC+', and closed before mid-2018 for UK SF and mid-2019 for US SF and leveraged loans in EMEA CLOs. US ABS figures include 23 Canadian ABS. Master trust issuances treated as individual deals.
Source: Fitch Ratings

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Just over 2,500 Fitch-rated structured finance (SF) transactions and covered bond programmes have legacy exposure to USD and GBP Libor liabilities, assets and derivatives beyond 2021 and must manage the transition from Libor to a new reference rate that is expected after December 2021.

Fitch is engaging with transaction parties, industry trade groups and regulators to assess credit risks stemming from the transition.

The transition plans for many transactions remain uncertain. This is particularly the case for those with legacy Libor exposure, which we categorise in this report as transactions that have a legal final maturity after end-2021, have any liabilities or assets that reference Libor, and closed before robust fall-back language was generally adopted. This was around mid-2019 for US SF and leveraged loans in EMEA CLOs, and mid-2018 for UK SF.

Transactions with legacy Libor exposure face particularly challenging obstacles due to the lack of clear guidance for transaction parties upon a permanent Libor cessation. The transition risk is higher still for transactions without an active sponsor because actions beyond contractual provisions are likely to be necessary unless legislative solutions are implemented.

The highest number of Fitch-rated transactions with legacy Libor exposure is in US RMBS and US CDOs and the share of outstanding transactions is highest for UK RMBS and US CDOs.

Assessing Transition Risk

We will determine the robustness of transition plans for transactions with meaningful legacy Libor exposure by considering adherence to guidance from the Alternative Reference Rates Committee (ARRC) for those in the US dollar market and to guidance from the Working Group on Sterling Risk-Free Reference Rates (RFRWG), UK Financial Conduct Authority (FCA) and Bank of England (BoE) for those in the UK sterling market.

The potential credit impact on rated notes will also depend on the magnitude of the following risks and how far they are offset by structural features like excess spread or credit enhancement:

- interest rate risk from a potential mismatch between the rates paid on the assets, notes and derivatives after transition to new reference rates;
- the market interest rate at the time of cessation in cases where no transition is planned and where fall-back provisions for notes specify fixing at the last published rate;
- the risk of payment disruption if there is no provision for a rate other than Libor in an asset contract;
- the costs and risk of swap terminations and replacement;
- the likelihood of litigation risk.

The extent of some of these risk factors and potential remedies will only become clearer over the coming months and possibly not for another year or more. In addition to actions by transaction parties, our assessments will depend on the actions of regulators and legislators, which may not become more evident for some time.

Limited Downgrade Risk, but Authorities' Actions Are Key for "Tough Legacy"

We believe that the main Libor transition risks for SF are operational, legal, and interest rate mismatch risks. While minor interest rate risk could affect many transactions, we do not expect many rated notes to be subject to materially increased credit risk due solely to interest rate risk unless the interest coverage is very low. However, litigation and swap termination risks could have a larger impact on ratings.

Regulatory developments can help manage these transition risks, especially for what the RFRWG and FCA call "tough legacy" contracts. A recent example is the proposed legislative change to grant the FCA additional powers to manage the transition for critical benchmarks such as Libor (see *Libor Transition Progresses but the Biggest Hurdles Remain*).

However, the FCA still expects all contracts that can transition to the Sterling Overnight Index Average (SONIA) to do so. Furthermore, the proposal does not eliminate the possibility of legal challenges, and the exact nature and application of the additional powers to FCA-regulated entities remains unclear, as do how they might be used in cooperation with US authorities to manage the transition in the dollar market.

Libor transition preparations and market developments will continue throughout 2020 and 2021. Continued progress will reduce the risk of rating impact on Fitch-rated transactions, particularly if it is underpinned by legislative or regulatory measures to help address potential litigation risks and operational issues.

Nevertheless, in the absence of progress in regulatory actions or specific legislation, some ratings could face negative rating actions. If we deemed ratings in deals exposed to transition risk as vulnerable relative to the structural protection in place, we would expect to place them on Negative Outlook from around the start of 2021.

If there is insufficient progress on transition plans or on legislative or regulatory solutions, we could put affected ratings on Rating Watch Negative (RWN). RWNs are typically resolved within six months and would therefore be unlikely before mid-2021 at the earliest.

Rating downgrades for affected transactions would be unlikely to occur before early 2022, because last-minute actions by transaction parties or regulatory intervention could mitigate or remove certain risks before they come into effect.

Transaction parties seem to share our view that these transition issues need addressing. However, in many cases, transition plans lack detail, partly because of continued uncertainty about how the process will ultimately progress. Our assessment of the robustness of transition plans will include both their content and implementation timeline.

We believe plans will need to be developed in more detail by end-2020 or early 2021, with implementation actions taken by mid-2021, to meet the end-2021 deadline. This will vary by transaction as some actions may be delayed until after the Libor cessation or pre-cessation trigger events have occurred under transaction documents.

However, associated actions to ensure a smooth reference rate transition upon a trigger event (such as ensuring sufficient communication to borrowers so that they are treated fairly) can be taken beforehand. Implementation of transition plans could also be delayed by further pandemic-related disruption.

The practical challenges of adapting legacy transactions where 100% investor consent is usually required (chiefly US transactions issued under the Trust Indenture Act of 1939) mean that we think legislative or regulatory action will be needed to support a smooth transition. In the UK, the noteholder approval threshold is typically around 66% to 75% and has proven to be more achievable.

We consider Libor exposure in transactions with fall-back provisions since around mid-2019 (for US SF and leveraged loans in EMEA CLOs) and since mid-2018 (for UK SF) to face low credit-related risk from the Libor transition. However, some credit risk is still possible and will depend on the robustness of specific provisions in individual transactions. For example, earlier fall-back provisions are less likely to include an adjustment for the credit spread if the new reference rate is a risk-free rate.

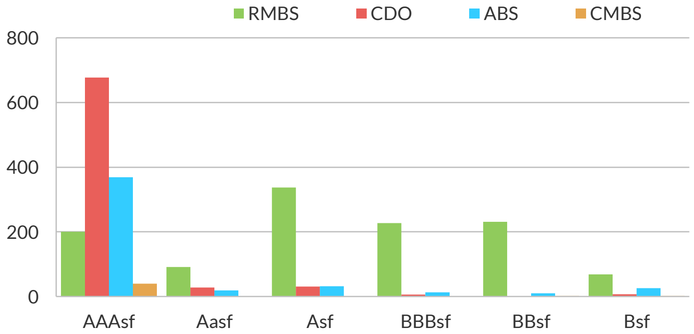
Varied Exposure Across Asset Classes

In the US, approximately 65% of Fitch-rated SF transactions have some form of Libor exposure either through notes or assets. That exposure falls to about half when including only transactions with legacy Libor exposure (for transactions issued before mid-2019) and transactions where the highest Fitch rating is above 'CCC+sf' (see charts below for rating distribution).

While the majority of US RMBS with legacy Libor exposure have their highest rating below 'AAAsf', this asset class has the largest overall exposure. This is followed by US CDOs, which includes mostly US CLOs and some trust preferred securities (TruPS) CDOs, and US ABS, with the legacy Libor exposure mostly in US FFELP student loan ABS.

Highest Rating Category for US Transactions with Legacy Exposure

By number of deals

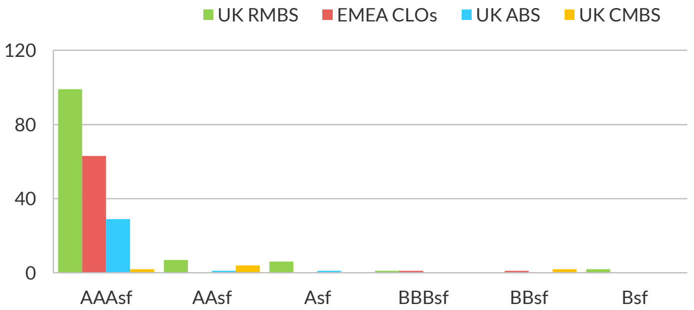


Note: Transactions that have any underlying assets or bonds referencing Libor, closed before mid-2018 for UK SF and mid-2019 for leveraged loans in EMEA CLOs, and mature after end-2021. Master trust issuances treated as individual transactions.
Source: Fitch Ratings

More than 75% of Fitch-rated UK SF transactions have some form of Libor exposure for notes or assets, nearly all of which is to GBP Libor. That exposure falls to about 65% when accounting for only legacy Libor exposure (for transactions issued before mid-2018). About 30% of EMEA CLOs have less than 6% of Libor-referencing assets in transactions with no Libor-referencing notes. The FCA is encouraging lenders to rely on compounded overnight rates for new instruments and to convert to these for legacy contracts where possible.

Highest Rating Category for EMEA Transactions with Legacy Exposure

By number of deals



Note: Transactions that have any underlying assets or bonds referencing Libor, closed before mid-2018 for UK SF and mid-2019 for leveraged loans in EMEA CLOs, and mature after end-2021. Master trust issuances treated as individual transactions.
Source: Fitch Ratings

US Libor Exposure

	RMBS	CDOs	ABS	CMBS	Total
Transactions with Libor exposure (number)	1,590	952	509	52	3,103
Transactions with Libor exposure closed before mid-2019 (number)	1,155	750	469	44	2,418
Transactions with Libor exposure as a share of all outstanding transactions (%)	74	92	55	7	64
Transactions with Libor exposure closed before mid-2019, as a share of all outstanding transactions (%)	53	73	51	6	50

Note: Fitch-rated transactions that mature after 2021, have any underlying assets or bonds referencing Libor, and have highest ratings above 'CCC+sf'. US ABS figures include 23 Canadian credit card ABS. Master trust issuances treated as individual transactions.
Source: Fitch Ratings, as of 31 March 2020

EMEA Libor Exposure

	UK RMBS	EMEA CLOs	UK ABS	UK CMBS	UK SF total
Transactions with Libor Exposure (number)	141	74	37	10	188
Transactions with Libor exposure closed before mid-2018 for UK SF and mid-2019 for EMEA CLOs (number)	115	65	31	9	155
Transactions with Libor exposure as a share of all outstanding transactions (%)	83	32	73	37	76
Transactions with Libor exposure closed before mid-2018 for UK SF and mid-2019 for EMEA CLOs, as a share of all outstanding transactions (%)	68	28	61	33	63

Note: Fitch-rated transactions that mature after 2021, and have any underlying assets or bonds referencing Libor. Master trust issuances treated as individual transactions.
Source: Fitch Ratings, as of 8 July 2020

APAC has minimal Libor exposure, with less than 3% of SF ratings having a bond coupon and derivative linked to Libor. Latin America also has minimal exposure, with only 4% of ratings having a bond coupon linked to Libor. This is mainly within ABS, where 14% of transactions have some bond exposure to Libor.

Transitions Plans Lack Detail

Preliminary feedback from several transaction parties indicates that, while there is significant focus on Libor transition risk, there are common practical challenges and limited progress on legacy portfolios. Many lenders and servicers have been monitoring industry and regulatory developments but have not yet determined the transition process for their assets. Most legacy transaction contracts provide for temporary reference rate disruption but do not envisage permanent Libor discontinuation.

The most common options under consideration are replacing Libor with an alternative reference rate or adding fall-back language to existing transactions. While the ARRC's recommended fall-back language provides greater clarity about when and how the replacement index will be chosen in the dollar market, amending contracts will prove challenging, as 100% investor consent is required in many cases and execution timing will vary by sector and jurisdiction. A transaction-by-transaction approach is therefore needed to identify the bondholders.

Some larger issuers started to make amendments to include robust fall-back language in transaction documents with legacy Libor exposure earlier this year. However, large numbers of amendments are unlikely and the transactions will likely depend on legislative or regulatory assistance.

RMBS

US RMBS Libor asset and liability exposure is heavily concentrated in transactions issued prior to 2009. Libor exposure in US RMBS issued since 2009 is primarily in seasoned reperforming RMBS assets that often already had loan-rate modifications, and in Government Sponsored Enterprise (GSE) bond coupons that are direct obligations of the GSEs.

Most UK RMBS closed before mid-2019 issued GBP-Libor referencing notes. However, Libor-referencing assets are uncommon for prime transactions and most legacy Libor exposure on the asset side, based on the current or reversion rate, is in non-conforming and buy-to-let RMBS. Libor derivatives are common for prime UK RMBS with Libor-referencing notes but their tenor matches the fixed-rate exposure at asset level, which is generally short at three to five years. Most of these contracts will therefore elapse or hedge immaterial amounts compared to outstanding issuance by end-2021.

RMBS issuers and servicers in the US and UK are working with other market participants, regulators and trade associations to define the next steps in replacing Libor with a new index and the timing of this process. All these changes are expected to be aligned with industry practice, regulatory guidance and contractual obligations for residential mortgage loans.

The GSEs and the US Consumer Financial Protection Bureau have recommended that existing Libor referencing products transition to a spread-adjusted index referencing the Secured Overnight Financing Rate (SOFR), as recommended by the ARRC. However, most servicers have made no changes to the index rates associated with existing Libor-linked assets as a Libor-cessation trigger event is not anticipated to occur before end-2021.

Some RMBS servicers and trustees have started to contact investors to identify plans for transition and compliance with GSE guidelines and to provide a mechanism by which investors can agree or object to the new index. The GSEs have also announced supplements and amendments to documentation for some existing collateralised mortgage obligations that are not highly detailed but leave room for the application of forthcoming GSE standards.

In the US, new adjustable-rate mortgage (ARM) loan originations are likely to follow GSE guidance and begin moving away from Libor in 2H20. We expect this transition to help progress key frameworks and infrastructure, including those used by servicers and trustees.

Some UK RMBS transaction parties have already made definitive plans to transition to SONIA, while others are still exploring their options when it comes to choosing an alternative benchmark rate. Most UK RMBS issued since 2018 already have robust replacement benchmark language in their transaction documents. The transactions with legacy Libor exposure will likely make the switch in early 2021 or when Libor ceases to exist. Most buy-to-let and non-prime assets with legacy Libor exposure have contractual provisions for changing to a new rate.

CDOs

CLOs represent the bulk of the US CDO exposure to Libor for both assets and liabilities. Most derivative exposure in CDOs is in TruPS CDOs. US CLO notes continue to pay Libor and leverage loans are Libor-linked.

No Fitch-rated EMEA CLOs have outstanding Libor-referencing notes as they are issued in euros. It is common for there to be a small percentage of GBP or USD Libor-referencing loans and related swaps in the pools. The proportions range from 0% to 6% and the average is less than 1%. Leveraged loans in these CLOs have had robust fall-back language since about mid-2019.

Nearly all outstanding US CLOs issued since 2018 already include some form of Libor-replacement provisions for the issued notes in their transaction documents, but the more robust fall-back provisions recommended by ARRC in the US were only adopted in the sector in mid-2019. The most common Libor-transition language still requires amendments and consent by the majority of investors for any change in the benchmark rate in a relatively short period of time.

Most CLO transactions issued prior to 2018 without initial Libor-replacement language have since been refinanced with the addition of benchmark replacement language, or are likely to reset prior to end-2021.

Some US CLO documents have started to include the ARRC's recommended standard replacement language that allows managers to pick an alternative benchmark rate that meets certain criteria, so consent from CLO noteholders is typically not required (see *Risk of Ignoring Libor Cessation for US Leveraged Loans*).

Leveraged loans in US CLOs feature fall-back language outlining the process for changing the reference rate. However, if a permanent replacement rate is not agreed, moving to the prime rate could increase leveraged borrowers' debt service costs and increase interest income for CLOs.

ABS

Most Fitch-rated US ABS with Libor exposure are US FFELP student loan ABS, followed by some auto ABS, private student loan ABS and credit card ABS. Most FFELP student loan ABS assets and liabilities have Libor exposure. FFELP asset exposure comes from special allowance payments from the federal government. There continues to be little movement towards transition on these assets as the market expects the US Department of Education to recommend, and Congress to pass, legislation that would allow for the use of a new reference rate. FFELP student loan transactions face the 100% investor consent threshold to add fall-back language.

For US auto ABS and credit card ABS, servicers expect most of their older transactions without any Libor transition language to mature before cessation. In addition, more recent transactions already include fall-back language that closely resembles that recommended by the ARRC.

UK ABS transactions do not have assets that reference Libor and most transactions with legacy Libor exposure in note form have already paid in full, are expected to pay in full by end-2021 or are transitioning the reference rate to SONIA.

CMBS

US and UK CMBS have the lowest number of transactions exposed to Libor. Those issued after the global financial crisis were characterised by Libor-linked loans, with yearly extension options exercisable by borrowers that, among other things, procure interest rate hedging (caps are typical) financed by Libor-linked notes. As these loans reach their extension dates, we expect this will provide an opportunity to switch to alternative bases in tandem with the notes. A small number of longer-dated pre-crisis deals included Libor-linked notes, swapped from fixed by issuer-level swaps. We await clarity on how these positions will transition to the successor basis.

Transaction parties for many transactions in the US and UK have identified their legacy Libor exposure, are closely monitoring market developments and are reviewing their options before changing the reference rate or adding fall-back provisions.

While there are some promising signs in the US of industry-led initiatives to address tough legacy exposures in contracts, some market participants believe that there is a general lack of consensus on a replacement rate, creating uncertainty. There is potential for litigation risk, given differences in the underlying loan documents regarding if and how the replacement of the reference rate would be addressed. Due to this uncertainty, we do not expect any communication between servicers and borrowers in the US until later in 2020 or early 2021.

Covered Bonds

UK covered-bond issuers are at different stages in their transition from LIBOR references to SONIA in their programmes. Exposure to Libor is practically non-existent in mortgage loans. Most references to Libor in covered bonds have been replaced with SONIA following consent solicitations (either for floating-rate covered bonds referencing Libor or fixed-rate covered bonds reverting to Libor during the maturity extension period). Only five covered bonds (or 2.5%) mature after 2021 and still reference Libor, and one has launched a consent solicitation to transition to SONIA.

The remaining Libor exposure in UK covered-bonds programmes is mainly through swaps (71 covered bonds, or 35.5%, are swapped to Libor and mature after 2021). Most asset swaps still reference Libor. This is the case for nine of 13 programmes rated by Fitch. Two programmes have asset swaps that reference SONIA as a proportion of the SONIA-linked bonds and reference Libor as a proportion of the Libor-linked liabilities. Two programmes are linked only to SONIA.

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