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Incomplete Fallbacks Attracting Opportunists

The planned phaseout of Libor is giving rise to an investment strategy focused on purchasing floating-rate structured products that lack robust provisions for the selection of new benchmarks.

Several unidentified investors already are amassing capital pools that they would deploy using the opportunistic approach. The idea: to buy the bonds today, typically at discounts, and pursue legal claims against the issuers should the replacement benchmarks result in less favorable interest rates later.

The strategy hinges on the idea that so-called fallback language spelling out the process for switching benchmarks only started to become more comprehensive after the **U.K. Financial Conduct Authority** signaled in 2018 that it would stop collecting Libor data. Fallback provisions drafted before that announcement generally accounted only for temporary disruptions in benchmark reporting, with wide variations from deal to deal.

The buysiders' efforts initially are focused on bonds backed by student loans, where issuers have been particularly active in implementing such terms for new transactions and where differences have emerged between the values of those securities and older ones. They also are watching for opportunities in bonds backed by auto loans, credit-card accounts and mortgages.

For deals lacking robust fallback language, the bet is that there likely will be uncertainty or disagreements over how the contracts should be interpreted. Even in cases where the intent is clear, the resulting adjustments may be inconsistent with investors' expectations. For example, relying on the last available Libor quote could result in a floating-rate obligation taking on a fixed-rate format.

Either way, there may be grounds for legal actions or settlements. To that end, investors could argue that because older fallback language wasn't drafted to address the permanent cessation of Libor, some other approach should be adopted.

When it comes to taking advantage of discounts, the belief is that more opportunities could emerge as asset managers act on orders from the **SEC** to identify their Libor-related risks and disclose them to clients.

In July 2019, the commission's Division of Investment Management warned that the discontinuation of Libor may impede the functioning, liquidity and values of assets pegged to the benchmark. "As we have been reviewing hundreds of securities, we find that the language was not standard by underwriter, counsel or issuer, and each document has to be carefully read to extract the small but critical distinctions unique to each transaction," **Houlihan Lokey** senior advisor **David Wagner** said. "These small distinctions could have potentially large impacts on value as we model the market impacts from Libor cessation."

The cost of identifying securities with the least robust fallback language isn't expected to be prohibitive, however. **Intex** maintains a library of deal documents that can be downloaded for a fee, and it's possible to use artificial intelligence to quickly scan documents for language that could flag higher risks.

That said, potential investors are reluctant to broadcast lists of securities that would suit their strategies and have yet to indicate how quickly they plan to put the money to work.

It is difficult to introduce more robust fallback language for older deals because material amendments require the consent of 100% of bondholders. Policymakers have been exploring other options, however, including the possibility of seeking a change to New York state law that would create an automatic replacement for Libor.

Another option would be to pursue a declaration from the **New York Department of Financial Services.**

Trustees also could seek declaratory court judgements, potentially based on their rights and responsibilities or interpretations of the issuance contracts. But that's only possible after a complaint has been filed.

Wilmington Trust, for one, said it has identified all Libor-based deals that could be affected and will follow the procedures set under their governing documents. "Where there is a lack of clarity, [Wilmington] will be working with investors, issuers and/or legal to ensure proper protocols are followed, depending on how the governing documents are worded," senior vice president **Patrick Tadie** said.

Libor reporting is set to cease as soon as yearend 2021. The **Federal Reserve's** Alternative Reference Rates Committee has recommended its Secured Overnight Funding Rate as the first choice to replace Libor, though a term version of the rate isn't yet available. Recent student-loan deals for the most part have followed the committee's guidance. ❖

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