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LIBOR Transition for RMBS and Other LIBOR-Indexed Securitizations

Much has been written over the past decade, in this journal and elsewhere, about the manipulation of the London Inter-Bank Offered Rate (LIBOR) and the subsequent decision to end its use as a benchmark interest rate. This article addresses the challenging issue of LIBOR transition—that is, moving from LIBOR to another benchmark rate—for asset-backed securities such as residential mortgage-backed securities (RMBS). RMBS is one of a class of assets that face the complication of two levels of transition: LIBOR-indexed mortgage notes that are assets of an RMBS securitization trust, and LIBOR-indexed interest rates paid on the securities issued by the securitization trust.

LIBOR-Indexed Mortgage Lending and Securitization

To understand the challenge, first consider how residential mortgages are

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securitized into RMBS trusts. When a lender makes a home loan, the loan typically is secured by note and a mortgage. The notes often have variable interest rates. In the run-up to the 2008 financial crisis, residential mortgage notes—and particularly sub-prime residential mortgage notes—often were indexed to LIBOR. This means that the annual interest rate the borrower paid was not set at a fixed number but instead as LIBOR plus an additional percentage, such as LIBOR plus 3%. As LIBOR changed, the rate the borrower paid was (at agreed time intervals) changed.

In an RMBS securitization, these notes and mortgages (among other rights relating to the loans) are transferred to a securitization trust. The trust pays for the loans by issuing securities entitling holders to a share of the revenue generated by the loans. Generally, the interest paid to investors in a securitization trust is *not* tied to (although it certainly correlates to) the interest rate borrowers agreed to pay in their mortgage notes. Rather, the rates paid to investors are set in the securitization document and vary by the amount of risk an investor is willing to take using sometimes-complex payment waterfalls. For many older trusts, the interest rate paid to investors was indexed to LIBOR.

Because crisis-era mortgages still are outstanding, the residential mortgage-backed security trusts into which

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those loans were securitized continue to exist. That means that there are and will be for years to come LIBOR-indexed mortgage notes securitized in trusts paying LIBOR-indexed interest to investors. If LIBOR ceases to exist, what is the interest rate that borrowers must pay to the RMBS trust on their home

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loan and what interest rates must the trust pay to investors on the securities it issued? That is the LIBOR transition challenge facing many RMBS and other LIBOR-indexed asset-backed securities.

LIBOR Transition and LIBOR-Indexed Mortgage Notes

The initial level of complication in the LIBOR transition occurs with the mortgage notes. It was common for mortgage notes to provide for LIBOR being unavailable, but that still makes LIBOR transition complicated, particularly for securitized loans.

First, many lenders use the FannieMae/FreddieMac standard note template, and that template contains LIBOR replacement language that commonly was used in mortgage notes. Even though *most* mortgage notes used the FannieMae/FreddieMac LIBOR replacement language, at some point soon, trustees and servicers will have to analyze *every* mortgage note to make sure that they know, for *every* loan, how the interest rate on that loan will be affected by the end of LIBOR.

The question for investors (and homeowners, of course) is what to do if trustees and servicers forgo that expensive and time-consuming process and just work off the assumption that all notes use the LIBOR replacement language in the FannieMae/FreddieMac standard note template.

Second, FannieMae/FreddieMac have adjusted their standard note template and policies to account for the LIBOR transition and, as of the end of 2020, no longer offer LIBOR-indexed products. Prior to that, however, the FannieMae/FreddieMac standard note form used this LIBOR definition and fallback language:

> The “Index" is the average of interbank offered rates for one month U.S. dollar-denominated deposits in the London market ("LIBOR"), as published in The Wall Street Journal. The most recent Index figure available as of the date 15 days before each Interest Rate Change Date is called the "Current Index". If the Index is no longer available, the Note Holder will choose a new index that is based upon comparable information. The Note Holder will give notice of this choice. The Note Holder will deliver or mail to me [Borrower] a notice of any changes in the amount of my monthly payment before the effective date of any change.

Here, once LIBOR ceases to be published, the trustee of the securitization trust, as the owner of the note, gets to “choose a new index that is based upon comparable information.” This is great for the trustee, perhaps not so much for the borrower. Even more, “comparable information” is a vague term that is sure to be the subject of litigation. There are legislative solutions (both adopted and proposed) to the problem of litigation over the trustee’s choice of a replacement rate that offer answers to this question. However, uncertainty—and hence substantial litigation risk—remains on the ultimate scope or effectiveness of those legislative solutions.

LIBOR-Indexed Payments to RMBS Investors

As with individual mortgage notes, there is no standard LIBOR fallback language in securitization documents. Since there are many fewer RMBS securitization trusts than the many millions of mortgage notes, it should not be unduly burdensome for a trust to determine how it is supposed to pay investors if LIBOR no longer is available.

The definition of LIBOR in the pooling and servicing agreement for a typical RMBS securitization trust, ABFC 2006-OPT1, explains what the trustee is to do if LIBOR is not available, offering a waterfall of choices based on the information is available to the trustee.

> “One-Month LIBOR”: With respect to each Interest Accrual Period, the rate determined by the Trustee on the related LIBOR Determination Date on the basis of the interbank offered rate for one-month United States dollar deposits in the London market as such rate appears on the Telerate Page 3750, as of 11:00 a.m. (London time) on such LIBOR Determination Date. If such rate does not appear on that page (or such other page as may replace that page on that service, or if such service is no longer offered, another service for displaying One-Month LIBOR or comparable rates as selected by the Trustee) on a LIBOR Determination Date, One-Month LIBOR for the related Interest Accrual Period will be the Reference Bank Rate, determined by the Trustee as follows:
> (i) If on such LIBOR Determination Date two or more Reference Banks provide Reference Bank Rates, One-Month LIBOR for the related Interest Accrual Period shall be the arithmetic mean of such Reference Bank Rates (rounded upwards

if necessary to the nearest whole multiple of 0.001%);

(ii) If on such LIBOR Determination Date fewer than two Reference Banks provide Reference Bank Rates, One-Month LIBOR for the related Interest Accrual Period shall be the arithmetic mean of the rates quoted by one or more major banks in New York City, selected by the Trustee after consultation with the Depositor and the NIMS Insurer, as of 11:00 A.M., New York City time, on such date for loans in U.S. Dollars to leading European banks for a period of one month in amounts approximately equal to the aggregate Certificate Principal Balance of the Offered Certificates and the Class B Certificates; and

(iii) If no such quotations can be obtained, One-Month LIBOR for the related Interest Accrual Period shall be One-Month LIBOR for the prior Distribution Date.

This LIBOR fallback language—which is common—is well-suited to the situation where LIBOR is temporarily unavailable, but not to the situation we now face, which is that LIBOR will permanently be unavailable. In particular, clause (iii) means that variable-rate securities would become fixed-rate securities, with the rate permanently set at the LIBOR rate last used by the trust before LIBOR terminated.

It is uncertain what trustees will do with this language, and this, coupled with the uncertainty associated with how LIBOR transition will be handled for each mortgage note, creates a double dose of litigation risk and valuation questions for RMBS owners.

In addition, the multi-level aspect of the securitization creates potential mismatches between the interest rate paid on a trust's assets and the interest rate paid to the trust's investors. To the extent stakeholders in the trust structure, such as the trustee or servicer, have discretion to choose what the LIBOR replacement rates will be, it is an open question how they will exercise that discretion and for whose advantage they will exercise it. Adding to the complexity, who will benefit and how will vary depending on many factors,

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including the status of the securitization trust and of each class of securities issued by the trust, the design of the trust's payment waterfall, whether the trustee also is a security-holder, and who has the right to do a clean-up call (that is, the right to purchase all of the trust's assets).

Uncertainties in the LIBOR transition—whether because of the right of players in the trust structure to exercise discretion or because of questions about how laws passed to facilitate the transition will (or can) be implemented—will impact how asset-backed securities should be valued and whether such uncertainties create financial risk or, alternatively, trading opportunities. And, of course, uncertainties create the potential for litigation and its attendant costs (including depletion of the trust estate to pay the trustee's legal fees) and delay.

Other Securitized Assets

This article focuses on RMBS, but similar LIBOR transition issues exist with other securitized or structured assets, such as commercial mortgage-backed securities and collateralized loan obligations.

Conclusion

These uncertainties invite legislative solutions and some have been adopted (more are proposed) to the problem of LIBOR transition in securitization trusts. They offer some solutions to the issues discussed above, but uncertainty—and hence substantial litigation risk—remains on their ultimate scope or effectiveness. I expect to address those legislative responses in a future article.