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Issuers Welcome Fallback Language for Libor-Based Floating Rate Notes.

WASHINGTON — Municipal bond issuer officials are welcoming recommendations released last week for contractual fallback language for Libor-denominated floating-rate notes and syndicated loans.

Emily Brock, director of the federal liaison center for the Government Finance Officers Association, said GFOA 100% supports the effort and was among the 60 organizations that submitted comments to the Alternative Reference Rates Committee. The ARRC released the recommended language on Thursday.

"It very clearly defines cessation triggers and the fallbacks," said Brock.

These two fallback recommendations are the first in a series of fallbacks that the ARRC is expected to issue in the coming weeks and months. Future ARRC fallback recommendations will address legacy contracts with Libor, new contracts and consumer product contracts.

ARRC said the recommendations are part of its mandate to address risks in contracts that refer to Libor as part of the larger shift to the Secured Overnight Financing Rate (SOFR).

The phase out of Libor, also known as the London Interbank Offered Rate, will affect municipal finance in not just the bond market but also in some legacy contracts with suppliers where Libor language is used, according to experts.

"It's no longer a question of if "but when" Libor will become unusable, yet most contracts referencing it don?t adequately account for this eventuality," Tom Wipf, chair of the ARRC and vice chairman of institutional securities at Morgan Stanley (MS), said in a statement. "With Libor's possible 2021 expiration date looming, that obviously poses a massive risk to financial stability and market participants."

Wipf described the fallback language as "a critical step."

"We encourage market participants to incorporate this language into new contracts, and when possible, to begin writing contracts using SOFR instead of U.S. dollar Libor," he said.

Floating rate debt is only a small fraction of the municipal bond market.

The Securities Industry and Financial Markets Association listed $76.9 billion in publicly issued municipal bonds from 872 issuances that used FRNs as of Dec. 18, 2018. That's only 2% of the $3.8 trillion municipal bond market and includes debt that uses the SIFMA index but doesn't include swaps.

Libor-based municipal debt was an even smaller amount at $47.6 billion or about 1.3% of the overall muni market.

In the bigger picture, the Federal Reserve estimated last year there were roughly $200 trillion of financial securities referencing U.S. dollar Libor.

ARRC said the recommended language for FRNs and syndicates is for voluntary use in new contracts that reference Libor with the goal of reducing the risk of serious market disruption in the event that Libor is no longer usable.

The fallback language may be used in a broad range of floating rate securities issued in the capital markets, including municipal bonds, pass-through securities, convertible debt and other debt issuances.

Municipal issuers rarely participate in syndicates, in which the risk of a large private placement issuance is shared by banks.

Brock said the recommended language is “well organized” with what she described as “clear definitions.”

“For FRNs, it is language that is usable,? Brock said. “It could be used right away by issuers. Of course, GFOA has urged issuers to have a discussion with their municipal advisors and their deal team.”

Historically, most FRNs provided for a fallback waterfall that would, upon Libor not being available, first revert to the average of quotes in the London interbank market obtained by polling banks and then would ultimately fall back to the last published value of Libor if such quotes cannot be obtained, ARRC said.

“Because most observers now believe that banks would be unable or unwilling to provide the quotes implementing the first stage of this waterfall, it would appear that most FRNs would effectively convert to fixed rate instruments paying the last published value of Libor upon a cessation of Libor,” ARRC said.

The ARRC said its recommended language is meant to provide a more robust waterfall that would allow for a conversion to SOFR-based rates in the initial stages of the waterfall

The fallback language for FRNs defines the trigger events that start the transition away from Libor and outline a “waterfall” approach to determine the SOFR-based successor rate and the spread adjustment that would apply to the successor rate.

For syndicated loans, there are two separate approaches to fallback language. One is a hardwired approach that clearly specifies the SOFR-based successor rate and the spread adjustment. The other is an amendment approach that offers a streamlined amendment mechanism for negotiating a benchmark replacement and standard language.

According to AARC, “Some market participants may be initially more comfortable with the amendment approach because it does not make references to rates or spread adjustments that do not yet exist.”

By Brian Tumulty

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