Bond Case Briefs

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The Transition Out of LIBOR: What State and Local Governments Should be Discussing with Their Financing Teams

The London Interbank Offered Rate (LIBOR) is a global benchmark interest rate calculated daily, and is the most widely used benchmark in the capital markets. State and local governments often see this rate in swaps/derivatives products intertwined with municipal debt, as well as in floating rate notes, lease contracts, bank loans, direct placements, and other types of financings and credit enhancements.

LIBOR will be phased out over the rest of 2020 and on December 31, 2021, will cease publication. Therefore, state and local governments need to know that existing contracts that reference LIBOR will need to be revised to perform as intended and new contracts will have to reference a new benchmark, such as the Secured Overnight Financing Rate (SOFR).

The Federal Reserve along with the Federal Reserve of New York, has established a working group with GFOA and other stakeholder groups – the Alternative Reference Rates Committee (ARRC) – to ensure a transition for the financial markets from LIBOR to a new rate, the Secured Overnight Financing Rate (SOFR). In some cases, state and local governments may see other rates used for some financing products.

To help governments best understand and address these changes, below are a list of questions that you should discuss with your financing team to ensure that as new benchmark rates take hold, these changes do not trigger rate revisions or other provisions that cause a financial disruption to the government/government entity.

Questions Issuers Should Ask Internal and External Finance Team

Does my jurisdiction have any LIBOR exposure?

Review contracts to identify contract terms and what exposure the government has with the impending change in the reference rate, LIBOR. Identify entity's outstanding/legacy financial products that may be predicated on the LIBOR rate:

- Swaps/derivatives
- Floating rate notes
- Bank loans
- Direct placements
- Letters of credit
- Purchasing cards
- Lease Contracts
- Investment Products, including Guaranteed Investment Products (GICs)

What do I do if I find LIBOR referenced?

Discuss with finance team – including counsel, swap advisor, and municipal advisor – the changes that may need to occur in these legacy contracts. Most swap/derivatives contracts are based on the standard terms contained in the International Swaps and Derivatives Association (ISDA) Master Agreement and related documents. The ISDA Master also contains a Fallback Protocol, which was recently revised and released on October 23, 2020. Discussing the new protocol with your Qualified Independent Representative (QIR) and your financing team is essential for your governmental entity. Members are encouraged to adhere to the protocol to modify contracts to reflect the change from LIBOR to SOFR or other rate using the ISDA LIBOR Fallbacks Protocol. NOTE that the fallback protocol includes a provision for ISDA to issue a "cutoff date." Failure to adhere in a timely manner will result in unnecessary complications.

In bank loans and direct placements, discuss with the bank/counterparty the replacement rate that will be used for these contracts and request to review with the bank/counterparty any financial penalties that could occur.

Governments may also have investments that are tied to LIBOR rates. Members should review investments and discuss any that do reference LIBOR with your financing team, including investment adviser.

What else should I think about if I find LIBOR referenced and need to make changes to my contract?

If approval from a governing body is needed to make changes with the contract, allow enough lead-time to have the contract reviewed and suggested changes made by members of the finance team to the governing body for approval.

How do I report the transition from LIBOR on my financial statements?

Identify any accounting matters, such as GASB 93 that need to be addressed when making changes to the contract and the reference rate. Governments should address these and other accounting and financial reporting implications that result from the replacement of an IBOR.

Is this a material event that should be disclosed?

Discuss with bond counsel/disclosure counsel if contract changes trigger a material event filing or if the entity should submit a voluntary disclosure filing in EMMA regarding contract changes away from LIBOR.

What else should I ask if the exposure originates back over a decade?

Some contracts may be in place that pre-date the passage of the Dodd Frank Act in 2010 that now requires, under Commodity Futures Trading Commission (CFTC) rules, that state and local governments and entities to use a Qualified Independent Representative (QIR)/Swap Advisor when engaging in derivative products. Governments need to have a QIR in place to assist them with some legacy transactions if changes are made, and for any new swap transactions.

Should I engage any professional particularly suited to assist?

When discussing derivative and swap transactions with the entity's municipal advisor, ensure that the municipal advisor is qualified and understands the breadth of this market. Governments may need to engage the services of a swap advisor (QIR) to assist them with these transactions, which could be a different party than the entity’s municipal advisor.

While the Department of the Treasury and IRS has provided guidance that changing LIBOR to SOFR in a financing does not constitute a new bond issuance, governments should discuss contract changes with bond counsel/tax counsel to address tax integration matters and ensure there are no federal tax compliance concerns.

What should I do if my entity will be engaging in a transaction within the next year?

When looking to engage in NEW swaps/derivatives, floating rate note transactions, bank loans or direct placements, discuss with your financing team and counterparties what reference rate will be used in the contract. Governments are advised to NOT accept continued use of LIBOR in new contracts, which could trigger the need for changes after 2021 and with that, possible additional fees.

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