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SIFMA Podcast: The Need for Federal Legislation in the LIBOR Transition

In the latest in SIFMA's podcast series, SIFMA president and CEO Kenneth E. Bentsen, Jr. is joined by Chis Killian, SIFMA managing director, securitization and credit, to talk about the need for Federal legislation in the transition away from LIBOR.

SIFMA is supportive of Federal legislation aligned with recommendations from the Alternative Reference Rates Committee to address these situations where contracts cannot be easily transitioned from LIBOR due to legal or regulatory reasons. We believe such legislation would benefit all market participants including LIBOR's end users, from investors to companies to consumers, and would provide four key benefits: (1) certainty of outcomes, (2) fairness and equality of outcomes, (3) avoidance of years of paralyzing litigation, and (4) preservation of liquidity and market resilience.

Transcript

Edited for clarity

[Ken Bentsen] Thank you for joining us for this episode in SIFMA's podcast series. I'm Ken Bentsen, SIFMA's president and CEO. I'm joined today by my colleague, Chris Killian, SIFMA managing director, securitization and credit, for a conversation on the transition away from LIBOR and, in particular, the need for federal legislation to aid that transition.

SIFMA has been engaged on this issue for seven years, since the Alternative Reference Rate Committee, or ARRC, began working on a replacement for LIBOR in the United States. It's a priority for both the industry and the official sector. Chris, can you give us the current state of play?

[Chris Killian] To start, LIBOR is referenced in approximately $223 trillion of financial products. And it's a very shaky foundation because LIBOR is intended to measure interbank lending costs, but those transactions upon which LIBOR is supposed to be based have dwindled in numbers over the years as financial markets and bank-funding models have evolved. Much of today's LIBOR submissions is derived from estimates of transactions and not actual transactions.

So global regulators saw the problem with placing the foundation for global financial markets on this sort of construct nearly 10 years ago, and they began to examine how more-robust alternative reference rates could be identified or developed to replace LIBOR. Since then, and really ramping up in 2017, the key message from the regulatory community has been and continues to be that LIBOR isn't suitable and that market participants must transition to alternative reference rates.

The ARRC, which SIFMA is a member of, identified SOFR as the preferred alternative to LIBOR. In contrast to LIBOR, SOFR is fully transaction-based, referencing the previous day's activity in the repurchase markets, which are very liquid and very active — such that SOFR is based on approximately a trillion dollars of daily transactions that come from a wide range of market participants. And SOFR is administered and published by the New York Fed.

What’s clear is that LIBOR is going away. There’s no doubt about that. In December, there were finalizations [on] proposals from the administrator of LIBOR and the FCA in the U.K., which is its regulator, that most non-U.S. dollar LIBOR tenors will cease publication on December 31st of this year. The main U.S. dollar LIBOR tenors are going to cease on June 30th, 2023. And it’s important to note two less used U.S. dollar LIBOR tenors will also cease at the end of this year, but the real deadline in the U.S. is June 2023.

[Chris Killian] Ken, here’s a question for you: Of the $223 trillion in outstanding LIBOR transactions, the ARRC estimated that 67 percent of that would roll off by June 2023, which leaves about 74 trillion in LIBOR exposure that ends beyond June 2023. What happens to that exposure?

[Ken Bentsen] About $68 trillion of that is comprised of swaps, futures, and related transactions. And many but not all of those transactions can be amended and addressed by industry-wide protocols, such as the ISDA protocol, or by actions by clearinghouses to convert the outstanding positions.

But the remaining $6 trillion or so of exposures are comprised of various types of cash products: bonds, notes, loans, asset-backed securities, and other extensions of credit. The ARRC estimates that about $1.9 trillion of this is comprised of bonds and securitizations, which commonly do not have fallback provisions.

Many of these products were not designed at the time of issuance with a permanent cessation of LIBOR in mind, and in many cases these products are difficult or effectively impossible to amend due to regulatory constraints or practical issues, such as identifying all of the holders of a widely distributed security.

There are tens of thousands of floating-rate securitizations and corporate-bond transactions, and some of those contracts don’t have fallbacks. More commonly, the fallback provisions would result in a floating-rate bond becoming a fixed-rate bond or other contracts’ fallback to the judgment of an issuer, administrator, or other party.

In other words, from a practical standpoint, the existing fallbacks aren’t effective. The outcome of a permanent cessation of LIBOR may frequently not be in line with the expectations of the issuers, investors or customers, and may lead to vast amounts of litigation that ties up courts for years and causes major disruptions in financial markets and with investor portfolios.

The ARRC has taken steps to address this in New York state, where many financial contracts, certainly not all, are governed by New York state law. Chris, do you want to talk about what was done there?

[Chris Killian] The legacy problem was clear to the ARRC, and the ARRC created a working group to look at options and develop recommendations for how to deal with these legacy transactions that we like to call “tough legacy transactions.”

In March of 2021, the ARRC published a proposal for a statutory mechanism to address these ineffective tough legacy transaction fallback provisions, and what the legislation would do is it would create a statutory safe harbor from litigation and replace LIBOR-based fallbacks with those that are recommended by the ARRC, the Federal Reserve, or the New York Fed. And these would be based on SOFR.

The goals of the approach are manifold. One is to provide certainty of outcomes to contract participants. Another is to make sure that those outcomes are equal and fair across all of the market participants. And finally, ultimately this is being done to promote the liquidity and stability of financial markets.

Given that many financial contracts are governed by New York state law, the ARRC initially proposed this legislation in the state of New York. SIFMA supported it — supported the publication of the language and advocated for its passage in New York. And just a couple weeks ago, the New York Assembly and Senate passed legislation that's in line with the ARRC's recommendation on a nearly unanimous vote, and the governor signed the bill. So, Ken, while the New York state legislation is a positive outcome and something we're very happy to see, we believe there's more to be done at the federal level. Can you talk about the reasons for why that is?

[Ken Bentsen] While, as you said, the New York legislation is quite useful in regard to New York-governed instruments or contracts, it's not a full solution for many of the instruments or contracts that are not governed by New York law or addressing such federal issues as the Trust Indenture Act, which is a key factor in this, as well.

Only federal legislation can apply a standard uniformly across all the states, and certainly only federal legislation can affect the Trust Indenture Act. A uniform federal law can promote the benefits provided by New York state for contract certainty, fairness, and equality in outcomes and avoid some litigation in market liquidity across the nation.

While certainly it's conceivable that 49 other states, plus other territories and jurisdictions like the District of Columbia, could attempt to enact similar legislation to New York, it's not really practical and would take a tremendous amount of time, definitely exceeding the period of time when LIBOR will cease to exist. So really, federal law is appropriate. And I might add: Given that the transition away from LIBOR is a federal public policy initiative and priority, it just underscores the need for federal legislation in and of itself.

In addition to this, I talked about the Trust Indenture Act being a federal statute. And the baseline of a trust indenture under the Trust Indenture Act requires unanimous consent to amend the document. In this case, the interest rate on the product. I might add – unless in the original contract, at that original point, that had been changed.

But in most cases, most of these contracts rely on the baseline unanimous consent. And that's not really practical because even if you could find all of the holders and get them to opine or take a position, you're not guaranteed that you would get 100 percent.

So federal legislation would provide narrow targeted relief that would allow contracts to transition to more-robust reference rates without having to deal with the really impossible hurdle of meeting unanimous consent requirements. And federal legislation could also ensure that there are not adverse tax or other consequences to issuers, holders, or consumers. In sum, federal legislation would offer a consistent outcome for all stakeholders and parties, and they would provide certainty about the outcome of the transition away from LIBOR.

And of course, lastly, federal legislation would help to avoid litigation gridlock, whether it's trustees seeking guidance from a court where it's not clear or various parties litigating over whatever fallback mechanism would be chosen without that certainty. And that's important not just to avoid unnecessary litigation but also to ensure market stability and liquidity.

Chris, obviously, a lot of work has been done over, really, the past seven years, since the formation of the ARRC. And then fast-forward 2017, with the establishment of SOFR, and now addressing these legacy contracts. What do you see next in terms of this? What's the status of potential federal legislation?

[Chris Killian] There was a hearing today, April 15th, in the subcommittee of the House Financial Services Committee, where legislation from Representative Brad Sherman, who's from California, was published and discussed. And the witnesses at the hearing were from federal regulators, like the Fed and the OCC and the Treasury.

The hearing, I think, was positive, and regulators expressed agreement with the need for federal legislation. And that legislation, hopefully, will expediently move through the congressional process because, despite the fact that the main U.S. dollar LIBOR tenors will be around until 2023, it takes a fair amount of time to implement changes.

In our mind, that legislation is something that needs to happen this year, as soon as it can. And that gives everybody ample time to change documents, update systems, be prepared to deal with different reference rates and all of those things that people need to do operationally and technically.

[Ken Bentsen] Great. Thank you, Chris. So, more to come. And I want to thank you for participating today, and also thank our listeners for tuning in to hear our views on this issue involving federal legislation and the transition away from LIBOR. To learn more about this issue and SIFMA and our various work to promote effective and resilient capital markets, please visit us at www.sifma.org. And thank you, again, for joining us.

April 19, 2021

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