

# **Bond Case Briefs**

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## **IRS and Treasury Release Final Guidance on Libor Transition.**

The Internal Revenue Service and Department of the Treasury have released final guidance on the transition away from Libor, setting Secured Overnight Financing Rate as an alternative and creating noncovered modification in the place of fair-value.

The cessation of Libor matters to the muni market because existing debt and contracts may reference it, potentially impacting variable-rate debt, swaps and contracts, among other things.

The final regulations hope to swap out the Libor rate that is no longer being published as of Dec. 31, 2021, but will be around until June 2023, with a new formula that won't change the economics of the deal or cause reissuance of the particular debt.

"It seems to follow pretty closely the recommendations of the Alternative Reference Rates Committee, the New York Fed group that's overseeing the Libor transition and it seems to provide needed flexibility for municipal issuers who may need to change the terms of outstanding deals in order to accommodate the loss of Libor without having to undergo a reissue," said Michael Decker, senior vice president of federal policy and research at the Bond Dealers of America.

"I think that's the main thing that the community was looking for and I think it's something that generally the community will be supportive of."

The proposed regulations, released on Oct. 9, 2019, leaned on fair market value to ensure the value of the debt stayed the same.

"How do you differentiate changes that are just swapping out the old formula for the new formula?," said Johnny Hutchinson, partner at Squire Patton Boggs and member of the National Association of Bond Lawyers' board of directors. "The way that the Proposed Regulations tried to do that was to say, the fair market value of your debt has to be the same, both before and after the change."

"But people get very skittish when you hand them a certificate signed that says these bonds are being sold at fair market value," he said.

Muni market participants often say that calculating marked-to-market fair-value poses challenges for municipal bonds because they don't often trade every day as stocks do. SOFR was another safe harbor outlined in the Proposed Regulations but has been somewhat controversial due to the short history of the formula being published, Hutchinson said.

With the final regulations, set to be published in the Federal Register on Jan. 4, the SOFR rate is mentioned as a qualified rate.

"A qualified rate is a SOFR-based rate or other qualified replacement rate, so long as it is in the same currency as the discounted IBOR or is otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in that currency," law firm

Cadwalader Wickersham & Taft said.

But satisfying the requirements with a constant fair market value has been changed.

“That requirement has been completely scrapped, it looks like from an initial read,” Hutchinson said. “Instead, the way that the Final Regulations are going to test whether the parties are really making changes beyond just swapping in a new formula for the old formula, is there are a list of what are called noncovered modifications and they all relate to changes in the timing or amounts of the cash flows on the debt.”

The shift in approach basically says as long as you don’t make these specific noncovered modifications, the IRS or Treasury won’t inquire as to whether the fair market value is the same.

But some modifications to existing agreements may include both covered and noncovered components, which should be tested on a standalone basis, the regulation says. In a way, this makes things a bit more definitive for bond counsel as when a modification event occurs, they’re able to pull up the list of noncovered modifications and see whether the specific event falls under it.

But still some uncertainty exists as bond counsel familiarize themselves with the long list of noncovered modifications. “If that’s how the regulations work, I think that’s a good thing,” Hutchinson said. “It’s helpful and it allows us to apply the rules with, a little bit more certainty than we had before.”

For issuers, this may result in additional time and money spent with bond counsel. “That’s what the attorneys do, they have to test whether or not they can be qualified,” Emily Swenson Brock, director of the federal liaison program at Government Finance Officers Association. “It’s hard because that adds a lot of cost and it adds a lot of time.”

There is currently legislation passing through Congress that could affect that would allow for non-penalized modifications to outstanding contracts when LIBOR ceases to exist in June 2023. It passed the House in December in a 415-9.

It follows New York State legislation that hopes to minimize disruptions by allowing “tough legacy” contracts or those that expire after June 2023 and do not have fallback language specifying an alternative to use SOFR.

In a letter to Speaker of the House Nancy Pelosi and Republican Leader Kevin McCarthy GFOA and many other industry groups hoped to tip the scale in the industry’s favor. “Without federal legislation to address these contracts, investors, consumers, and issuers of securities may face years of uncertainty, litigation, and a change in value,” the letter said. “This would thereby create ambiguity that would lead to a reduction in liquidity and an increase in volatility.”

By Connor Hussey

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