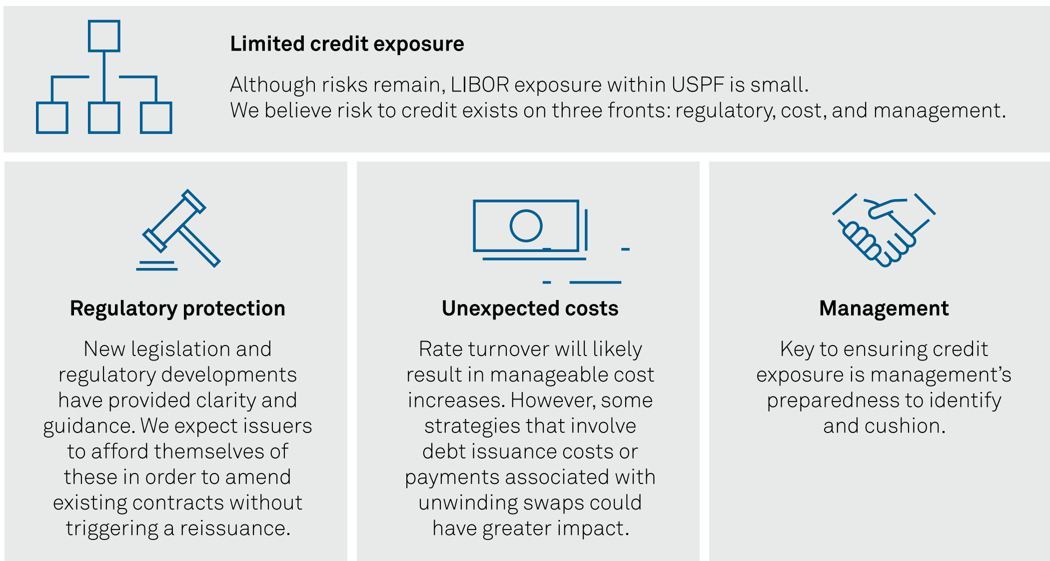
[Bond Case Briefs]

Municipal Finance Law Since 1971

[S&P Credit FAQ: Will LIBOR's Expiration Adversely Affect U.S. Public Finance Issuers?]

The London Interbank Offered Rate (LIBOR) as we know it has about a year left. The one-year countdown until the cessation of one-, three-, six-, and 12-month U.S. dollar LIBOR publication by the ICE Benchmark Association begins July 1, 2022. While the one-week and two-month LIBOR ceased to be published effective Jan. 1, 2022, the remaining tenors cover the vast majority of LIBOR-based exposure for U.S. Public Finance (USPF) issuers.

What We Are Watching



Source: S&P Global Ratings.

USPF issuers service most debt by applying cash available from total operating revenues, net of expenses. Because the notional amount of LIBOR exposure tends to be modest relative to USPF issuers' overall debt service obligations, it is our view that substituting a successor benchmark for LIBOR-exposed instruments will not impair an issuer's capacity to meet debt service payments. Even adjustment factors to reconcile LIBOR with its successor benchmarks are imperfect and contribute to modestly higher interest rates. We view the USPF sector's use of cash available for debt service across all instruments as distinguishing it from some other sectors, in which the capacity to meet obligations is specific to the debt issue's cash flows and not to the issuer's broader cash flows. In the former structure, cash flows tend to be tightly aligned with debt service obligations, and even small changes in interest rates can have consequences, which we do not view as an exposure for USPF issuers.

In our ongoing due diligence calls, issuers across USPF sectors have afforded us insights into preparatory and transitional trends as they continue to work with their counterparties to migrate to a new benchmark or rely on newly established legislation to enact SOFR as the replacement benchmark. There is belief among issuers that the cost increase as a result of imperfect harmonization between LIBOR and SOFR will be inconsequential to overall operating performance and subsequent debt service obligations. Below we answer some frequently asked questions to address these issues.

Frequently Asked Questions

What credit risks remain for USPF issuers?

Although we believe recently passed legislation will aid the municipal bond market in achieving a smooth transition from LIBOR to an alternative benchmark, in certain circumstances management's adoption and execution of a strategy that limits financial exposures could be key to credit stability. Most issuers within public finance that have LIBOR exposure exists predominately in the form of variable rate debt which are often hedged with fixed payer swap instruments. Risks could remain acute for some issuers if management fails to identify and address exposure adequately, resulting in elevated basis risks and increased costs through untimely or unmatched transition between their debt obligations and hedging instruments. Alternatively, fixing variable-rate portfolios through reissuance in unfavorable market conditions could subsequently weaken an issuer's budgetary performance, flexibility, and liquidity. In our view, a credit-sound strategy by management includes the identification of an issuer's complete LIBOR exposure with proactive measures already in place to amend any existing documentation with fallback language, while budgeting for some increased costs. We believe there is risk associated with strategies that have not yet identified which obligations need to be amended and/or will not assume increased cost of capital as part of their annual expenses.

Further limiting any credit exposures that USPF issuers might face as they transition to benchmarks that succeed LIBOR are federal legislative and regulatory developments that define the replacement benchmark as the Secured Overnight Financing Rate (SOFR), where financing documents are silent on the question of substitution. Nevertheless, the parties to the financing need to agree on a spread adjustment to reconcile the differences in these measures of interest rates. While time still remains, many USPF issuers have indicated that they have already assessed potential exposure to LIBOR across all obligations and are either in or have completed discussions with their counterparties.

What recent regulatory developments have provided guidance for USPF issuers?

The Federal Reserve, the Federal Deposit Insurance Corp., and the Office of the Comptroller of the Currency prohibited new contracts to use LIBOR as of Jan. 1, 2022, and S&P Global Ratings believes that transition risk for USPF issuers would exist mainly in legacy contracts that have proven difficult or problematic to amend. The recent passing of the federal Adjustable Interest Rate (LIBOR) Act has created a safe harbor for those who select SOFR as the replacement benchmark, and they will not be subject to legal liability. The law also provides that the Federal Reserve can select a SOFR-based replacement for LIBOR in contracts where there is no fallback language that specifies LIBOR or where any fallback language is not sufficient, maintaining an active rate for those contracts. This federal law supersedes the New York State law that provided similar fallback language. While many issuers have already worked with their lenders to adopt fallback language, some cited legislation as their preferred method of transition.

Clarity on avoiding a taxable event was published on Jan. 4, 2022, when the IRS provided guidance on the transition from LIBOR. The guidance states that the IRS will not consider the transition a taxable reissuance if the LIBOR replacement includes any rate recommended by the Alternative Reference Rates Committee or the Federal Reserve. While these new rules have a 12-month grace period beyond the cessation of LIBOR, the additional timing affords issuers the confidence to transition from LIBOR without the concern of a forced reissuance in a rate environment that could be detrimental to their overall cost of capital.

What risks associated with derivatives remain for USPF issuers?

For swaps and other derivative instruments, similar protocols are in place to facilitate a smooth transition that provides robust fallbacks for those parties who elect to adopt the protocols. The International Swaps and Derivatives Association (ISDA) has published the IBOR Fallbacks Protocol and Supplement, effective Jan. 25, 2021, which identifies SOFR as the successor to LIBOR, but leaves open to negotiation between the issuer and its counterparty the spread adjustment for reconciling SOFR's interest cost to LIBOR's, which can define financial capacity to meet debt service requirements.

While not affecting all sectors in USPF, the Financial Accounting Standards Board (FASB) has proposed an update to accounting standards on April 20, 2022, to include flexibility regarding hedge accounting qualifications during the LIBOR transition period. Previously, in the event a hedge was deemed no longer highly effective, and hedge accounting was discontinued, issuers would have reported the change in fair value of the non-hedged interest rate swaps as an interest expense, inflating their recorded expenses and possibly affecting debt service coverage requirements that may be required by individual indentures and other covenants. Should FASB adopt these proposed changes, the risk is mitigated as long as management applies for relief through Dec. 31, 2024.

What risks do USPF issuers face if they transition to another benchmark that is not SOFR?

Although the prospects for transitioning to benchmarks other than SOFR are remote, transition to an index that results in higher interest rates relative to current interest rates, or that triggers a taxable reissuance under the tax code, might negatively pressure credit ratings if the costs are material to cash available for debt service and debt service. While there are other replacement rates available, only SOFR being a substitute for LIBOR will enable a safe harbor protection under the new regulations.

What does S&P Global Ratings expect the transition from LIBOR to look like from here?

Based on our polling of issuers across USPF sectors, we have found that there is considerable variability among issuers in their preparation for LIBOR's expiration. Although many have completed discussions with counterparties surrounding the selection of replacement benchmarks and adjustment factors, there are also many whose discussions remain in the preliminary stages. We do not expect negative credit consequences among the latter group because their LIBOR exposure tends to be small and any basis differential between LIBOR and its successor after applying an adjustment factor should be inconsequential. Moreover, the modest ratio of LIBOR instruments relative to total debt instruments, when viewed against the backdrop of debt payments that come from cash available for debt service from all revenue sources, rather than those dedicated to a specific issue, further limits the potential for negative financial pressures attributable to the transition. Legislative and regulatory guidance that will facilitate the transition should further insulate credit quality. We believe that there will be additional costs associated with the transition and surveyed issuers believe these additional costs to be nominal to their budgetary performance.

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