FedFin Client Report

Thursday, April 15, 2021

HFSC Readies LIBOR-Transition Remedy

Client Report: LIBOR5

Executive Summary

Following Fed agreement earlier this year that federal legislation is needed (see Client Report **FEDERALRESERVE61**), the HFSC Capital Markets Subcommittee today laid the groundwork for rapid introduction and action on Chairman Sherman's draft bill. Although Republicans raised legal questions about the measure, none disagreed with its purpose or the need. Witnesses from the FRB, FHFA, the OCC and Treasury all supported action, describing potential systemic risk if legacy contracts do not remain binding despite work by counterparties such as the GSEs to remove LIBOR benchmarks. The SEC has not yet taken a position on the bill but is open to it. We expect rapid action to address an array of technical issues in the draft legislation followed by quick full Committee votes. However, "quick" here may still take months even as nothing along similar lines has yet to advance in the Senate. As a result, despite the bipartisan nature of today's hearing and consensus on the need for federal preemption, it may be a close race between new law and LIBOR's demise.

Analysis

Opening Statements

Chairman Sherman emphasized the need for timely federal legislation targeting legacy contracts, highlighting the non-partisan nature of the issue and the need for federal intervention. He and Ranking Member Huizenga (R-MI) agreed on the non-partisan nature of the issue and the challenge posed by legacy contracts without fallback language. Rep. Huizenga noted however that legislation does need to be collaborative and open to input, emphasizing the need to both ensure market stability and market liquidity.

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Chairwoman Waters (D-CA) also delivered a brief opening statement, reflecting on the manipulation of LIBOR by big corporations and emphasizing the need to protect consumers, investors, and the U.S. financial system as markets transition away from LIBOR.

Testimony

Dan Coates, Senior Associate Director of the Office of Risk Analysis and Modeling at FHFA supported federal legislation to reduce disputes over contracts that do not address the permanent end of LIBOR. He expects ARRC soon to announce the final spread-adjusted rate for consumer products, with the GSEs then making announcements about successor rates for all legacy LIBOR products later this year. Mr. Coates indicated FHFA's particular focus is on ensuring a seamless transition away from LIBOR for those with adjustable-rate mortgages and its continued work with other agencies to prevent any payment shocks when LIBOR ends. Mr. Coates also noted that FHFA's regulated entities have already moved almost entirely to SOFR, and GSEs have stopped taking on new LIBOR-indexed CMO exposure and CRT transactions.

John Coates, Acting Director of the Division of Corporation Finance at the SEC noted that disclosures related to the discontinuation of LIBOR may be required, including the disclosure of risk factors, management's discussion and analysis, board risk oversight, and financial statements. To meet their disclosure requirements, companies may thus need to adjust their IT systems, internal controls, and related policies. Mr. Coates also noted that broker-dealers, CCPs, and exchanges may need to consider transition-related impacts, warning that broker-dealers should be particularly mindful of their sales practice obligations.

Brian Smith, Deputy Assistant Secretary for Federal Finance at the Treasury Department urged federal legislation to address LIBOR transition issues, specifically for "tough legacy" contracts. He also noted that federal legislation could both ensure Treasury has the authority to address tax consequences of the LIBOR transition and amend the Higher Education Act's reference to LIBOR for Special Allowance Payments under the legacy guaranteed federal student loan program. He applauded New York's passage of LIBOR transition legislation.

Mark Van Der Weide, FRB General Counsel urged federal legislation to mitigate risks related to legacy contracts that is narrowly targeted to address legacy contracts with no fallback language. Federal legislation should not, however, affect legacy contracts with fallbacks to another floating rate, nor should it dictate what benchmark rate market participants should use in future contracts. Mr. Van Der Weide noted also that federal legislation should preempt state legislation and law.

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Kevin Walsh, Deputy Comptroller of Market Risk Policy, supports legislation but said the OCC will work with Congress to "perfect" it, signaling some remaining concerns. He also praised new ISDA protocols and recent New York state law which he believes will help ease the transition, reducing the risk of disruption in the derivatives market. However, he noted that transitioning legacy contracts will impact consumers, bringing the Truth in Lending Act into play, requiring a CFPB proposal to amend Regulation Z.

Q&A

- SOFR: Rep. Huizenga inquired about potential problems using SOFR; Mr. Walsh does not see any. Rep. Wagner (R-MO) asked how SOFR will address the risk of manipulation highlighted by LIBOR; Mr. Smith noted that SOFR is based on a robust set of transactions made by a diverse set of market participants. Rep. Foster (D-IL) asked if there are systemic differences between LIBOR and SOFR, worrying that there may be winners and losers if the rates have different basis points; Mr. Van Der Weide acknowledged that, although SOFR may show more volatility on a daily basis than LIBOR, SOFR and LIBOR averages correlate closely together. He thus believes there will not be significant winners or losers in the long term. Rep. Hill (R-AR) asked about community banks' discomfort with SOFR; Mr. Walsh explained that community banks have raised concerns about SOFR's unsecured construct and cash-flow challenges. Mr. Walsh noted that there is work being done to attempt to both create a credit spread and find a forward-looking term rate for SOFR. Rep. Davidson (R-OH) worried that a spike in the repo market similar to that of September 2019 might occur again, and asked about its implications on the system; Mr. Van Der Weide acknowledged the need to improve the resiliency of Treasury markets, explaining that short spikes in SOFR will not have a significant volatility effect on the usage of the rate in contracts and that SOFR's averaging mechanism will manage volatility in repo rates. Rep. Foster (D-IL) worried about systemic risk from institutions underlying SOFR; Mr. Van Der Weide noted that SOFR is based on many underlying transactions and comes from a variety of market participants.
- Federal Legislation: Chairman Sherman asked if there should be rapid federal legislation; Mr. Dan Coates, Mr. Smith, Mr. Van De Weide, and Mr. Walsh agreed. Although the SEC has not formally taken a position on the legislation, it is ready to support the committee's efforts. Chairman Sherman worried about increased price volatility or discounting of instruments that lack clear fallback language in the absence of a clear solution for LIBOR-based contracts; the SEC witness agreed. Chairman Sherman urged passage of legislation prior to the end of October, noting the need to provide agencies time with which to adopt regulations. Rep. Huizenga asked about potential risks without legislation; Mr.

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Walsh noted massive litigation concerns. Rep. Vargas (D-CA) asked about potential risks to consumers; Mr. Smith noted that consumers could see disruptions in their mortgage payments, credit card payments, and lending. Rep. Huizenga asked if federal legislation would need to preempt state law; Mr. Walsh said that federal legislation would help provide consistency across all markets. Rep. Hill (R-AR) inquired about the recent New York state law addressing this issue; Mr. Van Der Weine noted that while the New York law covers many instruments, federal legislation is needed for a unified solution.

- Legal Issues: Rep. Huizenga worried that Congress may be susceptible to litigation challenging the constitutionality of interfering with private contracts; Chairman Sherman said that the contracts clause limits the power of state governments, not the federal government. Rep. Stivers (R-OH) worried that the Trust Indenture Act could harm investors without LIBOR, asking if the SEC would be able to issue narrow guidance related to the application of TIA and the LIBOR transition; Mr. John Coates agreed that TIA can create problems, noting that the SEC could provide exemptive relief, although this would require notice and comment rulemaking. He noted however that the LIBOR draft legislation would address this issue with TIA, limiting the SEC's potential involvement.

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