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Legislation is needed to ease shift from Libor

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Markets Insight

After almost four decades of use, Libor is coming to a long-planned and much-anticipated end as the debt pricing benchmark for millions of borrowers around the globe.

This presents an immense challenge. Specifically, how do you transition from such a ubiquitous index without causing widespread financial disruption?

Floating rate mortgages, student loans, even fixed-income investments in a traditional 401k pension plan in the US make or receive payments based on this rate. For more than 30 years, Libor has been used for almost every financial product involved in consumer lending.

At the end of 2020, Libor was the benchmark for over $6.2tn outstanding consumer and corporate loans, $2.7tn cash investments and $214tn hedging instruments in the US alone.

After the global scandal over the manipulation of the rate, regulators are putting it to bed forever from mid-2023. But millions of consumer and business contracts with terms based on this rate remain outstanding.

Industry experts, global regulators and the US Federal Reserve have been working for years to manage a transition away from Libor. Progress has been made, with many new consumer and business contracts today tied to a different rate.

The Secured Overnight Financing Rate is an interest rate that allows large financial institutions to borrow from one another on an overnight basis. Futures are beginning to trade with this rate and liquidity is growing as more contracts include it in their terms. Unfortunately, even with a strong, reliable replacement rate available, some challenges remain with millions of Libor contracts left in limbo. Put simply, many consumer-based contracts signed before Libor was set to expire do not specify what rate the contract would migrate to in the absence of the benchmark. Currently, the US has roughly $16tn of these $73.1tn contracts — now known as "tough legacy" Libor — standing behind millions of consumer and business contracts where no fallback language exists.

And to be sure, no one can wave a magic wand and change the rate on these loans. "Tough legacy" contracts often have very high legal and operational hurdles to changes in their terms, not the least of which is identifying, contacting and negotiating with the large number of contractual parties who must unanimously consent to any amendment.

> 'Congress has the power to ensure an economically neutral outcome without years of court wrangling'

As a result of the looming uncertainty, many have called for legislation to address the issue. Importantly, US Treasury Secretary Janet Yellen and Federal Reserve chair Jay Powell recently echoed those calls during congressional testimony. Powell called federal legislation "the best answer" and Yellen declared that "Congress does need to provide legislation for the Libor transition".

While market participants typically loathe legislative action related to contractual matters, they have determined that legislation is not only the best option, but the only viable option. It is needed to safely, fairly and equitably transition "tough legacy" contracts while avoiding a legal and financial mess that would clog our court system for years, create confusion for borrowers and degrade the value of fixed-income investments for savers, pensioners and retirees.

New York recently took the lead and enacted a Libor transition law. The bill came on the heels of a great deal of work from parties on all sides of these contracts with conflicting incentives. This was a big, positive step. But many contracts do not fall under New York law, and it would be unfair to have some consumers, businesses and bond investors receive protection and others not — not to mention for the same consumer to receive protection on an investment in their 401k but not on their mortgage.

As a result, federal legislation has been introduced in Congress that creates a safe harbour and allows for consistent treatment for all borrowers, investors and lenders.

We are at a critical moment and need absolute certainty as it relates to rates and products on which ordinary Americans rely. While they may not understand how the system works, they will surely understand the disruptions to their lives if something is not done to smooth the transition away from Libor. Only Congress has the power to ensure an economically neutral outcome without years of court wrangling and confusion. Federal legislation for all Libor-based contracts is the best way to end this saga once and for all.

The writer is chief executive of the Structured Finance Association. The SFA's Kristi Leo contributed to this article

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