Statement for the Record

On behalf of the

Structured Finance Association

before the

Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

of the

United States House of Representatives

April 14, 2021

Introduction

The Structured Finance Association[1] (SFA) appreciates the opportunity to submit a statement for the record for the hearing titled, "The End of LIBOR: Transitioning to an Alternative Interest Rate Calculation for Mortgages, Student Loans, Business Borrowing, and Other Financial Products." The discontinuation of the London Inter-Bank Offered Rate ("LIBOR") is one of the biggest challenges currently facing global financial markets. The subcommittee's attention to this important issue is both critical and timely. Our comments primarily focus on the need for federal legislation to support the transition away from LIBOR for contracts that have no other realistic means to transition and the concern a state-by-state legislative approach could lead to an inconsistent patchwork of requirements, thus increasing the risks of a disruptive and costly transition with broad public and investor confusion.

SFA is well suited to provide this perspective given our founding mission to support a robust and liquid market while safeguarding essential protections for investors, consumers and the financial system. Importantly, our statements reflect the collective insights across our more than 370 members who represent all sides of the structured finance market – that comprise the largest cash (non-derivative) component of the tough legacy LIBOR contracts, as discussed further below – from investors (many of which are pension plan and mutual fund managers, insurance companies and depository financial institutions) to lenders, issuers and servicing agents.

Discontinuation of LIBOR

Given significant concerns regarding the viability of LIBOR as a robust benchmark rate, a monumental multi-year global effort began over seven years ago to transition millions of contracts away from LIBOR. With approximately $400 trillion in financial contracts linked to LIBOR worldwide, the cessation of this benchmark presents significant risks across the global financial markets, impacting borrowers and consumers, lenders, investors, banks, and other market participants. The scale of the transition has rightly been compared to that of the multi-country currency changeover to the Euro currency.

On March 5, 2021, the U.K. regulator charged with LIBOR oversight, the Financial Conduct Authority, and the administrator and publisher of LIBOR, ICE Benchmark Administration, provided much-anticipated clarity regarding LIBOR's final cessation dates. In coordination with U.S. regulators, it was determined that the least used U.S. Dollar LIBOR rates, 1 Week and 2 Month tenors, will end on December 31, 2021, along with all other non-U.S. Dollar LIBOR rates, while the most used U.S. Dollar rates, overnight and 1-, 3-, 6- and 12-Month tenors, will end on June 30, 2023. Extending the publication of the heavily used U.S. Dollar

[1] The Structured Finance Association (SFA) is the leading securitization trade association representing over 370 member companies from all sectors of the securitization market. Our core mission is to support a robust and liquid securitization market and help its members and public policymakers grow credit availability and the real economy in a responsible manner. SFA provides an inclusive forum for securitization professionals to collaborate and, as industry leaders, drive necessary changes, advocate for the securitization community, share best practices and innovative ideas, and offers professional development for industry members through conferences and other programs. For more information, visit www.structuredfinance.org.

LIBOR tenors was to support a smoother transition away from LIBOR by allowing many "legacy USD LIBOR contracts to mature before LIBOR experiences disruptions", according to U.S. regulators.[2]

In the United States, retail financial products from floating rate mortgages, student loans and even bond investments in traditional 401k or pension plans calculate interest based on LIBOR rates. Similarly, it is also used in floating rate business loans, lines of credit, securities and interest rate hedges. In fact, for the past 30+ years LIBOR has been used for almost every consumer and business floating rate product. At the end of 2020, LIBOR exposure in the United States accounted for over half of the $400 trillion globally, used as the benchmark for over $6.2 trillion outstanding consumer and corporate loans, $2.7 trillion cash investments, and $214.0 trillion hedging instruments.[3]

We believe significant disruption to consumers and businesses, as well as waves of litigation, are inevitable unless Congress works quickly to provide a meaningful solution that offers fair, equitable and consistent treatment for all tough legacy contracts that still lack an adequate replacement mechanism under U.S. law.

Pressing Need for a Federal Solution to Address "Tough Legacy"

Led in the U.S. by our financial regulators and the Fed-convened Alternative Reference Rate Committee (ARRC), the carefully choreographed changeover away from LIBOR, which will be a decade long undertaking by the mid-2023 cessation date, has already greatly minimized the legacy contracts that remain. Nevertheless, there remains a meaningful legacy population still including longer term, difficult to address contracts such as mortgages, student loans, business loans and capital market transactions that finance and hedge these legacy LIBOR-based contracts, thereby affecting a broad range of American households and businesses including pension plan and other retirement savers, millions of Americans with mortgages and student loans, small and large businesses, and financial institutions.

It is hardly surprising that, after more than 30 years of publication, the legacy contracts that were entered into prior to the announcement of LIBOR's likely end simply did not contemplate the cessation of LIBOR. Still, after the call to end LIBOR, the development and widespread adoption of a trusted replacement rate to LIBOR was required. Therefore, when LIBOR disappears it is unclear what benchmark rate will underpin interest payments unless the contracts are amended, but systemic operational and legal challenges make doing so for some contracts realistically impractical.

Even so, much progress has been made to address the $73.1 trillion[4] U.S. governed legacy LIBOR contracts that will remain outstanding after LIBOR's end. This effort includes the almost unimaginable task of amending of tens of trillions in U.S. contracts to incorporate an effective replacement rate mechanism where none existed. Even with this well-organized multi-year effort, we estimate that over $16 trillion

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[2] Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (November 2020). *Statement on LIBOR Transition* *https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20201130a1.pdf*

[3] Alternative Reference Rates Committee. (March 2021). *Progress Report: The Transition from U.S. Dollar LIBOR* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/USD-LIBOR-transition-progress-report-mar-21.pdf

[4] Ibid.

contracts have no realistic means to be renegotiated, so called “tough legacy” contracts, posing an enormous risk to the financial system and the underlying borrowers, investors and banks.

These tough legacy contracts often have very high legal and operational hurdles not the least of which is identifying, contacting, and negotiating with the large number of contractual parties who must consent to such an amendment. For instance, in each and every widely distributed bond, there is often upwards of many hundreds of bondholders who must be involved in the negotiation. Moreover, due to investor privacy constraints and operational hurdles, even simply identifying and communicating with bondholders is very challenging and time consuming, making unanimous consent across those bondholders to legally amend the benchmark rate practically impossible.

U.S. regulators have acknowledged the difficulty of these tough legacy contracts, and they have even supported the temporary extension of the most-used U.S. Dollar LIBOR tenors until mid-2023 to allow the natural roll off of even more contracts. In spite of this, there will still be over $16 trillion of tough legacy contracts outstanding after mid-2023.

Recognizing the significant economic, operational and legal risks of these $16 trillion contracts, SFA investors, bond issuers, lenders, paying agents and servicers members have worked extensively with each other, and with consumer groups, regulators and other sector participants, to evaluate potential solutions. Early in the process of managing away from LIBOR, many of these market participants expressed concern about the use of legislative action that would affect previously agreed contractual matters. However, the cessation of this critically important benchmark rate presents such a unique challenge that other alternatives examined were inoperable, led to potentially inequitable outcomes for investors, consumers and lenders, presented extensive and costly litigation risk, or all the above.

After much discussion amongst our members and stakeholders, SFA members found that legislation is not only the best option, but the only viable option to safely, fairly, and equitably transition tough legacy contracts while avoiding a legal and financial mess that would clog our court system for years. Moreover, it became clear that, absent congressional action, the remaining challenges of the LIBOR transition will create a great deal of confusion for borrowers and investors while degrading the value of bond investments for savers, pensioners, and retirees.

With that as background, SFA market participants identified five key principles of a legislative approach:

- **Minimize any value transfer among the contractual parties**
- **Use a single, consistent replacement benchmark for all similar LIBOR contracts** based upon a liquid, robust replacement benchmark, agreed to be Secured Overnight Financing Rate “SOFR”
- **Minimize litigation risk through a comprehensive but narrow safe harbor** that provides adequate operational flexibility for billing and paying agents to implement the use of the new replacement benchmark
- **Narrowly scope legislation to facilitate the transition away from LIBOR without impacting investor, consumer or other counterparty rights and protections**
- **Do not impact contracts that already have a sufficient replacement mechanism** unless contract parties opt-in on their own

SFA is strongly supportive of this prospective federal legislation aligned with the ARRC's recommended legislative model, as it is consistent with our five key principles.

Further, as you likely know, recently, both Chairman Powell and Secretary Yellen expressed their support for federal legislation. On February 24, 2021, Jay Powell, Chair of the Federal Reserve, called federal legislation the "best solution" to address outstanding legacy contracts that will have not run off by June 2023. On March 23, 2021, Treasury Secretary Janet Yellen agreed with Chairman Powell's assertion and stated that the transition of certain legacy contracts would be difficult without legislation, specifically noting, "Congress does need to provide legislation for the LIBOR transition." We understand that these statements of support are the result of meaningful examination of the issues and challenges involved by both the Federal Reserve and Treasury Department.

Only a federal legislative approach to fixing inadequate LIBOR replacement provisions can offer a comprehensive solution that would apply a consistent, fair and transparent approach to protect all consumer and business borrowers, investors and lenders of tough legacy contracts under U.S. law and promote financial stability by eliminating ambiguity and confusion, thereby reducing legal uncertainty and risk of mass litigation, and reducing any adverse economic impact on financial contracts.

State-by-State Patchwork Approach is not a Viable Solution

On April 6, Governor Andrew Cuomo of New York signed AB164B[5] into law. The legislation provides businesses and consumers paying or receiving LIBOR-based payments crucial clarity, minimizing adverse economic impact and legal uncertainty in New York-based tough legacy contracts. The bill passed by the New York state legislature was consistent with the ARRC legislative model

This was a big, positive step forward in the orderly transition of LIBOR as we estimate almost half of tough legacy contracts are governed in New York State. Building off this legislation established in New York State, a uniform federal framework would expand the protections to also include the over $7 trillion tough legacy contracts remaining across the United States, allowing for all tough legacy LIBOR contracts to transition on time and in an equitable and fair manner. Timely and consistent treatment is crucial for the acceptance of the replacement rate by the investing and borrowing public. The success of the transition ultimately depends not only on the coordination across easily amendable contracts, but also on the positive and timely resolution of tough legacy contracts.

The most important reason for a federal legislative approach is to avoid the foreseeable downside risk to a state level approach. Simply put, a state-by-state approach would provide fewer comprehensive protections than what could be achievable at the federal level given the very limited time remaining until LIBOR's end in just over two years. Additionally, we risk a patchwork of varying state laws, which would compromise the very intent to provide a smooth transition.

State-by-state solutions cannot ensure all borrowers, lenders, investors, and financial intermediaries of tough legacy contracts have the same fair, equitable and consistent treatment across the country which

[5] https://legislation.nysenate.gov/pdf/bills/2021/A164B

is paramount to ensuring the public and market confidence in the fairness, viability and liquidity of the replacement rate they receive for the remaining term of their contract.

Individuals would need to but would have no basis for understanding a different replacement rate used for an individual's mortgage versus their student loan and/or bond in their 401k. Retail and institutional investors may find themselves with certain bonds that have a new little-used replacement rate that decreases its liquidity and value. Securitization issuers may move from having LIBOR loans funded with LIBOR securities to those assets and liabilities referencing different rates – or a corporation with hedging instruments that are no longer providing the protection to the same reference rate. Any states that take no legislative actions will fail to articulate a path forward at all, leaving Americans and their businesses with potentially negative economic consequences and legal costs needed to protect their interests.

Given the ordinary complexity and significant time and resources required to move legislation through individual state government processes, attempting to also do so with one consistent model is unfathomable especially given the individualized state processes and underlying state laws, and limited time remaining until the mid-2023 deadline. Not to mention, federal legislative actions would still be necessary to address certain ambiguity, in some contracts, to the implementation of state legislation. As a result, borrowers, investors and lenders cannot rely on an approach that is dependent on separate and distinct state legislative sessions which vary extensively across the country.

In order to avoid the potential for wide-spread litigation, the timing of legislative action matters. Paying agents, lenders, servicers, investors and other service providers ideally need at least a year to operationalize, communicate and accurately bill borrowers and pay lenders and investors on millions of contracts – a task made much more difficult when a lack of national uniformity regarding changes in the benchmark rate exists. Without an appropriately authorized alternative solution, some parties responsible for directing LIBOR-based calculations in structured finance transactions have already notified bond investors and issuers that they will seek court direction to determine the appropriate replacement rate and mechanism. This approach would lead to a patchwork solution for consumers, and present a great deal of confusion.

But if this path were to be taken, in order to have sufficient time to not only seek that judicial direction through state courts on tens of thousands of contracts but to also implement the necessary operational and legal changes needed to calculate and bill those payments, calculation and paying agents will likely need at least 12 months prior to LIBOR's end to start the court process if a legislative solution fails to materialize. To be clear, this is an action market participants do not want to have to take. As such, they have been actively involved in every effort outlined to find a viable solution to these tough legacy contracts.

By providing the certainty of an equitable, liquid and transparent replacement rate and eliminating the potential for costly litigation, the legislation recently passed in New York State will serve to protect New York consumers, investors and other market participants if their contracts are governed by New York law. Similar legislation – adopted at the federal level – would provide the same protections to help ensure all consumers, investors and borrowers receive equitable and fair treatment regardless of where their contract is governed.

Conclusion

We are at a critical moment in the LIBOR transition and there is a need for absolute certainty as it relates to rates and products Americans rely on for legacy contracts. All borrowers and investors need a smooth transition away from LIBOR to avoid uncertainty, confusion, and potential mass litigation. The Structured Finance Association agrees that federal legislation is the best solution and is committed to working with you on responsible legislation that will ensure stability for consumers and businesses though this massive transition. Congress has the power to ensure as economic-neutral outcome as possible that can guarantee all U.S. tough legacy contracts are provided fair, consistent treatment thereby minimizing any value transfer and confusion. Failure to address the matter with comprehensive federal legislation risks foreseeable market disruption, confusion, and legal disputes for years to come.