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Introduction and Background

Chairman Brown, Ranking Member Toomey, and other members of the Committee, my name is Michael Bright, CEO of the Structured Finance Association, or "SFA." On behalf of the member companies of SFA, I thank you for inviting me to testify. I also thank you for your focus on finalizing the transition away from LIBOR for millions of consumers and investors with loans or savings tethered to these rates.

The Structured Finance Association is a consensus-driven trade association with over 370 institutional members representing the entire value chain of the securitization market. By facilitating the issuance and investing of loans and securities, this market provides trillions of dollars of capital to consumers and businesses in communities across the country. Our members facilitate credit and capital formation across a wide breadth of asset types and industries, including auto loans, mortgage loans, student loans, commercial real estate, business loans, among others.

SFA members include issuers and investors, data and analytic firms, law firms, servicers, accounting firms, and trustees. Importantly, many of our investor members are fiduciaries to their customers. Unlike some trade associations, before we take any advocacy position our governance requires us to achieve consensus by agreement rather than majority vote, ensuring the perspectives of all our diverse membership are included. This diversity is our strength, as it builds healthy tension in arriving at our consensus positions. Because of this, we are methodical and thoughtful as we analyze the pros and cons of legislative and regulatory proposals, as well as market dynamics, before we reach a mutually acceptable position that represents the entirety of the capital markets.

Formed in 2013, the Structured Finance Association's stated mission is: *"To help its members and public policy makers grow credit availability and the real economy in a responsible manner."*[1] There are very few issues that touch on this core mission as much as the work we are doing to help responsibly

[1] https://structuredfinance.org/about-us/

transition away from U.S. dollar ("USD") LIBOR. Further, this issue is one that has unified all participants in our membership – from issuer to investor, and everyone in between – on the need for federal legislation to help ensure a final transition takes place smoothly and efficiently.

Absent federal legislation to provide a consistent and fair solution as well as a safe harbor for certain so-called "tough legacy" contracts – that is, USD LIBOR contracts lacking clear fallback language – retirees and savers will be forced to foot the bill for billions if not tens of billions of dollars in legal costs. This will occur as trustees would need to seek court guidance on which replacement rates to select and how to incorporate that rate into the existing contract. The absence of federal legislation for these contracts also opens the possibility that consumers could be left in an uncertain position under contracts that fail to provide a fallback directive upon LIBOR's cessation. With legislation, however, there are critical incentives for lenders to provide consistent treatment to all consumers. I will outline in detail in my written testimony below how this dynamic has come about, and why, as to this remaining pool of legacy contracts, the market is unable to resolve this issue without enormous litigation expense.

Securitization and structured finance are critical elements of today's economy. The pooling of loans into a security, coupled with the separation of highest credit and prepayment risks from lower prepayment and credit risks, allow for efficient matching of borrower and investor preferences. This segmentation of risks lowers the cost of credit to the consumers and businesses that the capital markets fund while providing more tailored investment options to investors with varying risk preferences. Our members know that, when done properly, this work facilitates economic growth and capital formation across all communities.

Background on LIBOR Transition To-Date

Let me first make abundantly clear that many of SFA's member companies were impacted by the LIBOR scandal. In particular, SFA investor members need to assured that this never happens again. All of our members must know that, going forward, contracts based on a floating rate index can rely on the integrity of that index. For these reasons, SFA has been an active member in the Federal Reserve's Alternative References Rate Committee, or "ARRC", a group whose purpose includes ensuring an orderly transition away from LIBOR.

Extensive progress has been made on this gigantic financial undertaking. Out of over $200 trillion of U.S. dollar-based contracts that are tied to LIBOR, nearly all have managed to put in place a plan for transition to a new rate. This was achieved across banking and financial sector regulators, market participants and consumer groups. As there wasn't a natural replacement rate for U.S. dollar LIBOR in existence, the transition started with the critical task of identifying and developing trusted and widely adopted alternative reference rates and ensuring those rates won't present the same flaws as LIBOR or other systemic deficiencies. As the alternative replacement rates were not previously published, groundbreaking work was launched to build market understanding, acceptance, and liquidity in these alternative rates required by borrowers, lenders and investors.

With alternative rates available and the liquidity and market acceptance of those rates steadily building, attention quickly turned to ensuring that all new contracts that still referenced LIBOR incorporated so-called "fallback" language. This fallback language is agreed to by all contract parties and clearly specifies what interest rate would be used in the event that LIBOR is unavailable or ceases to exist. In parallel to incorporating fallback language in new contracts, work began in large scale by lenders, borrowers and investors to amend millions of existing LIBOR contracts that mature after the expected cessation date of LIBOR. All this effort, significantly supported and helped by a wide-spread number of market

participants, consumer groups, and regulators within product-specific working groups of the ARRC, has reduced the USD LIBOR exposure that will remain after the June 2023 LIBOR cessation date from over $200 trillion to an estimated $16 trillion[2].

Meanwhile, market participants have continued to work to build liquidity and transparency in the alternative reference rates, which allow for the hedging of interest rate risk in a liquid capital market. That hedging allows borrowers to access products like the fully prepayable fixed rate mortgage, or to issue corporate debt that matches a company's assets and cash flows.

Finally, new security issuance continues to increase in all product types. Building off the liquidity of a secondary market for hedging, the amount non-LIBOR floating rate contracts continues to increase each month.

"Tough Legacy" Contracts, and Other Remaining Challenges

Even with this well-organized multi-year effort, these estimated $16 trillion contracts have no realistic means to be renegotiated and amended. While small compared to the overall size of outstanding LIBOR contracts, this is still a large sum, posing an enormous risk to the financial system and the underlying borrowers, investors and banks if not dealt with properly. These so-called "tough legacy" contracts include mortgages, student loans, business loans and capital market transactions that finance and hedge these legacy LIBOR-based contracts, and therefore impact a broad range of American households and businesses.

[2] This is a best guess estimate taken by surveying our member firms. This number includes many types of contracts, ranging from floating rate mortgage to student loans, loans to businesses, and embedded interest rate swaps in contracts.

The simplest explanation for these contracts is that, after more than 30 years of publication and use in over 98% of U.S. dollar floating rate contracts, most contracts that were entered into prior to the announcement of LIBOR's end simply did not contemplate the permanent cessation of such a ubiquitous rate. While in hindsight today it may seem obvious that LIBOR could come and go, for many decades this simply and unfortunately was not the case.

These tough legacy contracts often have very high legal and operational hurdles to amending their terms, not the least of which is identifying, contacting, and negotiating with the large number of contractual parties who must consent to any such amendment. For instance, in all widely distributed bonds there are upwards of hundreds of bondholders who must be involved in the negotiation – and most often unanimous consent – that is required to change the interest rate of the bond. Moreover, even in normal market circumstances, due to investor privacy constraints and operational hurdles, identifying and communicating with bondholders in certain products is very challenging, if not impossible. On the massive scale required by the LIBOR transition, it is viewed as fruitless.

Finally, in the likely absence of meeting these impractical hurdles, the third-party trustees, who administer certain contractual provisions in the structured finance market, would need to seek direction through judicial proceedings to navigate the transition to a replacement rate. This is what will happen in the absence of safe harbor legislation, and – as per the contracts – most of the legal costs for structured finance bonds will be borne by the underlying investors and savers.

Recognizing the significant economic, operational and legal risks of these $16 trillion contracts, for the past few years SFA investors, bond issuers, lenders, trustees, 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 stakeholders expressed concern about the use of legislative action that would affect previously

agreed contractual matters. However, after lengthy deliberation and debate, a consensus position across the entire market emerged that the cessation of this critically important benchmark rate presents such a unique challenge that other alternatives examined were inoperable, could lead to inequitable outcomes for investors or consumers, presented extensive and costly litigation risk, or all the above. As such, firms that would under normal circumstances find legislation to amend contracts anathema, are now strong advocates for federal legislation to ensure a smooth and fair transition.

Principles of A Legislative Solution

Again, 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. 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 further degrading the value of these fixed-income 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
- **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

To be clear, SFA believes that legislation should in no way prohibit parties from agreeing together on a different replacement rate, if they so choose. Legislation should pay careful attention to all Constitutional rights embedded in contracts, and for this reason SFA has spent considerable time working with experts in this area of the law. And legislation should in no way contribute to wealth transfer between parties. These all represent important boundary conditions on how any law would work, and therefore discussions over every provision of proposed legislation have taken thousands of hours of work.

With these principles in mind, SFA is strongly supportive of the prospective federal legislation that recently passed out of the House Financial Services Committee. We also know that legislation may undergo additional technical edits, and we know that the Senate is working on similar legislation with similar goals. With the principles enumerated above, we continue to be appreciative of all this legislative work. On behalf of the entire membership of SFA, I specifically want to thank Senators Tester and Tillis for the leadership they are providing on this issue.

As you likely know, recently, both Chairman Powell and Secretary Yellen also 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.

State-by-State Patchwork Approach is Not Viable

Recognizing the importance of legislative assistance to transition away from LIBOR, on April 6, New York state passed AB164B[3] 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 also consistent with our five key principles.

This was a big, positive step forward in the orderly transition of LIBOR as we estimate almost half of tough legacy contracts are governed by the law of New York State. But a uniform federal framework would expand the protections to also include all other 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 fair 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

[3] 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.

Ultimately, 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. 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

In conclusion, let me thank you all again for your focus on helping to transition our markets and economy away from LIBOR once and for all. The work that some members of this committee are currently undertaking is critical to ensuring that all investors, consumers and business borrowers, and lenders are treated equally and fairly. It also will help to prevent billions of dollars of potential litigation, where no one wins but savers and retirees foot the bill.

Please know that the membership of the Structured Finance Association has been committed to being part of the healthy evolution and productive improvements in our markets as they continue their final transition away from reliance on LIBOR, and we thank you for your work in helping to facilitate this important market evolution.