Confusion as separate states pass their own Libor legacy law

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The decision by a slew of states to issue their own version of a Libor legacy bill months away from the legislation being passed at the federal level has puzzled many US market participants.

At the time of writing, at least six states – Alabama, Florida, Georgia, Indiana, Nebraska and Tennessee – had published a bill to address and provide for the legal effects of the discontinuance of Libor in contracts, securities and instruments, while Washington State was considering it.

“There is no need for individual state legislation if the federal one passes, and it’s highly likely that it will,” said Michael Koegler, managing principal and co-founder at Market Alpha Advisers. “No one is certain why individual states are passing their own versions of the law. There is no reason for a state like Tennessee, for instance, to have its own legislation if the federal legislation passes.”

What’s all-the-more striking, as several sources pointed out, is that the majority of those states do not cover the largest exposures – unlike New York State, which governs the bulk of USD Libor contracts and was the very first one to pass a legacy bill in November 2021.

“The number of Libor-based contracts that extend past the middle of 2023 that are governed by Indiana law, for example, is probably limited, which suggests a strange use of political capital,” said Anne Beaumont, partner at Friedman Kaplan Seiler & Adelman. “Most commercial contracts in the US are governed by New York law, which is why the legislation was passed there in the first instance. Of all the states that have passed this, Florida might be the only one whose law covers a meaningful number of such contracts.”

The bill has received bipartisan support from the House of Representatives and the Senate, which means there is little chance that it won’t pass at this stage. Although the bill had been gridlocked in Congress for several months, the Senate published last week an updated version that included major changes, including a proposal for fixed spread adjustments, amendments to the Trust Indenture Act, as well as new specific provisions for consumer and student loans.

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"These are all states whose laws are extremely rarely used for financial transactions, so I imagine this might be a performative effort by some legislators to show they are actively involved," Beaumont added. "It would seem more plausible if states such as Delaware, Pennsylvania or California got on the bandwagon. The only common thread among those states would seem to be that most of them are red."

Other sources echoed the thought that these moves could be attributed to states' willingness to show their commitment to the issue. "It is almost as if they are trying to make themselves look good," said Koegler. "Some of them may be doing this to make it look like they're being proactive on addressing the cessation of Libor, but it's a waste of time if the federal legislation passes. Tennessee, Alabama and other state laws will be superseded by the federal legislation."

Not everyone, however, agreed with this view. "It would be too big an effort for it to be simple political posturing," said Alexandre Bon, group co-head of interest rate benchmark reform at Murex. "There would be other ways to demonstrate your commitment at the state level. I would argue it's rather a case of adding a seatbelt on top of the airbag that is the projected federal legislation."

Consistency is key

A key concern is also the risk and added complexity that could arise from having different versions of the legacy bill developed in different places – assuming that all the proposed versions aren't entirely similar.

"If all 50 states passed their own bill and these were identical, then market participants would have a clear answer," said Adam Schneider, partner at Oliver Wyman. "But having 50 different versions is less useful to the marketplace as most of the required work is not state-by-state. With limited customer impact until July 2023 and the federal legislation pending, there's truly no reason to push this through at the state level today."

Many have also been wondering what has been holding up the passage of the bill at the federal level, advocating that the process should be sped up for market participants to have time to process it before June 2023 next year – when all USD Libor settings are discontinued.

"The federal legislation seems likely to happen, but there is a concern that the timeline for getting it implemented will be tight," said Robert Mackenzie Smith, senior research analyst at Bloomberg Intelligence. "Passing a bill into actual law can take up to 18 months, but Libor has an end date. Perhaps some of those states are just concerned and want to put something in place now, in case there is any issue with the federal legislation."

See also: USD Libor report 2021

Overall, both market participants and regulators have everything to gain from having the bill passed sooner rather than later.

"They should just get it done so that people can quit wasting their time lobbying at the state level and focus on remediation," said James Lovely, Libor-focused independent consultant. "The problem is they need to get the bill finished and passed, and then reconcile the [House and Senate] bills because they're not going

to be carbon copies of each other. But midterm elections are also coming up in the autumn, so putting all this together, it is clear why some may think there's no guarantee that Congress will pass a federal Libor bill in time."

Pressure from beneath

Another possible reading is that some of those states may have been pressured by local market participants to put a solution together to ensure any outstanding exposures can be remedied come June 2023.

"There's a lot of motivation from influential bankers in each state to say they want a uniform outcome in the absence of a one-size-fits-all federal solution," said Lovely. "As long as the federal legislation languishes – and given that legislative bodies have their own rhythm and cycle – there is only a certain window to get a

backstop solution at the state level. For each new law there is a gestation time, so they might as well do it, because the alternative – as low-probability as it may be – of lacking a federal legislative solution is a real problem."

Having this solution in place is particularly important for banks that focus on state-law governed loans, which are extensive in the US, Lovely explained. "Even in smaller states such as Indiana, there will be a lot of banks doing business under Indiana law," he added. "Those transactions, probably most significantly loans, may or may not be hedged with New York State law-governed derivatives."

Conversely, individual states may have wanted to give reassurance to local players that they have their back in case something goes wrong with the federal legislation.

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"They want to give them all the comfort they can that the federal law is there to help, but also that state law is committed to the same change," said Edward Ivey, partner and co-chair of swaps and derivatives practice at Moore & Van Allen. "There is no doubt that local banks are talking to their state governments and saying they need something to be sure they can safely move off these contracts. Having that in place mitigates any perceived litigation and state law risks were someone to claim that the federal law is not sufficient."

The legal view

Beyond market-based considerations, however, there could also be a much simpler legal explanation.

"It's relatively common for there to be some overlap between state and federal statutes in the US: in fact, you often see them working together to make sure they cover all aspects of an issue," said Leigh Nathanson, partner at King & Spalding. "This is because the powers of the federal government are limited, and because states have different priorities in terms of what they want their legislation to focus on."

In New York, for instance, which is a choice-of-law state for ISDA contracts, there are often incentives to cover more specific ground than the federal government, Nathanson explained.

"Another explanation is that the federal government can work more slowly sometimes, so there is a patchwork of legislation between state and federal that emerges when the dust settles," she added. "Then there are issues prompted either by regulatory scrutiny or by litigation, where you're looking at how these different legislative schemes interact, how they overlap, if there are any contradictions, or whether the federal statute preempts the state laws and to what extent."

Nathanson anticipated that this would probably happen with the Libor legacy law once the federal legislation gets passed. "Broadly, they will operate in tandem to the extent that they're able to, just as you have state analogues to many federal laws that are either coextensive or broader," she said.

"Down the line, the cumulative effect will hopefully be that you go from a hit-or-miss state-level solution that looks to the ARRC's recommendations, to a comprehensive federal solution that ultimately looks, through the Fed, to the ARRC's recommendations."

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