MARKETS

Fed Won't Use Stimulus Aid to Push Libor Replacement

Central bank faced pressure not to use new interest-rate benchmark in Main Street Lending Program

Fed Chairman Jerome Powell speaking at virtual news conference last month amid the coronavirus pandemic.

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The Federal Reserve has scrapped plans to use a $600 billion aid program for small and midsize businesses to promote the use of its preferred replacement for the troubled London interbank offered rate.

The Fed's retreat, in the face of opposition from some of the country's biggest banks, highlights the challenges of shifting debt markets to a new short-term, interest-rate benchmark. Regulators globally are pushing to replace Libor, which fell into disrepute after a manipulation scandal, before the end of next year. But markets have been slow to embrace the Fed's replacement choice, known as the secured overnight financing rate, or SOFR.

Settling on new benchmarks for short-term interest rates is an urgent issue for regulators and financial firms; Libor underpins trillions of dollars' worth of financial contracts, from complex derivatives transactions to variable-rate home mortgages. Even before the coronavirus pandemic, doubts were growing about the financial system's ability to make the switch.

Getting borrowers and lenders to widely adopt SOFR is a monumental undertaking that touches every corner of global financial markets. Regulators now face more resistance from lenders who don't want to add complexity to stimulus efforts in the midst of global economic upheaval.

The American Bankers Association last month asked the Fed to allow banks to either continue using Libor or another alternative, such as the prime rate, for loans being advanced under the Fed's business-loan facilities. These are collectively known as the Main Street Lending Program.

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On April 30, the Fed relented, issuing new terms for the loans that jettisoned a requirement they be priced with SOFR. Instead, it reverted back to the Libor benchmark.

The Fed said in a question-and-answer document accompanying the announcement that it made the change based on feedback from program participants. They had warned that "quickly implementing new systems to issue loans based on SOFR would require diverting resources from challenges related to the pandemic."

The Fed's initial requirement to use SOFR was taken by many in the financial industry as an aggressive move to discourage the continued use of Libor and boost adoption of its preferred alternative.

The ABA warned that it might undermine the program's effectiveness. "In the midst of a pandemic, with diverse demands on finite management resources, such an abrupt transition to SOFR would deter participation in the [Main Street Lending Program]," the ABA said in a letter to the Fed.

Some said it put too much burden on banks in the middle of a crisis. "It's like rebuilding the engine while the car is barreling down the highway," said Brian Reynolds, chief market strategist for Reynolds Strategy LLC.

Community lenders also took issue with the SOFR requirement, said Paul Merski, executive vice president in charge of congressional relations and strategy at the Independent Community Bankers of America. He said most smaller banks aren't currently using the rate and it isn't used widely enough to inspire their confidence.

"They don't know if SOFR has been proven," he said. "The changes make the program more usable."

Some early adopters of SOFR say the Fed and other regulators need to make a push to replace a rate whose credibility has been irreparably damaged.

"The more places it can be used, encouraged, required, the smoother the transition to SOFR will be," said Randy Snook, chief executive of the office of finance for the Federal Home Loan Banks. The FHLBs have been among the heaviest users of SOFR in the capital markets.

The Main Street Lending Program—through which the Fed will use banks as conduits to extend bridge loans of up to four years to small and midsize businesses—is the first lending program to nonbank firms the central bank has initiated since the 1930s.

The U.K.'s Financial Conduct Authority, which regulates Libor, said in March that it has no plans to delay the expiration of the benchmark in December 2021, even though the pandemic has upended many parts of the financial system and the economy. The regulator repeated that stance on Wednesday.

Even before the coronavirus outbreak, banks, investors and corporations were struggling to meet the looming deadline to rewrite contracts, lending agreements, and retool back-office software to replace Libor. The benchmark is used to underpin more than $200 trillion of financial contracts around the world.

Existing bonds, loans and other credit agreements that already benchmark interest payments off Libor may not specify what happens when it expires in 2021. The Fed said that banks tapping its Main Street Lending Program will need to specify in their loan contracts what will happen when the benchmark expires in 2021.

A committee of banks, industry groups and other advisers on the Libor transition effort convened by the Fed welcomed the move to require a fallback option once Libor ceases. "This is a practical consideration," Tom Wipf, the committee's chairman, said in a statement.

Not everyone cheered the Fed's turnaround.

By backing down, the Fed lost an opportunity to test how well SOFR could work, said Anne Beaumont, a partner in the litigation practice of New York-based law firm Friedman Kaplan Seiler & Adelman LLP.

"They've blown the opportunity for institutions that do have the ability to use SOFR to test drive their systems," she said.

The Fed also lost a chance to reduce the amount of new Libor-based debt that is accumulating ahead of the transition deadline by restricting its use in the Main Street program, she said. "You don't want to add more rocks to the pile."

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