US SENATE COMMITTEE
ON
BANKING, HOUSING AND URBAN AFFAIRS

"The Libor Transition: Protecting Consumers and Investors"

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Testimony of
Hon. J. Christopher Giancarlo

Introduction

Thank you, Chairman Brown, Ranking Member Toomey, and Committee Members. It is an honor to appear before this committee once again.

I am Chris Giancarlo, Senior Counsel at the law firm of Willkie Farr & Gallagher. I had the honor to serve our country as the thirteenth Chairman of the U.S. Commodity Futures Trading Commission (CFTC), a Federal agency that has led and continues to lead the transition away from the LIBOR interest rate benchmark, the subject of today's hearing. I am also an independent director of the American Financial Exchange.

I commend Chairman Brown and Ranking Member Toomey for holding this hearing. Congressional leadership on this issue is important to ensure banks and all financial institutions of every size, shape and location understand that LIBOR will be replaced and will be replaced soon.

Over four years ago, on the very day that the U.S. Senate unanimously confirmed my nomination as CFTC Chairman, Federal Reserve Chairman Jerome Powell and I published an opinion piece in the _Wall Street Journal_, entitled "*How to Fix Libor Pains*". In it, we wrote:

> *"…the time has come for market participants and regulators to work together on a plan for dealing with existing Libor-based contracts maturing after 2021. This plan must also address how to expand adoption of the broad Treasury repo rate into a wider array of products that rely on a benchmark. … There is time for this transition to be done thoughtfully. Our agencies are prepared to help ensure that it is done cooperatively and smoothly."*

I was committed then and remain committed today to do everything possible to assist the transition away from LIBOR. The transition is here and now. Beginning in January 2022, no new capital markets or lending contracts can be based on LIBOR.

Beginning in June 2023, all existing LIBOR contracts must be replaced with a LIBOR replacement. This hearing is an important step in getting it done.

The Shortcomings of LIBOR

As you well know, the London Interbank Offered Rate, or LIBOR, plays an important role in American finance. The credit cards, floating-rate mortgages and car loans of many of our fellow American citizens and even the day-to-day funding for the companies where they work are all influenced by LIBOR. This arcane interest rate is meant to reflect the rate that large banks must pay to borrow short term. It is used to calculate the rate of interest on more than half of American home mortgages. LIBOR is cited in financial contracts setting trillions of dollar-denominated loans, securitizations and derivatives.

I have extensive experience, both as a market regulator and business executive, with financial benchmarks and, most particularly, with LIBOR. Before entering public service, I served as the Executive Vice President of GFI Group, a leading trading platform and technology vendor to global markets for OTC swaps and other financial derivatives, many of which refer to LIBOR. As former Chairman of the CFTC, I am familiar with the critical importance of reference benchmarks for the sound functioning of U.S. markets for risk mitigation and reliable price discovery.

The shortcomings of LIBOR first came to light during the 2008 financial crisis with reports of manipulation of the rates used to calculate it. My former agency, the Commodity Futures Trading Commission, was a leader in investigating and sanctioning a number of major banks for benchmark manipulation. Prosecution of many of those cases proceeded determinedly under my administration.

LIBOR is calculated daily from the quoted rates that a panel of a few large banks provide to ICE Benchmark Administration, an independent subsidiary of the Atlanta-based firm Intercontinental Exchange. The quotes represent the rates at which the banks estimate they would be able to borrow in short-term money markets. Yet, apart from overnight transactions, the large banks providing those submissions no longer borrow much in those markets. There are very few actual loan transactions on which these quoted rates are based. In essence, a few large banks are contributing a daily judgment about something they no longer do.

As a result, LIBOR suffers from two fatal flaws: shallowness of liquidity because of thin trading volume and narrowness of liquidity because of its reliance on only a handful of rate setters. When it comes to the potential for manipulation, the second shortcoming may be worse than the first.

Back in 2017 during my CFTC service, the U.K.'s Financial Conduct Authority, the agency primarily responsible for regulating LIBOR, called for a worldwide transition away from LIBOR because of these very shortcomings and the risk they present. Here in the United States, we welcomed this move. The CFTC's Market Risk Advisory Committee under the keen leadership of Commissioner Russ Benham, now Acting Chair and the President's nominee for CFTC Chairman, led agency efforts during my Administration and continues to lead efforts to spur the transition away from LIBOR.

LIBOR Alternatives: SOFR

At the same time in 2017 as the CFTC was prosecuting LIBOR manipulators and considering its risk to financial markets, the Federal Reserve Board convened a group of institutional participants that broker and clear LIBOR transactions to form the Alternative Reference Rates Committee, known as ARRC. It is a pleasure to appear today alongside Tom Wipf of Morgan Stanley, who chairs ARRC. Tom has worked tirelessly on these issues and has ably led the ARRC Committee. Under his leadership, the ARRC is focused on ensuring a smooth transition away from LIBOR for existing and new contracts.

Following an extensive consultation, the ARRC committee recommended replacing LIBOR with a rate derived from short-term loans that are backed by a range of Treasury securities as collateral (known as Treasury repurchase agreements or "Repo"). The Treasury Repo market is a fully collateralized financing market that enables the largest institutions to lend and borrow amongst each other, typically on a very short term basis. This interest rate derived from this market is a measure of practically risk-free borrowing because US Treasury securities serve as collateral. With such risk-free collateral, the interest rate does not reflect the credit quality of the market participants, but rather the status of US Treasury securities as the world's safest investment.

Unlike LIBOR, SOFR is built upon actual market transactions of roughly $800 billion in daily activity. That provides much greater depth of trading liquidity than LIBOR. This feature directly addresses a key weakness of LIBOR: shallowness of trading liquidity.

The Treasury Repo market is not only critical to the world's largest financial institutions, but it is also critical for ensuring liquidity in the US Treasury debt market.

The Federal Reserve Bank of New York is deeply involved in the Repo market in its role of managing Fed Open Market Operations in implementing Federal Reserve monetary policy. Widespread adoption of the SOFR benchmark is supportive of the US Treasury debt market.

SOFR is complementary to the cost of funding for many of America's largest banks that are primary dealers of Treasury securities and can use them as collateral for funding. Combined, these institutions have over eleven trillion dollars in assets. SOFR is therefore a highly appropriate LIBOR replacement for a broad range of financial institutions, especially primary dealers of US Treasuries and other large firms that participate in that essential marketplace. I am very supportive of widespread adoption of SOFR as a well-constructed and durable, risk free interest rate benchmark.

LIBOR Alternatives: AMERIBOR

Away from Wall Street, America has almost 5,000 community and regional banks and lending institutions with another $11 trillion in assets. These institutions lend to the real economy of America's small to medium sized businesses, including manufacturers, equipment dealers, service providers, agriculture producers and home builders that are America's job creators. These community lenders generally do not hold US Treasury securities and other risk free collateral. Rather, they lend against relatively illiquid collateral of plant and equipment liens, property mortgages, auto leases and personal guarantees. In effect, these lenders take real risk. They are highly credit sensitive.

Over my five years at the CFTC, I travelled over half the country to meet with thousands of Americans who depend on CFTC-regulated markets to hedge the prices of agriculture, mineral, or energy commodities they produce. In the course of those travels, I descended 900 feet underground in a Kentucky coal mine, climbed 90 feet in the air on a North Dakota natural gas rig and flew 900 feet in the air in a Arkansas crop duster. I walked factory floors in Illinois, pecan farms in Georgia, grain elevators in Montana, feed lots in Kansas, and power plants in Ohio. Almost all of the small and medium sized businesses I met were supported by America's community, state and regional banks. I know how much those community banks, in turn, need support from Washington.

Among other roles I have assumed since completing my service at the CFTC, I serve as an independent member of the Board of Directors of the American Financial Exchange (AFX). AFX was founded in 2015 by Dr. Richard Sandor, American economist and entrepreneur, who pioneered interest rate futures and created the world's first trading exchange for the reduction and trading of greenhouse gas emissions, for which he is known as, “The Father of Carbon Trading.” My professional relationship with Dr. Sandor began almost two decades ago in the private sector. Upon completion of my government service, I was delighted when Dr. Sandor invited me to serve as an independent board member of AFX.

AFX is an electronic marketplace where banks in the US can directly lend and borrow short term funds to one another on an unsecured, credit sensitive basis. AFX has over 225 members as well as over 1000 correspondent American banks. The assets of AFX members exceeds $5.3 trillion dollars. Measured by both the number of U.S. banks and aggregate bank assets, AFX members constitute about twenty-five (25%) percent of America’s banks and community lenders, including the 5^{th}, 6^{th} and 7^{th} largest banks in the United States.

AFX member banks are in all fifty U.S. states, including states represented by every member of this committee. AFX members include some of America’s most respected local and regional banks as U.S. Bank, Keybank, Zions, First Financial, Citizens Trust, Brookline, East-West, Abacus Federal Savings, Cambridge Savings, Cape Cod Five Cents Savings, Cathay Bank, Customers Bank, Dime Community, Fulton Bank, Glacier Bank, Hope Bank, Asian Bank, Dollar Bank and Signature, ServisFirst, Unity and Truist Banks.

AFX members are highly representative of America’s community, minority-owned and regional banks. That includes a significant share of America’s critical minority-owned depository institutions that play a vital role in serving traditionally underserved communities, often lending to businesses and entrepreneurs with minimal collateral. By asset size, AFX members today represent about forty (40%) percent of U.S. Minority Depository Institutions (MDIs), including some of America’s most innovative African American, Asian-American, Hispanic and Native-American banks. The National Bankers Association, the leading minority-owned bank trade association in America, has endorsed AFX’s interest benchmark as an approved rate to be used for loan documentation for its members.

AFX was conceived and founded well before the decision to transition away from LIBOR. AFX was not created to benefit from LIBOR’s demise. Like all good ideas, AFX was created to address a commercial need: to provide America’s community and regional banks with a way to lend to and borrow from each another in a regulated, transparent market on a peer-to-peer basis. AFX offers America’s community and regional banks a complementary alternative to their traditional source of funding from large money center banks on Wall Street.

Every business day, tens of billions of dollars of loans are lent and borrowed by hundreds of participants in the AFX institutional marketplace. The marketplace is electronic, transparent and self-regulated under the scope of the CFTC's comprehensive regulatory framework. It is compliant with standards developed by the International Organization of Securities Commissions (IOSCO) for appropriate LIBOR benchmark replacements. The interest rate at which AFX members independently agree to borrow and lend are tracked and compiled into a series of benchmarks that include the AMERIBOR® Term-30 index. The index is published nightly and displayed on almost all financial data feeds like Reuters and Bloomberg and financial broadcast media.

These AMERIBOR benchmarks are complementary to the cost of funding for thousands of AFX members and correspondent firms whose lending activities to the real economy is highly credit sensitive and supported by relatively illiquid, physical collateral and personal guarantees. For these institutions, AMERIBOR best represents their cost and risk of funding. As a result, AMERIBOR benchmarks are favored by the thousands of AFX members and correspondent firms as an interest rate benchmark for commercial lending contracts. For this reason, I support adoption of AMERIBOR by institutional lenders who require a well-constructed and durable, credit sensitive interest rate benchmark.

Market Diversity and Durability

It will not surprise the Committee to hear that at my core I believe in open and competitive U.S. markets. But my comments today are frankly less about the need for competition in the LIBOR replacement market and more about choice. SOFR and AMERIBOR should not be viewed as competitive but as complementary. They are different. SOFR is a risk-free rate and AMERIBOR is a credit sensitive rate. They are alternatives for different needs and different sectors of the marketplace.

From my service at the CFTC, I know that most of America's important trading markets feature a diverse set of pricing benchmarks serving different needs. In our grain futures markets there are multiple pricing benchmarks, including Chicago soft red winter wheat, Kansas City hard red winter wheat and Minneapolis hard red spring wheat. The different benchmarks serve to establish the cost of different varieties of wheat used in different bread products. (Pizza dough is made from different wheat than breakfast cereal). In oil markets there is West Texas Intermediate and Brent crude oil, again setting distinct prices for different fuel products, like domestic auto gas or industrial diesel. Of course, in our equity markets, there are multiple benchmarks like the Dow Jones Industrials, the S&P 500 and the Russell 2000 to measure the different performance of large cap and small cap companies. Such existence of a variety of specifically designed benchmarks allows market participants to engage in investment activities that are specifically crafted to their investment needs rather than a "one-size-fits-all" approach. Choice of benchmark is one reason why U.S. futures and equity markets are the world's deepest, most liquid and most attractive to global capital.

Strangely, one U.S. market that has not traditionally enjoyed a similar choice of benchmark is bank lending, where LIBOR has been dominant for decades. In fact, the ubiquity of LIBOR and long absence of competing, commercially derived interest rate benchmarks is one of the reasons why the demise of LIBOR presents a potential crisis today. Lack of choice of interest rate benchmark is itself a systemic risk.

Nassim Nicholas Taleb, the well-known market observer who coined the phrase "Black Swan" has written about the increased fragility of today's top-down designed, overly complicated economic systems.[1] He warns that concentration in complex systems such as financial markets makes them more vulnerable, not less to cascading runaway chains of reactions and ultimately fragile in the face of outsized crisis events. He posits that the opposite of such fragility is "anti-fragile," meaning systems that become stronger when subject to stress, the way a human body becomes immune to a disease through exposure or inoculation. He explains that financial markets that are allowed to grow organically through gain and loss with plenty of redundancy and choice best resemble biological organisms that adapt and, indeed, thrive.

The United States banking industry is quite unique and extraordinary. On the one hand, its large money center and Wall Street investment banks lead the world in sophisticated global trading, investment banking and large project finance. On the other hand, America's community and regional banks spread out across the urban, suburban and rural landscape finance the everyday needs of America's consumers, small and medium sized businesses and domestic job creators.

A banking industry that is so varied, so complex and so essential to the American economy needs the diversity and durability that comes from choice in interest rate benchmark. A one-size-fits-all response to the demise of LIBOR would be a source of systemic risk to the U.S. economy. As we rightfully move away from LIBOR, we should make clear that lending institutions – be they money center banks or local, regional or MDI banks - should have the flexibility to choose among IOSCO compliant benchmark alternatives that best meet both their lending activity and their customers' needs.

<u>Federal Legislation</u>

[1] See generally, Nassim Nicholas Taleb, *Antifragile: Things that Gain from Disorder* (Random House) 2012.

There is a clear consensus, that I share, that federal legislation is necessary to ensure smooth and efficient transition away from LIBOR. As Treasury Secretary Janet Yellen stated in her testimony before the House Financial Services Committee earlier this year, legislation is necessary for tough legacy contracts that do not specify a workable fallback rate making it not feasible for private-sector actors to modify on their own.[2] Legal certainty is absolutely critical to ensuring that institutions with existing tough legacy contracts can replace their LIBOR benchmark before the end of June 2023, the termination date for all existing LIBOR contracts.

There is legislation moving through the House of Representatives, H.R. 4616, the Adjustable Interest Rate (Libor) Act of 2021, that would provide much needed legal certainty. The legislation makes clear that all LIBOR contracts must be converted to an alternative benchmark before June 30, 2023. Furthermore, if the contract does not provide clarity how an alternative benchmark can be reassigned, the institution would have legal certainty if LIBOR is replaced with SOFR. Also, as it relates to "new" contracts, the legislation, in the "Findings" section, provides helpful language that institutions entering into new contracts will have choice of which benchmark they can utilize. AFX supported this legislation when it was before the House Financial Services Committee where it was ordered to be reported to the full House.

Enactment of legislation providing legal certainty for the conversion of those tough legacy contracts is absolutely critical. I would also urge the Committee to consider providing stronger language ensuring that, as institutions are entering into new contracts, they have the clear ability to choose among properly qualified benchmark replacements. Qualifying factors could include, for example, benchmarks meeting the IOSCO standards and benchmarks that are built around market-based trading and fully transparent price discovery.

Conclusion

LIBOR has been the world's most used interest rate benchmark. A such, the transition away from LIBOR has been, and continues to be, a long journey. In less than two months LIBOR will cease as the benchmark for new contracts and in less than 20 months all legacy LIBOR contracts must be replaced with an alternative benchmark.

SOFR and Ameribor and, no doubt others, will help us put LIBOR in the rear view mirror. But this Committee and this Congress can help facilitate that smooth transition

[2] Oversight of the Treasury Department's and Federal Reserve's Pandemic Response." U.S. House Financial Services Committee (March 23, 2021), https://www.youtube.com/watch?v=AQsLydo6mJI&t=3488s at 58:44.

by providing legal certainty as it relates to tough legacy contracts and responsible choice for new contracts.

If I can leave you with one thought, it is that there is simply no one-size-fits-all lending benchmark for an economy as unique and diverse as the United States. Having choice among multiple, properly qualified benchmarks not only facilitates the transition away from LIBOR, but it also enhances efficiency, reduces systemic risk and encourages economic growth as we progress through the transition process. Both SOFR and AMERIBOR represent the kind of home grown American ingenuity and innovation, along with a sound regulatory infrastructure, that has helped make US markets the deepest, most liquid and most efficient markets in the world.

Thank you and I look forward to your questions on this important matter.