BPI Credit-sensitive Benchmark Symposium
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Speaking Notes – not a verbatim transcript

Introduction

- It's great for me to join this discussion today, so thank you for inviting me. I got started on the collective effort at benchmark reform in 2013 and '14 when I represented U.S. treasurers on Darrell Duffie's Market Participants Group convened by the FSB.

- That group and now the ARRC both stress the importance of having a significant volume of underlying transactions on which to base a new reference rate, as urged in 2013 by the International Organization of Securities Commissions (IOSCO).

Background

- One of the principal concerns with LIBOR is that only half a billion of underlying inter-bank transactions support some $200 trillion of US$ LIBOR financial contracts.

- However, in addition to these purely financial transactions referencing US$ LIBOR, there's an unmeasured volume of contracts for the exchange of goods and services in the real economy that also reference LIBOR.

- Based on the relative size of the overall economy compared to the financial markets, it's likely that the amounts of outstanding commercial transactions that also reference LIBOR is significantly more than the $200 trillion estimated for financial markets. These include:

    - commercial supply agreements,
    - contracts for purchases of major capital equipment,
    - real estate,
    - and business assets generally,
    - not to mention inter-company advances with a relevant interest rate component to comply with arm's-length cross-border transfer pricing requirements.

- This additional volume of contracts referencing LIBOR makes it even more critical that any benchmark itself must have a significant volume of auditable underlying transactions in relation to the contracts referenced.

- One of the reasons the ARRC recommends SOFR as this new reference rate benchmark, is that it has over $1 trillion of underlying Treasury repo transactions that support it.

- While, for example, Ameribor's volume of underlying bank funding transactions has grown, its significantly less than SOFR's Treasury repo base and we know from hard experience what happens to credit-sensitive instruments in times of financial stress – their liquidity and issuance volume can shrink a lot in a short time.

The Current Balance

- The discussion thus far has focused on loan pricing and bank funding costs as two elements in isolation that must somehow be balanced.
- Let me bring you a perspective from the real economy with my 40 years of experience in corporate treasury in U.S. manufacturing companies.
- After assuring the cash is safe, the next responsibility of a corporate treasurer is to maintain, at all times, access to adequate credit for the company's day-to-day operations and to fund its future growth.
- To do this we lay down a base of term funding from the public financial markets and put together a syndicate of banks that understand our business, have the services we need where we want them, and who want a relationship with us. We arrange for them to commit, typically over three to five years, revolving credit facilities that we can draw if we need to or that can back up our commercial paper issuance if we have access to that market for funding.
- While the banks cannot explicitly tie their provision of credit to a requirement that we as borrowers commit to work with them on other financial services, we can, and do, require that if they want our
    - cash management,
    - FX trades and derivatives,
    - M&A advisory business,
    - bond underwriting,
    - and other fee-generating business,
    - they must commit credit to support our business.

- On the launch of a revolving credit syndication, every bank adamantly maintains that the pricing does not clear that bank's cost of providing the loan, but somehow the deals get done. How is that?
- Based on each bank's strengths in particular ancillary services and ability to commit capital to us, we achieve a mutually satisfactory balance of credit and non-credit services.
- We actively work with our banks to adjust the structure of the lending commitments to market conditions and achieve a balance of funding costs and a risk-return balance in light of current conditions.
    - Initial tenors can move in to three or back out to five years.
    - Commitment fees for undrawn commitments and up-front fees can move up.
    - Pricing grids based on ratings or financial ratios can adjust the risk-return mix.
    - Since March, especially for lesser credit deals, interest rate floors have come in, as have provisions against borrowing on a "just-in-case" basis to invest the idle funds through the corporate treasury.
    - Some banks say they can't make their return targets and can't achieve profitability with us, so they drop out, but we try to make this an unappealing choice by reminding them that they won't have a seat at the table for other business.
- So, into this balance, achieved through a competitive process and full transparency, with both sides looking at the same crystal ball, some are appealing for intervention by legislators and regulators to add a credit-sensitive term, but to borrowers, this actually upsets and unbalances the equilibrium we've so laboriously achieved.

<u>Where to manage the risk?</u>

- If loan terms continue to develop that constrain corporate borrowers' advantage in drawing to put the money in the mattress, and arbitraging their banks, then surely the asset-liability mix is best left with the banks to manage.
- If we consider the risk balloon to have a fixed overall volume, then pushing a bank's credit sensitivity onto a corporate treasurer instead of keeping it at with a banker, who has functional expertise, access to broader markets, and reserve credit, is surely the better structure.

Finally, what about timing?

- Treasurers need certainty as to the accounting, tax, and regulatory treatment of any changes they must make to their contracts to transition away from LIBOR.
- We are just now getting through all the work with the FASB, Treasury Department, SEC, CFTC, and banking regulators to deal with the complexities of the transition.
- Having participated in most of these discussions since mid-2018, I can tell you that to start again with a new index would be too high a hill to climb in the remaining time we have.
- Consider that corporate treasurers must adapt their systems and accounting processes to accommodate the changes we've already teed up.
- We're in competition with Engineering, Marketing, Sales Administration, and all the other corporate departments for a finite IT resource. Budgeting and systems planning for 2021 have already begun.
- The protocols for SOFR allow for a waterfall of possible outcomes, depending on future market developments, and because we don't know where exactly we will end up, we have to allow for all of those future outcomes.
- How can a treasurer commit his or her company to a protocol with specific future outcomes, requiring different systems changes along with different accounting and reporting treatments without having those changes already implemented?
- To call an audible at this point is just not feasible.