Financial Services Management

LIBOR Transition

Cite:
H.R. 4616, Adjustable Interest Rate (LIBOR) Act of 2021

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Impact Assessment

- If enacted, there would be considerably less litigation over the LIBOR transition, reducing controversies that could prove disruptive enough to threaten systemic stability.
- Derivatives markets are likely to be significantly strengthened.
- Fed control over preemptive benchmark rates provides clarity but may disadvantage contractual counterparties in arrangements not aligned with SOFR or any additional approved Fed replacement rate.
- If alternative Fed benchmarks do not comport with legacy contracts, then the affected asset class will still be subject to significant litigation risk unless a benchmark administrator nonetheless adopts the Fed's approved replacement and counterparties are deprived of many grounds to dispute it.

Overview

The House Financial Services Committee has reported H.R. 4616, a bill designed to prevent the chaos feared when the use of the LIBOR benchmark ceases for legacy contracts that lack language authorizing reliance on an alternative, "fallback" rate. The measure in no way obviates the obligation U.S. financial institutions have to various regulators to abandon LIBOR where fallback language exists or in new contracts. Instead, the bill only applies to eligible legacy contracts to prevent disruptive disputes that could expose financial institutions and even the system as a whole to significant operational or even credit risk. SOFR is the preferred benchmark replacement, providing considerable stability to derivatives contracts subject to U.S. law. Other legacy LIBOR contracts might get like-kind certainty if the Fed exercises its authority to provide for relevant benchmarks and/or if various permissible adjustments to SOFR suffice.

Impact

According to this legislation's findings, outstanding global LIBOR-based contracts amount to as much as $200 trillion, many of which lack the contractual language needed to effectuate a seamless transition to an alternative benchmark such as SOFR. In LIBOR's absence, the rate governing such contracts will surely be disputed in many cases because SOFR might be disadvantageous to a counterparty and, if a financial institution prefers a SOFR alternative, its use might also be deemed unduly favorable to the financial company. Disruptive litigation would surely result at considerable cost and, in key financial markets, potential systemic risk in a stress event such as an interest-rate shock.

Reflecting this risk, New York State has adopted language governing legacy contracts to specify how a substitute benchmark is to be determined, but many observers believe federal preemption is essential to ensuring that all contracts subject to U.S. law are covered. The bill thus expressly preempts state and local law, rule, or similar edict to the extent they apply to selection of a benchmark-replacement rate or limit the way interest is calculated. The extent to which state usury ceilings continue to apply is uncertain, although it appears to be the bill's intent also to preempt them in this limited arena. New York State's law would thus be subsumed within this new framework, one that would also unify treatment for all contracts subject to U.S. law.

As with current regulatory standards, the bill takes no position on alternative benchmarks in new contracts. These are under development in several arenas because SOFR is deemed problematic for unsecured arrangements such as certain consumer loans. U.S. regulators understand these concerns and thus have not barred alternative benchmarks even though some agencies (e.g., the SEC) fear that certain alternatives may have the embedded conflicts of interest that led to LIBOR's downfall.

Although there was a significant effort to allow the use of preferred alternative benchmarks also for legacy contracts, the bill reflects these fears. It thus establishes SOFR as the governing rate for legacy contracts without fallback language except in cases where the Federal Reserve has expressly sanctioned another benchmark. The measure does so due to fears that a wide, unregulated choice of rates would create disparate outcomes for parties in different contracts for like-kind goods or services (e.g., derivatives). The vast majority of the $200 trillion noted above are financial contracts related to derivatives and similar instruments, contracts which the Fed will almost surely find SOFR appropriate because the benchmark aligns well with guidance from this sector's largest industry group. Although there is considerable private agreement about SOFR's use in these contracts, financial institutions alone lack the authority to alter contractual language to insist on SOFR if counterparties are unable or unwilling in the near term to agree.

However, despites its SOFR preference, the bill does allow for alternatives as long as these are also approved by the Federal Reserve under rapid rulemakings required by the measure. It is hoped that this approach will permit the use of SOFR alternatives in contracts for which SOFR is not appropriate (e.g., consumer loans, mortgages) without exposing consumers to risks that might result if financial institutions could pick any benchmark replacement that suited them.

What's Next

HFSC reported this bill by voice vote on July 29. It should move quickly through the House but faces an uncertain future in the Senate. There is as yet no companion measure pending to this bill nor has Chairman Brown (D-OH) held a hearing or taken any preliminary action necessary to advance the bill in regular order. However, even in the absence of such action, the bill could become law if included in any of the last-minute, must-pass bills Congress will surely take up before year-end.

Analysis

The measure includes a rule of construction to emphasize that it does not govern and thus SOFR is not the prescribed benchmark for prospective contracts. It also enumerates the causes of action that may not be brought against a financial institution or other party that alters rates in a legacy contract in accordance with the bill's provisions, also making it clear that counterparties must perform all their duties under the agreement but those related to what was previously a LIBOR-pegged rate. Other key provisions require:

- The "Board-selected benchmark replacement" would be a rate set by the Fed based on SOFR. However, this SOFR-based rate may be adjusted for any transaction category where the Fed deems this necessary to reflect tenor or LIBOR-spread considerations. The initial rate would otherwise be between the Board's chosen replacement and LIBOR at most (but not all) relevant tenors as defined in the bill immediately before the LIBOR-replacement date, allowing any needed tenor adjustments for a one-year grace period.
- Contracts covered for purposes of rate-reset are not only a wide array of financial contracts but also equity, ownership, and other contracts that deploy LIBOR.
- The mandatory LIBOR replacement date would be the first London-banking day after June 30, 2023 unless the Board sets a different date. After that date, any fallback language based in any way on LIBOR must be determined by a benchmark administrator or on complex surveys detailed in the legislation. The administrator may pick a rate not approved by the Board but this rate then must be irrevocable and must have been set before the LIBOR replacement date. If no rate has been selected under these procedures, then the Board-selected replacement applies.
- The replacement-rate calculation does not require third-party consent under the bill's provisions but other contractual terms and conditions would continue even if the contract specified that the law implementing this bill is inoperable.
- Use of an approved LIBOR replacement constitutes TILA compliance for consumer loans.
- The Trust Indenture Act would also be revised to ensure that benchmark replacements do not adversely affect payments or other rights under the Act.
- The Fed would implement the benchmark-replacement process under rules finalized within 180 days of enactment.

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