Legacy-Contract LIBOR-Replacement Benchmarks

Cite

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Impact Assessment

- The Fed appears to have decided in favor of certainty by June of 2023 over the substance needed to address many questions the Fed acknowledges remain unanswered in the NPR. Potential costs to financial institutions, borrowers, and others remain to the extent post-LIBOR rates may be different in rate and/or risk than initially intended.
- Despite rate certainty, omissions in the NPR may leave some litigation risks unaddressed with the clarity sought by financial institutions.
- LIBOR-based consumer loans may see higher rates at advantage to lenders and harm to borrowers if the single term-rate index authorized by the Fed does not suffice.

Overview

Moving belatedly but now expeditiously to implement legislation governing legacy-contract benchmarks when there is no contractual fallback rate,[1] the Fed has proposed a new framework for derivatives, consumer loans, certain GSE contracts, and any other legacy contracts without clear LIBOR-replacement provisions and a "determining person" to effectuate them. As required by the LIBOR Act, the new approach is SOFR-based and incorporates statutory "tenor spreads" designed to reflect the differences between a rate calculated with some amount of credit risk (LIBOR) to one premised on risk-free sovereign obligations (SOFR). The manner in which this was done was one of the most challenging aspects of finalizing the new law and reflects an uneasy compromise between the Fed and many in the industry, especially regional banks with large consumer-loan books. Perhaps due to the late date at which the proposal was issued, many other issues are not addressed, creating

1 See **LIBOR7**, *Financial Services Management,* March 14, 2022.

areas of potential uncertainty related to affected contracts and the broader body not only of Fed rules, but also the broader regulatory framework governing nonbanks.

Impact

Although there was broad consensus to end LIBOR reliance after large-bank borrowing patterns changed in the wake of the great financial crisis and numerous severe rate-setting governance problems emerged, finding an alternative reference rate proved far more difficult than initially anticipated. Ultimately, the rate-setting body in the U.S. – the Fed-convened Alternative Reference Rate Committee – settled on the secured overnight financing rate (SOFR). However, it quickly became apparent that this secured rate was in many ways different than LIBOR, not only in that it is secured, but also by virtue of the challenges converting legacy contracts premised on returns different than those derived from SOFR. As a result, despite agreement in 2019 on SOFR, trillions of outstanding contracts rely on LIBOR without clear contractual fallback language permitting one or both parties to select another rate. Given that banks are essentially barred from using LIBOR after next June, this created the potential for significant market disruption and extensive, expensive litigation.

The Fed long believed it could resolve these challenges on its own as markets adapted to SOFR, but markets in several cases balked. Derivatives markets largely agreed to SOFR and like-kind non-dollar reference rates, but regional banks were concerned with the inapplicability of SOFR to their lending obligations and transition problems were also evident across the spectrum of trillions in LIBOR-based obligations related to the operations of Fannie Mae, Freddie Mac, and the Home Loan Banks. As the transition date neared and fears increased, New York State initially passed a law addressing legacy contracts, but the financial industry believed that federal, preemptive standards were essential to address contracts for which SOFR was deemed unsuitable. The Fed ultimately conceded the point, leading to the law now being implemented by the Federal Reserve, but it remains to be seen if the solutions now proposed suffice to ensure a smooth transition before next June, when LIBOR is effectively banned.

Contracts with no fallback language and authority for a determining person to set a fallback rate come under the rules below, based on provisions in the Act requiring a Fed-set new SOFR benchmark adjusted for certain maturities by tenor spreads detailed in the new law. These contracts also enjoy statutory protections to limit litigation risk. Other contracts may also allow for new benchmarks based on a determining person, but the SOFR-related benchmarks would apply if this person does not set a new benchmark in time for LIBOR's end. Statutory protections again apply if the selected replacement rate complies with the Board's rules. Conforming contractual changes to reflect the new benchmark are also permitted under certain conditions that afford additional safeguards.

Transition in the derivatives market is likely to be smoothest. A global self-regulatory organization governs this sector and transition there was already well under way. Indeed, this was so much the case that the "tenor spreads" designed to adjust SOFR to pre-existing LIBOR contracts in the new law are those also adopted for derivatives transactions. The Board's proposal thus makes no changes to rates governing derivatives beyond referencing those detailed by the International Swaps Derivatives Association (ISDA). However, consumer loans and certain GSE contracts may have a more challenging transition if the adjustments proposed to the basic SOFR-plus regime do not suffice. Rates tied now to overnight LIBOR could also face challenges if the single provision of an additional term adjustment is not deemed appropriate, an issue with significant market implications if this proves the case for very short-term Home Loan Bank advances.

What's Next

The FRB released this proposal, which was adopted unanimously, on July 19; comment is due thirty days after *Federal Register* publication. The Act was signed into law on March 11, 2022 and requires that final rules be in place no later than 180 days thereafter, i.e., September 11. It seems likely that the Fed will miss this deadline even though the accelerated comment deadline suggests it will seek to issue a final rule as quickly as possible thereafter. The final rule would be effective on the first day of the next calendar quarter after the final rule's publication in the *Federal Register*.

Analysis

The rule reiterates provisions in the Act stipulating that contracts that do not fall under the definitions of various legacy agreements without appropriate fallback language may use whatever benchmark is desired with express protection from enforcement action when this is based only on use of a non-SOFR benchmark. The "covered" contracts subject to this rule would be those that contain no fallback provision, have fallback provisions without a specific benchmark replacement or determining person, and those where a determining person has failed to select a replacement rate by the earlier of the June replacement date or the date governing its contractual authority to set an alternative rate. With the possible exception of exempt contracts and those with synthetic LIBOR rates (see below), any replacements or other actions based in any way on LIBOR would be prohibited after next June. Contracts are exempt from this rule if both parties have agreed in writing that the Act does not apply.

A. Derivatives

As noted, permissible benchmark rates in these sectors are SOFR-adjusted by the law's tenor spreads as long as the contract complies with ISDA protocols. Derivatives are defined as instruments which may be subject to this protocol.

B. Cash Transactions

Cash transactions that are not consumer loans or covered GSE contracts (see below) would replace references to overnight LIBOR with the approved forward-looking SOFR rate and a static spread adjustment reflecting those in the Act.

C. Consumer Loans

Cash transactions that are consumer loans would come under SOFR plus the tenor spreads along with a forward-looking linear transition calculation detailed in the NPR for one year following the mandatory LIBOR-replacement date. This is designed to protect consumers from sudden rate adjustments, but this approach is complex. The NPR thus also allows one term-rate products designed for consumer loans to substitute for the need for parties to calculate a permissible rate.

D. Covered GSE Contracts

These are cash transactions with Fannie Mae, Freddie Mac, or a Home Loan Bank when the obligation is:

- a commercial or multifamily mortgage loan;
- a collateralized mortgage obligation;
- a credit risk-transfer obligation; or
- an FHLB advance.

The benchmark replacement rate for these obligations is generally SOFR plus the static tenor spread. However, FHFA has also allowed an alternative rate based on a thirty-day SOFR average for certain multifamily loans and structured obligations. Rates selected under FHFA standards would also be permissible if the relevant tenor spread is applied.

E. Additional Provisions

The NPR also clarifies matters such as the fact that its new benchmarks apply on dates specified in the pre-existing contract, replacing only LIBOR references, not other terms. The Fed otherwise saw no need for conforming or technical changes to its rules or additional clarifications for existing contracts. However, it reserves the authority to mandate such changes should it decide to do so following the final rule's effective date.

F. Preemption

The Act expressly preempts state and local law governing LIBOR that restricts use of the Board-determined replacement. The rule reiterates this with regard to the power of its rule implementing the Act.

G. Request for Comment

Cash Views are expressly sought on matters including:

- the extent to which synthetic LIBOR rates could or should be used as fallbacks;
- alternative derivatives benchmarks;
- alternatives for covered GSE contracts;
- alternatives for other cash transactions;
- use of other providers for the term rate;
- the benefit of a selected Board rate for all covered contracts;
- the need for additional clarification;

- whether determining persons should be required to send counterparties a notice advising them of the replacement rate;
- the need for conforming changes to other rules; and
- the benefits of incorporating statutory protections into the final rule.

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