Legacy-Contract LIBOR Replacement Benchmarks

Cite

Federal Reserve, Final Rule, Regulation Implementing the Adjustable Interest Rate (LIBOR) Act

Recommended Distribution:

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Websites:

https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20221216a1.pdf

Impact Assessment

- Many LIBOR transition questions are now settled in favor of federally mandated SOFR.
- The Fed has decided in favor of certainty by June of 2023 over the substance needed to address many questions the Fed acknowledges remain unanswered in the final rule.
- Financial institutions, borrowers, and derivatives end-users remain at risk to the extent SOFR-based rates are different in rate and/or risk than initially intended.
- Despite rate certainty, omissions in the final rule may still leave some litigation risks unaddressed with the clarity sought by financial institutions.
- As required by law, legacy-contract counterparties are free to choose a non-SOFR benchmark if allowed by their governing agreement and this is done before July 1, 2023.

Overview

Shortly before its statutory year-end deadline, the Federal Reserve finalized its proposal defining legacy-contract benchmarks when there is no clear, practicable contractual fallback rate.[1] The new framework sets a statutory benchmark for derivatives, consumer loans, housing-GSE contracts, and other legacy contracts without clear LIBOR-replacement provisions and a "determining person" to effectuate them. As required by the LIBOR Act,[2] the new benchmark is SOFR-based and incorporates statutory "tenor spreads" designed to reflect the differences between a rate calculated without credit risk in contrast to LIBOR. 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.

[1] See **LIBOR8**, *Financial Services Management*, July 25, 2022.

[2] See **LIBOR7,** *Financial Services Management*, March 14, 2022.

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Perhaps due to the late date at which the proposal and now the rule were issued and the year-end deadline, some transition issues remain unaddressed and the extent to which litigation will delay the transition and increase market uncertainty remains to be seen.

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 by the Fed's committee 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. The 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 and other states 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 rule suffices to ensure a smooth transition before next June, when LIBOR is effectively banned. Immediately after the rule was released, Fannie Mae and Freddie Mac announced new, SOFR-based rate schedules, but it will take time for these to move into the TBA, derivatives, and other financial markets in which they are dominant counterparties. The year-end timing of the final rule and delayed effective dates for new rates move transition challenges into early 2023, but initial signs suggest that this will be rocky, especially in corporate and non-mortgage consumer finance.

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 rule thus makes no changes to rates governing derivatives beyond referencing those detailed by the International Swaps and Derivatives Association (ISDA). Even so, there will be misalignment between LIBOR-based rates and those under the new SOFR

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regime that may alter the expected benefits of derivatives contracts. The final rule notes that, for these instruments as for all others, there is no prohibition on parties to a LIBOR-based contract that use SOFR-based rates from transition to preferable rates at some future date such that all parties agree to do so.

What's Next

Although the LIBOR Act required a final Fed rule by September 11, the FRB only finalized it on December 16. It will be effective thirty days after *Federal Register* publication.

Analysis

A. General Provisions

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 must use the Fed's benchmark rates in the absence of a "determining person" or may use SOFR set by a contractually enabled determining person with express protection from litigation or other efforts to enforce the interest-rate provisions in the contract. SOFR also applies where a determining person has failed to select a replacement rate by the earlier of the June replacement date or the date governing contractual authority to set an alternative rate. Any replacements or other actions based in any way on LIBOR are prohibited after next June. Contracts are exempt from this rule if both parties have agreed in writing that the Act does not apply.

The final rule also reiterates the statutory provision making it clear that, in instances in which a legacy contract has no fallback language but there is a "determining person," that person may pick any benchmark he or she chooses based on calculations from a "calculating person" without risk of legal liability or Federal Reserve enforcement action.

B. Derivatives

As noted, new benchmark rates for these contracts are those calculated under the ISDA SOFR protocol unless a determining person picks another SOFR-benchmark. The final rule includes numerous technical changes to make Board-Set SOFR better align with the way ISDA SOFR rates are calculated.

C. Cash Transactions

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

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D. Consumer Loans

Cash transactions that are consumer loans 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 rule thus also allows one term-rate products designed for consumer loans to substitute for the need for parties to calculate a permissible rate.

E. Covered FHFA-Regulated Entity Contracts

Transactions covered here 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.

With the final rule making minor technical changes to conform to FHFA's preferred approach, 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 are also permissible if the relevant tenor spread is applied.

The final rule also includes a separate benchmark for FHLB advances. Here, the fallback rate is that set and calculated by ISDA.

F. Additional Provisions

The rule also clarifies matters such as the fact that its new benchmarks apply on the dates specified in the pre-existing contract, replacing only LIBOR references, not other terms. The Fed otherwise sees 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.

G. Preemption

The Act expressly preempts state and local laws governing LIBOR that restrict the use of the Board-determined replacement. The rule reiterates this regarding the power of its rule implementing the Act.

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