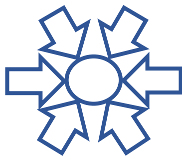

Financial Services Management

LIBOR Transition

Cite
Omnibus Funding Law, H.R. 4616: Adjustable Interest Rate (LIBOR) Act

Recommended Distribution:
Legal, Treasury, Asset/Liability Management, Government Relations

Website:
https://rules.house.gov/sites/democrats.rules.house.gov/files/BILLS-117HR2471SA-RCP-117-35.pdf

Impact Assessment

- There will now be considerably less litigation over the LIBOR transition, reducing controversies that might have proven 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 legacy counterparties in arrangements not well-aligned with SOFR or any additional approved Fed replacement rate.
- Financial institutions and counterparties may still more clearly elect non-SOFR benchmarks of their choosing on new contracts.
- Supervisory risk related to the LIBOR transition has been reduced.

Overview

The President has signed into law legislation based on a House-passed bill[1] 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 measure clarifies legal risk in 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 are likely to get like-kind certainty when the Fed exercises its authority to provide for relevant benchmarks and/or if various permissible adjustments to SOFR suffice. However, nothing in the legacy provisions applies to new contracts, where LIBOR is clearly prohibited but benchmark discretion remains.

[1] See **LIBOR6**, *Financial Services Management* August 10, 2021

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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 legacy contracts 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 ensure that all contracts subject to U.S. law are covered. The new law 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.

As with current regulatory standards, the law takes no position on alternative benchmarks in new contracts. These are under development in several arenas because SOFR is often 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. New language added in the Senate may reduce the ability of banking agencies and the SEC to outlaw benchmarks that concern them.

Although there was a significant effort to allow the use of preferred alternative benchmarks also for legacy contracts, the law reflects fears about unlimited benchmark discretion. 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.

What's Next

Although the House passed its version of the LIBOR preemption legislation in 2021, it was held up in the Senate by concerns that it had unanticipated tax consequences and unduly limited market discretion. The final version of the legislation reflects compromises on these and certain other issues, leading to its

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inclusion in the omnibus funding bill necessary to keep the government open. This was signed into law by the president on March 11.

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 provisions, also making it clear that counterparties must perform all their duties under the agreement except for those related to what was previously a LIBOR-pegged rate. The measure also includes provisions barring bank supervisors from sanctioning a financial institution that uses any interest rate it selects on non-legacy contracts regardless of the extent to which that rate references SOFR or fails to do so.

Other key provisions stipulate that:

- This federal law supersedes state and local law regarding interest-rate benchmarks and related contractual provisions.
- The “Board-selected benchmark replacement" is 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 law immediately before the LIBOR-replacement date, allowing any needed tenor adjustments for a one-year grace period.
- Any legacy contract that uses LIBOR, but also has a well-defined and practical fallback rate with a clearly set effective date that does not reference LIBOR is to reset as provided in that contract.
- Contracts covered for purposes of rate-reset are not only a wide array of financial contracts, but also equity, ownership, and other contracts that now rely on LIBOR.
- The mandatory LIBOR replacement date is 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, but other contractual terms and conditions would continue, even if the contract specified that this law is inoperable. Application of a Board-set rate does not entitle counterparties to any additional rights or obligations related to contract performance. No person is subject to any claim of law or other liability by virtue of an interest-rate reset that complies with the law's requirements.
- Use of an approved LIBOR replacement constitutes TILA compliance for consumer loans. Federal law, including the Trust Indenture Act, is revised to ensure that benchmark replacements do not adversely affect payments or

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other rights under the law.

- The Fed is to implement the benchmark-replacement process under rules finalized within 180 days of enactment.

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