Discontinuation of USD LIBOR

Ensuring Financial System Stability

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The future of USD LIBOR is uncertain after 2021.
Financial markets, regulators, legislators, and consumer finance must act immediately.
Federal action can ensure financial system stability by eliminating confusion and reducing the risk of mass litigation.

LIBOR underpins nearly $400 trillion in financial contracts globally

The London Interbank Offered Rate (LIBOR) is a measure of the average interest rate at which major global banks borrow from one another. LIBOR is quoted in 5 currencies and 7 tenors using data reported by private sector banks. Countless financing and hedging activities conducted by U.S. entities are indexed to LIBOR, including business and consumer loans, residential mortgages, student loans, corporate loans and other hedging and financing vehicles.

$200 trillion in contracts indexed to USD LIBOR
- over 10x U.S. GDP -

Derivatives:	$ 190 Trillion
Small Business Loans:	$ 2.0 Trillion
Securitizations:	$ 1.8 Trillion
Floating Rate Notes:	$ 1.8 Trillion
Residential Mortgages:	$ 1.0 Trillion
Other Consumer Loans:	$ 100 Billion

The future of USD LIBOR is uncertain

The U.K.'s Financial Conduct Authority – which regulates LIBOR – announced that it would not compel banks to submit indicative rates to produce LIBOR after December 31, 2021. The ICE Benchmark Administration, the publisher of LIBOR, is currently contemplating producing certain tenors of USD LIBOR through June 30, 2023.

Cause: Nonrepresentative

- After the 2010 global financial reforms, bank borrowing changed, causing banks to submit rates for LIBOR based on judgement without a reliable way to confirm that the submitted rates were based on lending activity
- LIBOR rate-setting scandals resulting in billions of dollars in fines also led to reduced creditbility
- Transactions among banks don't occur as often as they once did, making the index less reliable

Effect: Discontinuation

- In 2017 FCA announced banks would no longer be required to submit quotes for LIBOR after 2021
- Regulators have signaled that continued reliance on LIBOR could present systemic risk and announced that LIBOR will be phased out

Remedy: Replacement

- The NY Fed Alternative Reference Rates Committee (ARRC) was formed to identify an alternative rate and encourage voluntary adoption as a replacement rate
- SOFR (Secured Overnight Financing Rate) was chosen as the alternative rate in the U.S. by the ARRC
- Significant challenges exist in transitioning legacy LIBOR contracts to SOFR

1. Alternative Reference Rates Committee. (March 2018). *Second Report of the Alternative Reference Rates Committee*. Federal Reserve Bank of New York. https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report
2. Pozen, R. & Schneider, A. (2018, June 28). *How the End of This Key Borrowing Rate Could Impact Mortgages and Other Loans*. MarketWatch.

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Contracts typically did not contemplate permanent discontinuation of LIBOR until 2019

Most financial contracts contain LIBOR fallback provisions which do not contemplate a permanent cessation of LIBOR upon which contractual payments are calculated. Contracts not easily able to be amended are referred to as "tough legacy".

- Most structured finance deals are widely distributed, each often involving tens to hundreds of bondholders, and commonly require unanimous bondholder consent for making amendments to the benchmark rate in tough legacy deals, making execution virtually impossible.
- Although consumer contracts commonly include fallback language to provide the loan owner the ability to select a replacement rate; **the transition of a borrower to a replacement rate is uniquely complex**. Communication and consistency are paramount in safeguarding consumer borrowers from confusion. Consistent treatment across consumer products will improve borrowers' understanding of the situation.

What is Fallback Language?

Fallback language is contractual provisions that specify events that will "trigger" the provision to become effective, and then specifies how to proceed once those events occur. Fallback language is the language that the contract "falls back to" when a trigger event occurs. As it pertains to the LIBOR benchmark, fallback language, if it exists, acts as a how-to guide for identifying the replacement rate should LIBOR be unavailable.

Addressing impacts is critical to financial system stability

It is widely understood that, without federal action, a discontinuation of LIBOR will result in widespread litigation stemming from the absence of provisions in the case of a permanent LIBOR discontinuance.

- The magnitude of the potential litigation will place a considerable and unnecessary strain our nation's courts and businesses already significantly impacted by the global pandemic, undermine financial stability, and potentially cause a drag on affordable access to credit.

Given the scale of LIBOR's use – from floating rate mortgages and student loans to fixed income bonds held in pension and 401k accounts – missteps can be catastrophic for consumers, retail and institutional investors, regulated institutions, and the economy.

- For example, the selection of an appropriate – and consistent – replacement rate is critical.
  - If the rate is higher, the consumer could be paying more than projected
  - While if the rate is lower it could cost retail and institutional investors hundreds of millions of dollars
- **A similarly significant secondary impact could manifest in the balance sheets of American businesses.** Often using financing and hedging vehicles to manage their assets and liabilities, it is likely these asset liability management tools will not function as intended and an economic mismatch will exist upon a LIBOR cessation if the fallback language is relied upon and is not aligned across contracts.

Led by the critical work of the Alternative Reference Rates Committee (ARRC), market participants are stemming the tide by minimizing the number of new contracts that are indexed to LIBOR, and adopting robust, resilient fallback language when LIBOR is used.

- However, market participants are highly concerned of the calamity that will be caused in the absence of government intervention on "tough legacy."

Federal action now can prevent negative consequences across the financial and loan markets, including millions of consumer loans

Action now by U.S. lawmakers to offer legislative solutions that can lead to effective regulation is paramount to ensure financial stability.

- The ARRC proposed draft NYS legislation[3], already backed by significant market support including SFA members[4], can be translated to a federal level to be enacted by Congress.
- A national solution to fixing inadequate LIBOR fallback provisions is a comprehensive solution that would apply a consistent, fair approach to all consumer and business contracts under U.S. law.
- The European Commission and the U.K. Parliament are seeking similar actions by proposing legislation to establish mechanisms that can remedy or reduce their tough legacy contracts.

A coordinated legislative and regulatory solution can ensure all U.S. legacy contracts are provided a fair, consistent treatment thereby minimizing any value transfer and confusion – while failure to do so risks instability, confusion, and litigations for years to come.

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3. Alternative Reference Rates Committee. (2020, December 17). *ARRC Proposal for New York State Legislation for U.S. Dollar LIBOR Contracts*. Federal Reserve Bank of New York. https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ny-libor-legislation
4. Members of the Alternative Reference Rates Committee and various other firms. Letter to New York Governor Cuomo, Majority Leader Stewart-Cousins, and Speaker Heastie. 16 Dec. 2020. https://structuredfinance.org/wp-content/uploads/2020/12/ARRC-Letter-of-Support-New-York-State.pdf