Discontinuation of USD LIBOR

Ensuring Financial System Stability

January 2021

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The representative rates for the most-used USD LIBOR tenors will cease mid-2023 – and at the end of 2021 for all other LIBORs.

The best way to avoid confusion and disruption across financial markets is for legislators to act swiftly.

Federal action can ensure financial system stability by eliminating confusion, curtailing the risk of mass litigation and reducing adverse liquidity and valuation on financial contracts.

The legislative approach should minimize economic transfer between parties of a contract.

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.

$223 trillion in contracts indexed to USD LIBOR

- over 10x U.S. GDP -

Derivatives:	$ 214 Trillion
Small Business Loans:	$ 2.0 Trillion
Securitizations:	$ 1.6 Trillion
Floating Rate Notes:	$ 1.1 Trillion
Residential Mortgages:	$ 1.3 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 in mid-2023 representative rates for the most frequently used USD LIBOR rates (1-day, 1, 3, 6 and 12-month LIBOR) will cease to be available. All other representative LIBOR rates, including 1-week and 2-month USD LIBOR, will cease at the end of 2021.

Cause: Nonrepresentative

- After the 2010 financial reforms, bank borrowing changed, causing banks to submit rates for LIBOR based upon significantly reduced number of actual transactions and increased judgement
- 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 convened the Alternative Reference Rates Committee (ARRC) 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 LIBOR-based financial contracts entered into prior to 2019 do not contain fallback provisions which contemplate a permanent cessation of LIBOR, the rate 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, making amendments 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, the discontinuation of LIBOR will result in widespread litigation stemming from the absence of fallback language or other contractual provisions.

- The magnitude of the potential litigation will place a considerable and unnecessary strain on our nation's courts and businesses already significantly impacted by the global pandemic, undermine financial stability, reduce liquidity and value of financial contracts including fixed income bonds held by pension plans and saving accounts 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/borrower could be paying more than projected
  - While if the rate is lower it could cost retail and institutional investors hundreds of millions of dollars in interest payments on their floating rate fixed income bonds (which are generally more prevalent in pension investments and lower-risk investors)
- **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 a legislative solution that can lead to effective regulation is paramount to ensure financial stability.

- A national solution to fixing inadequate LIBOR fallback provisions is one that is comprehensive and that would apply a consistent, fair approach to all consumer and business contracts under U.S. law.
- On July 29, the House Financial Services Committee (HFSC) approved H.R. 4616, the "Adjustable Interest Rate (LIBOR) Act of 2021," authored by Representative Brad Sherman (D-CA), by unanimous voice vote.
- H.R. 4616 is similar to the ARRC model passed into law in New York state and aims to minimize marketplace disruption and legal uncertainty by establishing a narrow, uniform and nationwide fix for "tough legacy" contract by:
  - **Designating which types of LIBOR Contracts are and are not subject to the legislation**:
    - Contracts that are silent with respect to LIBOR cessation are included
    - Contracts that fallback to a replacement rate based on LIBOR, or requires a poll to determine LIBOR are included
    - For contracts where one party has the discretion to select a replacement rate that party may opt-into the legislation
    - Contractual parties may opt-out of the legislation by mutually agreeing to an alternative replacement approach
  - **Directing parties of designated contracts to replace USD LIBOR with a SOFR-based rate, selected by the Federal Reserve, on or after July 1, 2023**.
  - **Providing a safe harbor to all parties of a LIBOR Contract that transitions away from LIBOR in accordance with the legislation.**
  - **Would not impact existing contracts that specify non-LIBOR replacement rate(s).**
- While H.R. 4616 awaits consideration on the floor of the House of Representatives, SFA is working with members of the Senate Banking Committee to introduce companion legislation in the upper chamber.
- Treasury Secretary Janet Yellen and Chair of the Federal Reserve Jay Powell have affirmed federal legislation is the best solution to address the LIBOR transition for "tough legacy" contracts, and the

Federal Reserve, Office of the Comptroller of the Currency, and Federal Housing Finance Authority all submitted letters to the HFSC in support of the bill's passage.

- 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.

To avoid wide-spread litigation timing of action is vital

- Without an appropriately authorized alternative solution, many of the parties responsible for directing LIBOR-based calculations (often the Trustee in structured finance transactions) have already notified the other contractual parties that they will seek court direction, the process of which needs to begin at least 12 – 18 months prior to the cessation of the respective LIBOR rate.
- Further, paying agents, lenders, servicers, and other service providers need significant time to operationalize, communicate and accurately calculate consumer, business and investor interest payments.

A coordinated legislative and regulatory solution can ensure all U.S. "tough 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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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