Federal LIBOR legislation: five things financial market participants need to know

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On March 15, 2022, President Joe Biden signed into law the Adjustable Interest Rate (LIBOR) Act as part of a $1.5 trillion omnibus spending package. The LIBOR Act is a significant piece of federal legislation — affecting contractual terms for trillions of dollars of existing financial transactions worldwide and providing much-needed guidance for borrowers, lenders, consumers, and investors navigating the upcoming cessation of LIBOR.

The stated purpose of the LIBOR Act is reducing the uncertainty and minimizing the economic impact of the end of LIBOR on existing USD LIBOR transactions.

The London Inter-bank Offered Rate (LIBOR) is a floating rate benchmark based on submissions by a panel of banks indicating their estimate of how much it would cost each of them to borrow. LIBOR has been widely considered the most liquid of floating rate benchmarks, with approximately $200 trillion in outstanding dollar-denominated LIBOR-based financial instruments (https://nyfed.org/3qnMIk5) at its height.

After a series of scandals involving allegations that banks manipulated the benchmark, LIBOR's U.K.-based regulators announced (https://bit.ly/3L7SMFj) in 2017 that LIBOR would cease being published. On March 5, 2021, LIBOR's regulators confirmed that the publication of LIBOR on a representative basis would cease for all tenors of USD LIBOR immediately after June 30, 2023.

Transitioning from LIBOR

Given the volume and variety of USD LIBOR-denominated financial instruments, U.S. financial institutions and their regulators have been grappling with the end of LIBOR for some time. A significant milestone occurred when the Federal Reserve Bank of New York selected the Secured Overnight Financing Rate (https://nyfed.org/3IyubHH) (SOFR) to replace LIBOR and began publishing SOFR in April 2018. Another milestone occurred on Nov. 30, 2020, when federal banking regulators announced (https://bit.ly/3L6bcGr) that financial institutions should not enter into new contracts based on USD LIBOR after Dec. 31, 2021.

Yet none of these measures addressed how to transition trillions of dollars of legacy USD LIBOR transactions to an alternative benchmark. These transactions span virtually all asset classes, including commercial loans, consumer loans, asset-backed securities, and financial market transactions, such as derivatives. Many of the contracts governing legacy transactions lack provisions that contemplate the permanent cessation of LIBOR, are difficult to amend (such as securities that often require unanimous consent), or both.

The LIBOR Act

The stated purpose of the LIBOR Act is reducing the uncertainty and minimizing the economic impact of the end of LIBOR on existing USD LIBOR transactions. After passing the House and Senate with bipartisan support, President Biden signed the LIBOR Act on March 15, 2022.

In broad strokes, the LIBOR Act has five main components.

First, the LIBOR Act automatically transitions certain USD LIBOR-based agreements to a replacement rate. Automatic transition applies to four categories of USD LIBOR contracts: (1) contracts with no "fallback provision"—meaning the contract contains no terms for determining a benchmark replacement; (2) contracts that do not identify a specific non-LIBOR replacement rate (e.g., prime rate); (3) contracts that do not identify a "determining person," meaning a person with authority to determine the replacement rate; and (4) contracts that identify a determining person, but no replacement rate has been selected as of the LIBOR cessation date. For each category, the Act will transition the contract to a statutory replacement rate as of July 1, 2023.

Second, the LIBOR Act nullifies certain specified fallback provisions that are based on USD LIBOR, such as requiring a party to poll to determine LIBOR or where the replacement rate is based on the last LIBOR screen rate. Practically, nullifying a LIBOR-based fallback provision means one of two things: (1) if the fallback provision includes a hierarchy of potential replacement rates (known as a "waterfall"), the parties continue to the next replacement rate option in the waterfall; or (2) if the LIBOR-based replacement rate is the only or last replacement rate option permitted under the fallback provision, the contract is deemed to have no fallback provision and will automatically transition to the statutory replacement rate.

Third, the LIBOR Act provides a safe harbor from disputes arising out of the replacement of LIBOR. Specifically, the Act immunizes parties from liability arising out of the selection or use of a replacement rate if the statutory replacement rate is selected to replace USD LIBOR. Additionally, the safe harbor applies to contracts that are subject to automatic transition.

Fourth, the LIBOR Act requires the statutory replacement rate to be based on SOFR. Because different versions of SOFR exist — such as Term SOFR and compounded SOFR — the Act requires the Federal Reserve to issue a regulation within 180 days (i.e., by September 2022) identifying which version of SOFR will apply to contracts subject to the legislation, such as asset-backed securities, business loans, consumer products, and derivatives. The Act also requires the Federal Reserve to add a spread adjustment to SOFR to account for LIBOR's credit-risk adjustment and establishes the spread adjustment for each tenor of LIBOR.

Fifth, the LIBOR Act authorizes the Federal Reserve to issue a regulation promulgating technical or administrative changes that may be incorporated into contracts subject to the Act in order to facilitate the implementation, administration, and calculation of the replacement benchmark, known as "conforming changes." The Act also grants certain contract parties the right to adopt additional conforming changes that are necessary or appropriate to replacing the benchmark. Under the Act, these conforming changes become an "integral part" of the contract.

Considerations looking forward

At bottom, the LIBOR Act provides a much-needed transition path for difficult-to-amend legacy contracts. And by providing a safe harbor, the Act also encourages market participants with authority to select a replacement rate to choose SOFR. The Act is not, however, intended as a primary LIBOR transition strategy — federal banking regulators have been clear (https://bit.ly/3qkzaFF) that they expect market participants to be proactive in addressing their LIBOR exposure.

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The LIBOR Act also has its limits: USD LIBOR contracts that fall back to a specific non-LIBOR rate, such as Base Rate, Prime Rate, or Fed Funds, are not within the scope of the Act; parties can contractually agree to exclude their contract from the scope of the Act; and the safe harbor would not cover contracts that select a non-SOFR replacement rate. These are just some examples where the Act would not apply. In addition, certain interpretative questions will need to be resolved in the months ahead.

Nonetheless, the LIBOR Act is unquestionably another significant milestone for financial market participants as they adapt to the end of LIBOR. Market participants should analyze their LIBOR-based agreements to determine how the LIBOR Act affects their unique LIBOR exposure and how (or whether) to rely on the Act to mitigate risk and facilitate a smooth transition from LIBOR.

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