Professional Perspective

A Guide to LIBOR Legislation

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Editor's Note: The author and Cadwalader, Wickersham & Taft are currently advising the Alternative Reference Rates Committee, including on its development of LIBOR legislation.

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U.S. Dollar LIBOR, the ubiquitous interest rate benchmark used in over $200 trillion of transactions worldwide, is going away. Regulators have issued stern warnings against its continued use in new transactions after this year. The publisher of LIBOR and its U.K. regulator have announced that LIBOR will no longer be published as a representative rate for new or legacy transactions after Dec. 31, 2021, for 1-week and 2-month tenors, and after June 30, 2023, for all other tenors. It is estimated that $90 trillion of legacy transactions will be outstanding at that time, including mortgages, consumer loans, syndicated business loans, swaps, bonds, securitizations, and other products. Through significant efforts by financial market participants, the vast majority of these legacy transactions are expected to include language that contemplates the end of LIBOR, or will mature before LIBOR ends.

This article describes legislative initiatives in the U.S. to avoid the uncertainty, disputes, litigation, and market disruption that could arise from the trillions of dollars of remaining legacy transactions. (In this article, "LIBOR" means USD LIBOR.)

How Did We Get Here?

LIBOR is published by an administrator based in London. Following investigations surrounding its manipulation, The Wheatley Review of LIBOR: Final Report was prepared at the request of British regulators. The report identified concerns about the suitability of LIBOR, given the large volume of contracts that used it and the declining volumes of transactions that the rate was based on. Subsequent reviews were conducted by international and U.S. regulators, leading to reports issued by the Financial Stability Board and the Financial Stability Oversight Council. In 2014, the Federal Reserve Board and the New York Federal Reserve convened the Alternative Reference Rates Committee (ARRC), a group of private market participants, to help ensure a successful transition away from LIBOR to a more robust alternative reference rate. After nearly three years of analysis, including a detailed interim report and public input from a wide range of market participants, the ARRC identified the Secured Overnight Financing Rate (SOFR) in June 2017 as its recommended benchmark rate to replace LIBOR.

Less than one month later, a speech by LIBOR's regulator in the U.K. set off a tsunami across the global financial markets. In that speech, Andrew Bailey, then-CEO of the Financial Conduct Authority (FCA), announced that publication of LIBOR could not be expected to continue beyond December 2021. To some, the four-year horizon and the magnitude of the challenge was a distant and nearly incomprehensible reality. But as the ARRC's plans progressed and announcements by Bailey and other global regulators grew more frequent and urgent, more market participants started to prepare for the change.

In 2018, the ARRC began to publish recommended documentation for use in new issuances of LIBOR-based cash market instruments, including loans, securities, and consumer products. This initiative was undertaken in coordination with a similar initiative for the derivatives market led by the International Swaps and Derivatives Association (ISDA).

The documentation established market standards for robust contract language to be added to new or amended contracts while the market continued to use LIBOR. The idea was to "stop digging the hole" of increased LIBOR exposure while the markets developed plans to transition toward SOFR. Specifically, the new language clearly provides that, when LIBOR ceases, the rate on the contract will "fall back" to a SOFR-based rate.

The ARRC then turned its sights on solving the problem of LIBOR contracts that will remain outstanding after LIBOR ends, so-called "legacy contracts." A critical component of the ARRC's strategy is legislation that addresses legacy contracts that never contemplated the permanent cessation of LIBOR, as described below.

The Benchmarks

LIBOR

LIBOR is an index determined by an administrator in London, the ICE Benchmark Authority IBA), on the basis of rates submitted by a panel of banks. The rates are supposed to reflect the interest rate at which each panel bank believes it could borrow on each day for a given maturity or "tenor" and in a given currency. However, the market for unsecured interbank lending, such as LIBOR, dropped steadily after the 2008-2009 credit crisis, resulting in an inverted pyramid and inherent fragility of LIBOR "where the pricing of hundreds of trillions of dollars of financial instruments rests on the expert judgment of relatively few individuals, informed by a very small base of unsecured interbank transactions," according to the Federal Reserve Bank of New York.

For the reasons described above, on March 5, 2021, IBA and its regulator announced that USD LIBOR will cease being published or cease being fit for purpose as soon as Dec. 31, 2021, for certain tenors and by June 30, 2023, for all other tenors. (More specifically, LIBOR will "no longer be representative" of the underlying market and economic reality that it is intended to measure. In this article, these events are all referred to generally as the "end" of LIBOR.) U.S. regulators have advised banks to stop entering into new LIBOR contracts "as soon as practicable" and that entering into new LIBOR contracts after Dec. 31, 2021, will create "safety and soundness risks."

SOFR

SOFR is the rate derived from overnight lending transactions secured by U.S. treasury securities, i.e., the overnight repo market, which has approximately $1 trillion in daily volume. It is produced daily by the New York Fed. It is a transparent rate that is representative of the market across a broad range of market participants, which protects it against manipulation. As the repo market is fully collateralized by U.S. Treasury securities, it also maintains relatively consistent trading volumes through various market cycles, unlike the unsecured rates underpinning LIBOR.

Because SOFR is an overnight secured rate and LIBOR is a term unsecured rate, an adjustment is added to SOFR to make the rates comparable. The ARRC has recommended spread methodologies that are appropriate for various cash products and consistent with the spread adjustment for derivative contracts adopted by ISDA.

The Legacy Contracts

Inadequate or Ambiguous Legacy Provisions

LIBOR is embedded in over $200 trillion of outstanding legacy transactions, including mortgages, consumer loans, syndicated business loans, swaps, bonds, securitizations, and other products. Over time, each of these markets developed its own conventions for using LIBOR in its legacy documents. Many of these contracts do not contemplate the permanent end of LIBOR. Some, for example, rely on a poll or survey of large dealer banks to request their input on where they would set LIBOR. When LIBOR ceases to be produced, it is unlikely these banks would respond to these polls. Other legacy contracts default to the last published value of LIBOR, in effect turning a floating rate instrument into a fixed rate instrument. Consumer contracts generally give the lender (or noteholder) discretion to choose the replacement for LIBOR.

Addressing LIBOR's End

It is certainly preferable for parties to a transaction to agree when possible on the replacement for LIBOR before its end date. Such an advance agreement can take the form of a specific replacement rate, a "fallback provision" where the replacement rate is determined according to an agreed method, or by authorizing one of the parties (usually the lender) to select the replacement.

Where none of those options exists in a legacy contract, market participants have been attempting to add them through amendments. Often these amendments are modelled on the ARRC's recommended documentation for new contracts. In the case of swap agreements, which are generally documented on standard forms, improved fallback language for new transactions and amendments for legacy transactions were published by the International Swaps and Derivatives Association Inc.

Unremediated Legacy Contracts

However, given the large volume of legacy contracts, it is likely that a significant number of transactions will not be amended in time. In some cases, particularly securities with diffuse holders and unanimous consent clauses, it is impracticable or impossible to amend the LIBOR provisions. Moreover, some transactions are administered by third parties, such as servicers or trustees, who often have a fiduciary or contractual duty and will not act under provisions that are ambiguous. In these cases, the parties to the transaction, and the markets generally, face the potential for uncertainty, disputes, litigation, and market disruption.

The Principles Underlying the Legislation

The recently enacted New York legislation and the publicly released discussion draft of the federal legislation are substantively nearly identical.

Freedom of Contract

First, the legislation does not prohibit parties from agreeing to use any rate they wish. Further, a legacy contract is not subject to the legislation if the parties mutually agree to opt out of its application—either before or after LIBOR cessation—although this may be impracticable or impossible in some cases, such as for securities as described above.

Policy Goals

The legislation was carefully crafted to: minimize legal uncertainty, disputes, market disruption and litigation, focus narrowly on the language in legacy contracts that results in uneconomic or unintended consequences upon the permanent cessation of LIBOR, address these problems while minimizing the impact on parties' contract rights, and minimize the economic impact arising from the transition of a contract from LIBOR to SOFR.

Foundation in Existing Law

To achieve these goals, the legislation is based on existing common law principles that would apply in the context of a legal dispute regarding the interpretation of a legacy contract. By codifying these principles into legislation that specifically addresses LIBOR transition, individual parties are spared the time and expense of pursuing numerous lawsuits. It also avoids burdening the judicial system. This approach worked well when legislation was enacted to address the introduction of the euro, which prevented disputes about contracts that contemplated performance in domestic currencies that had been discontinued.

Attention to Constitutional Rights

Because the legislation operates to cure contracts that do not adequately address LIBOR transition, it will have a direct impact on certain rights of the parties under those contracts. For that reason, the legislation was crafted to attempt to meet important Constitutional protections against the impairment of contracts, "takings," due process rights, and other applicable principles, as described below.

Role of the Federal Reserve

The legislation reflects the public policy for LIBOR transition, including the choice of SOFR to replace LIBOR. To implement this policy, the federal legislation provides for a relatively narrow delegation of authority to the Federal Reserve Board, including rule-making authority, to select the method for calculating SOFR to correspond to various tenors of LIBOR and for calculating a spread adjustment, as described below. Under the New York legislation, this role is expected to be filled by the ARRC. If challenged, the scope of this delegation should be held to fall within Constitutional limits.

How the Legislation Minimizes the Impact on Contract Rights

Contracts With Discretion

For contracts (such as many consumer contracts) where one party has the existing contractual right to choose a replacement rate, the legislation will cause no impairment of rights. Rather, that party may exercise its discretion according to the provisions of the legacy contract. If SOFR falls within the scope of discretion permitted by the legacy contract, then the legislation encourages the selection of SOFR by providing a liability and litigation safe harbor. The contract terms are not modified by the legislation.

Contracts With Non-LIBOR Replacement Rates

Similarly, the legislation does not affect legacy contracts that result in a non-LIBOR-based replacement rate for LIBOR, such as the Prime Rate or the Effective Federal Funds Rate (EFFR), which are common in commercial loans.

'Silent' Contracts

For contracts that are silent regarding how to address LIBOR cessation, disputes would ordinarily be resolved under common law principles. The legislation is based on these principles but by codifying the treatment of these contracts when LIBOR ceases, it provides consistent outcomes and a predictable interpretation without courts being burdened or individuals incurring steep legal fees.

Contracts With a LIBOR Fallback or Polling

The primary focus of the legislation is two other types of legacy contracts: those that result in a replacement rate based on LIBOR, and those that require a poll to determine LIBOR. When LIBOR is no longer published or no longer represents market conditions, these contracts are likely to lead to disputes, litigation, and market disruption. There is a strong public policy interest in trying to minimize these consequences. The legislation addresses these contracts by replacing LIBOR with the recommended replacement rate—i.e., SOFR plus a spread adjustment to account for the historical difference between LIBOR's unsecured rates and the collateralized rates underlying SOFR. Again, the parties to those contracts may opt out of the legislative outcome. The statute also provides that polling provisions in contracts should be disregarded.

Other Features of the Legislation

Single Replacement Rate

As described above, where parties have been unable to amend a legacy contract that has no fallback language or falls back to a LIBOR-based replacement rate, the legislation steps into the void to minimize uncertainty, litigation, and market disruption. The parties continue to have the right to opt-out of the legislation after the LIBOR end date or otherwise agree on a replacement rate. However, it is structurally not possible for the legislation to step into the void with a choice of endorsed rates. The situation with these affected contracts exists specifically because the parties have been unable to prevent it. Giving them a choice in the legislation between various rates—or providing for them to agree on a replacement rate—does not solve the problem. They had that opportunity before the legislation applied to their contract.

Further, giving one party a right to choose among several rates, when that doesn't exist under the legacy contract, would essentially confer legislative protection for it to act in its own best interest, potentially to the detriment of the counterparty. Instead, the legislation imposes a single rate that meets the underlying policy of the law, while giving the parties the right to opt out of it so that they can agree on another rate. However, legislation that is conditioned on a choice of alternative rates or the right to agree on a replacement rate would create the type of uncertainty and potential negative outcomes that the legislation is designed to prevent and possibly weaken the constitutional underpinnings of the law.

Safe Harbor

The legislation offers a safe harbor that applies only where the recommended replacement rate (SOFR plus the applicable spread adjustment) has been imposed on the contract—because it is silent or has a LIBOR-based fallback—or where contractual discretion permits a party to choose the replacement. The safe harbor does not extend to any other contract or party. It operates to promote the use of a replacement benchmark that meets the policy goals of the legislation described above. Lenders are not required to choose SOFR.

Some banks have argued for the safe harbor to protect them for using replacement benchmarks that have not been subject to the same rigorous selection process as SOFR. The legislation does not protect a bank that chooses another rate against claims that its choice fails to satisfy the applicable legal standards. On the other hand, the legislation does not prevent them from choosing another rate. It just does not relieve them from any liability they would otherwise have for making that choice.

Securitizations

The legislation does not function by specifying particular types of contracts to which it applies. Rather, it is based on the language of the contract, which is its fundamental purpose—minimizing disputes about the proper interpretation under applicable state law. For this reason, securitizations face an especially difficult challenge with LIBOR transition.

The securities issued as part of these transactions, like most securities, generally cannot be amended without the unanimous consent of the investors. Not only is it impossible or impracticable to locate every single investor and expect a decision from every one of them, the requirement to obtain 100% consent creates the opportunity for a single investor to threaten litigation or "hold out" for special treatment.

Further complicating the problem, the securities issued in these transactions are often governed by one state law while the assets backing those securities are governed by a different state law or, even more complicated, many different state laws. Think, for example, of the securities issued under a trust agreement governed by New York law and whose assets are home mortgages governed by the laws of all the states where they are located.

There would almost certainly be conflicting decisions by courts around the country interpreting the various fallback provisions. Not to mention the time and expense suffered by investors, consumers, businesses, pension funds and others—as well as the court system—as a result of litigation.

Litigation Risks

It is not likely that the legislation will prevent all litigation. First, some contractual party or parties may challenge its constitutionality. As described above, the legislation has been drafted with constitutional limitations in mind. In preparing the New York legislation, the ARRC obtained a report from the New York City Bar Association supporting its enactment and confirming its view that the law is constitutional.

In any event, a single litigation can establish its constitutionality and set a precedent for trillions of dollars of contracts. Absent legislation, a blizzard of lawsuits could be filed over countless individual contracts in courtrooms around the country. Second, the legislation does not resolve every ambiguity in every single contract. Rather, the legislation attempts to minimize the scope of uncertainty and litigation, and promote the speedier resolution of disputes, by establishing defined outcomes for affected contracts within its scope. While there will always be outliers and litigious parties, the general principles of the legislation should also help guide the settlement of potential disputes over fact patterns it does not expressly cover.

Benefits of a Federal Law

New York Precedent

LIBOR legislation was recently enacted in New York to provide legal certainty and promote economic stability for the vast number of contracts governed by the law of that state. The New York law was developed by the ARRC over a period of almost three years, with input from a wide range of market participants, including issuers, asset managers, trustees, consumer groups and others who supported it. That legislation served as the model for the proposed federal legislation.

Consistent Treatment Throughout the Country

There are several advantages to a federal law addressing LIBOR transition, which has been supported by the Secretary of the Treasury, the Vice Chairman of the Federal Reserve and others. First, given the size of the LIBOR market, it appears in contracts governed by the laws of every state. Ordinarily, disputes about the interpretation of a contract, such as what happens when LIBOR ends, are governed by the law of the applicable state.

While New York has set a precedent for addressing LIBOR contracts governed by New York law, and many LIBOR-based contracts are governed by New York law, ultimately state laws can only provide a partial solution. Some of the limitations of a state law are described above regarding securitizations. Another disadvantage of individual state laws is the risk of a "crazy-quilt" regulation of a market that needs consistency to maintain the stability and efficiency of the country's capital markets. On the other hand, the legislation should not pre-empt state laws that apply to some of the ancillary effects of LIBOR transition, such as exemption from the Florida documentary stamp tax.

Clarification Under Other Federal Laws

State laws, including the New York legislation, are also unable to address some of the issues that arise under federal law regarding LIBOR transition. There needs to be certainty that there are no tax consequences arising from the modification of a contract to cure its LIBOR provisions. While regulatory relief has been provided, a federal law addressing LIBOR transition can provide added guidance and rule-making authority in this area. The same is true for certain technical problems arising from the use of LIBOR in the federal statute authorizing special allowance payments for Federal Family Education Loans, ensuring that student borrowers are protected from adverse consequences of this transition.

Undoubtedly the issue that needs the most attention from a federal solution arises under the Trust Indenture Act of 1939. The TIA includes a provision that protects an investor's right to receive payment on a security from being impaired or affected without the consent of that investor. That provision was designed to prevent a majority of investors from adversely affecting the rights of other investors, such as in an out-of-court restructuring of debt. Here, investors originally purchased a security with an interest rate that floats on the basis of a benchmark (LIBOR) whose discontinuance was not expected. Federal legislation could address the TIA in the context of LIBOR transition and avoid market disruption for the large number of outstanding legacy LIBOR securities.

Next Steps

Enactment of a federal legislative solution is not the final step in a smooth transition from LIBOR. Once enacted, certain aspects of the law will require rule-making, including time to draft the rules and provide for a comment period. Further, once the rules are finalized, institutions, as well as vendors providing services to them, will need time to operationalize the requirements of the rules by making the appropriate adjustments to their risk management systems, documentation and related internal policies. Markets will also look for clarity sufficiently far in advance to avoid unexpected disruptions in valuations and trading.

Finally, in the absence of clear legislative direction, trustees and other third party administrators that are responsible for LIBOR transition will be inclined to seek guidance in judicial proceedings, sometimes known as Article 77 proceedings. These proceedings, including appellate review, can take over one year to resolve any questions left unanswered by the legislation.

Conclusion

Financial markets have never confronted a change as large and complex as the $200 trillion LIBOR transition. Fortunately, both regulators and market participants have been addressing it for over a decade. A great deal of expertise and effort have gone into identifying SOFR as the appropriate replacement for LIBOR and crafting legislation to address legacy contracts that have not been remediated.

New York has already set a precedent that has broad market support. Consumers, borrowers, investors, businesses, municipalities, and issuers across the country all need a similar solution to minimize uncertainty, disputes, litigation, and market disruption. Time is running out for a smooth transition. Federal LIBOR legislation should be enacted as soon as possible.

