Federal Legislation Would Save 'Tough Legacy' Contracts from LIBOR Limbo

Tara Payne and Brett Waxman | April 12, 2021

The London Interbank Offered Rate, known as LIBOR, will soon end its reign as the reference rate of choice for many financial contracts around the world, from a global conglomerate's bonds to your teenager's student loans. Regulators have mandated its demise because the markets from which it is derived are now insufficiently active, making it less reliable as a benchmark, although there were also earlier concerns about manipulation.

So, what happens to those contracts when their key building block evaporates? That's the $400 trillion question. Regulators and market participants have spent years devising a plan on what to do going forward, but going backward is much tougher: there has been no real solution to the problem of "legacy" contracts that were priced to an index that will soon cease to exist, even though the contracts continue to live on (in some cases for several years). To prevent confusion and a profusion of commercial litigation, Congress needs to act.

LIBOR won't vanish all at once. Even after some forms of LIBOR stop being published at the end of 2021, some benchmarks of U.S. dollar LIBOR -- an important version of the rate that underpins $200 trillion of loans and derivatives contracts -- will be published until June 30, 2023. Regulators have urged banks not to enter into new contracts after 2021 that are based on LIBOR to make it easier to wean off the rate, and have begun scrutinizing banks' plans to move away from LIBOR, underscoring the urgency of the transition.[1]

A Fed-sponsored panel known as the Alternative Reference Rates Committee has named SOFR, the Secured Overnight Financing Rate, as LIBOR's eventual successor for certain USD derivatives and other financial contracts. But the availability of SOFR as a successor to LIBOR does not alleviate concerns around those tough "legacy" contracts that don't have clear fallback language that permit the substitution of another rate when LIBOR is no longer published. So, what happens to these contracts when LIBOR ceases to exist?

Think of LIBOR as a small, unremarkable part in airplane machinery around the world. It's so ubiquitous that dislodging it from a global fleet of planes without a smooth plan for replacing it would bring air traffic to a disruptive halt. But it has problems, so new planes are now supposed to use a new part in its place. What the markets need is a clear instruction manual for planes – in this case, financial contracts like mortgages and corporate bonds – that still use the old part and lack a clear plan to replace it, so they don't suffer a crash landing. (For a recent analogy, note that the B-52 Stratofortress began flying in 1949, and the Pentagon has recently announced that it will remain part of the U.S. bomber fleet until 2050, its 100th anniversary.)

Congress should provide that instruction manual through legislation that covers "legacy" financial contracts without effective fallback language that mature after June 30, 2023, the official death date for the last versions of LIBOR. Any legislation should permit "legacy" contracts without effective fallback language to transition to a new rate (i.e. SOFR, including a potential credit-sensitive spread) when LIBOR goes away, including a safe harbor. While the recent extension in publication of certain USD LIBOR tenors from Dec. 31, 2021 to June 30, 2023 is estimated

[1] Federal Reserve, SR letter 21-7, *Assessing Supervised Institutions' Plans to Transition Away from the Use of the LIBOR* (March 9, 2021) available at: https://www.federalreserve.gov/supervisionreg/srletters/SR2107.htm.

to capture roughly 67 percent of outstanding USD LIBOR exposures, about $74 trillion in financial contracts will remain outstanding after June 2023.[2] Some contracts already have clear language about what rate should apply in the event of LIBOR's demise, but many do not and cannot easily be altered. Legislation would give clear answers to the businesses, borrowers, investors and banks about what interest rate they will pay (or earn) come July 1, 2023.

The absence of legislation to ensure a smooth transition from LIBOR could invite chaos into the financial markets when it is least welcome – amid an economic recovery from a black-swan historical event. If answers about who pays what in legacy LIBOR contracts aren't clear, investors could seek them in court and challenge any alternative rates chosen by institutions. The lack of contingency language would leave a hole in financial agreements that span every facet of the financial system. Litigation could sow confusion, uncertainty and financial damage.

Leaving those gaps unfilled could also cloud the market with outdated borrowing costs frozen in time from when LIBOR ended on June 30, 2023. Thus, one party in such a contract will be a "winner" from freezing the rate, and the other a "loser," and we don't know which it will be; what we do know for sure is that neither party had this outcome in mind when they contracted for a floating rate that was assumed would continue to remain in place. Cost of capital – the basis for borrowing that underpins every business decision – could grow disconnected from current economic reality. No one wants interest-rate time travel.

New York state recently enacted legislation to help prevent legacy contract chaos, but not all legacy contracts at issue are governed by New York law. Additionally, some issues, like the need for clarity for trust banks that may need to determine the right payments to investors in certain securitized products, can only be addressed at the federal level. Federal legislation is the best path to a smooth post-LIBOR future. A recent draft bill that is backed by the Alternative Reference Rates Committee offers a straightforward solution that will keep capital flowing smoothly in global financial contracts after LIBOR ends.

Fortunately, legislation for a smooth LIBOR transition has support. "We do think federal legislation is the best answer," Federal Reserve Chair Jay Powell said in late February at a House Financial Services Committee hearing. In a congressional hearing on March 23, Treasury Secretary Yellen also expressed support for a legislative fix for "certain legacy contracts where the transition could be difficult without legislation."

The Fed's Vice Chair for Supervision Randal Quarles also affirmed the need for a legislative solution. "Some of these contracts should already have workable fallback language, but many still have no effective means to replace LIBOR upon its cessation," Quarles said in a March 22 speech. "We continue to believe that legislation is a necessary step to address these contracts." Quarles pointed to other jurisdictions that have passed or are considering LIBOR transition legislation, such as the European Union and the UK.

The markets need Congress to weigh in soon. A smooth transition away from LIBOR keeps the financial system protected and stable.

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[2] "Keynote Remarks," Quarles, Randal K., Federal Reserve, at the SOFR Symposium: The Final Year, hosted by the Alternative Reference Rates Committee, March 22, 2021: https://www.federalreserve.gov/newsevents/speech/quarles20210322a.htm.