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April 12, 2021

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: April 15, 2021, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Hearing entitled, "The End of LIBOR: Transitioning to an Alternative Interest Rate Calculation for Mortgages, Student Loans, Derivatives, and Other Financial Products"

The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, "The End of LIBOR: Transitioning to an Alternative Interest Rate Calculation for Mortgages, Student Loans, Derivatives, and Other Financial Products" at 2:00 PM EST on the virtual platform Cisco Webex. There will be one panel with the following witnesses:

- **Dan Coates**, Senior Associate Director, Office of Risk Analysis and Modeling, Federal Housing Finance Agency
- **John Coates**, Acting Director, Division of Corporation Finance, Securities and Exchange Commission
- **Brian Smith**, Deputy Assistant Secretary for Federal Finance, U.S. Department of the Treasury
- **Mark Van Der Weide**, General Counsel, Board of Governors of the Federal Reserve System
- **Kevin Walsh,** Deputy Comptroller, Market Risk Policy, Office of the Comptroller of the Currency

Overview

The London Interbank Offered Rate (LIBOR) is a daily reported reference rate at which large banks indicate that they can borrow short-term wholesale funds from one another on an unsecured basis.[1] In order to calculate the LIBOR, a "self-selected, self-policing committee of the world's largest banks" self-report their daily estimated borrowing costs to the Financial Conduct Authority (FCA), the UK financial regulator.[2] As of the 4th quarter of 2020, it is estimated that there are $223 trillion in outstanding exposures to USD LIBOR.[3]

The LIBOR's self-reporting structure has created opportunities for individuals or institutions to manipulate or falsify data. In the wake of the 2008 financial crisis, upon discovering a widespread culture of LIBOR manipulation built around industry relationships, [4] U.S. and U.K. regulators settled

[1] Federal Reserve Bank of New York. LIBOR: Origins, Economics, Crisis, Scandal, and Reform. March 2014.
[2] The Guardian. LIBOR Scandal: The Bankers Who Fixed the World's Most Important Number. Jan. 2017.
[3] Alternative Reference Rates Committee. Progress Report: The Transition from U.S. Dollar LIBOR. Mar. 2021.
[4] The New York Times. Deutsche Bank to Pay $2.5 Billion Fine to Settle Rate-Rigging Case. Apr. 23, 2015.

with various banking institutions, including some of the world's largest banks such as Barclays, JP Morgan Chase, Citigroup, and UBS over allegations that these institutions manipulated the LIBOR[5] by pressuring their colleagues to report artificially low or artificially high interest rates in order to manufacture trading opportunities.[6]

Though its decision was not explicitly linked to the numerous LIBOR rigging scandals, the FCA announced in 2017 that it would no longer compel banks to report LIBOR after December 31, 2021 and would discontinue its publication.[7] However, in response to the global COVID-19 pandemic, the ICE Benchmark Administration (IBA) announced that it would not cease publication of the overnight and 1, 3, 6, and 12 months USD LIBOR settings until June 30, 2023.[8]

The Treasury Department's Financial Stability Oversight Council (FSOC) has identified the "cessation of degradation of LIBOR" as having the potential to "significantly disrupt" financial markets.[9] FSOC has also expressed concerns that if market participants fail to "adequately adapt" to an alternative reference rate, there may be a risk to the liquidity and the stability of the markets.[10] The Securities and Exchange Commission has similarly warned that LIBOR's discontinuation may pose significant risks to the markets.[11] Former Treasury Secretary Steven Mnuchin also suggested that legislation may be necessary to address contracts that reference LIBOR and lack appropriate fallback language.[12] More recently, while testifying before the House Financial Services Committee, both Treasury Secretary Janet Yellen and Federal Reserve Chair Jerome Powell have stated that they believe it will be necessary for Congress to pass legislation to allow for a smooth transition away from LIBOR in the U.S.[13]

Alternative Reference Rate Committee

In 2014, in response to recommendations established by the Financial Stability Board and the Financial Stability Oversight Council, the Federal Reserve Board and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (ARRC) in order to address the various risks associated with the LIBOR.[14] However, following the FCA's 2017 announcement that LIBOR would no longer be published after 2021, the ARRC was reconstituted to facilitate the U.S. transition away from the LIBOR to a risk-free alternative reference rate.[15]

The ARRC's membership consists of a variety of private-market participants such as large financial institutions and financial industry trade groups, as well as relevant government agencies that serve as ex officio members.[16] The ARRC is also supported by a number of working groups that focus on specific

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[5] The New York Times. Tracking the LIBOR Scandal. Mar. 23, 2016.
[6] Council on Foreign Relations. Understanding the LIBOR Scandal. Oct. 12, 2016.
[7] https://www.lexology.com/library/detail.aspx?g=7beb2910-1346-4a6d-ae89-18af2ae80305
[8] Bloomberg. LIBOR Enters 'Final Chapter' a s Global Regulators Set End Dates. Mar. 5, 2021.
[9] Financial Stability Oversight Council.2019 Annual Report.
[10] Financial Stability Oversight Council.2019 Annual Report.
[11] Securities and Exchange Commission. Staff Statement on LIBOR Transition. Jul. 12, 2019.
[12] American Banker. Congress May Need to Step In On LIBOR Switch, Mnuchin Warns. Dec. 5, 2019.
[13] American Banker. Calls Intensify for Congress to Intervene On LIBOR. Mar. 26, 2021.
[14] Federal Reserve Bank of New York. About ARRC.
[15] Federal Reserve Bank of New York. About ARRC.
[16] Federal Reserve Bank of New York. About ARRC.

issues or industries in connection with the LIBOR transition, including working groups focused accounting and tax, consumer products, business notes, regulatory issues, and securitizations.

Secured Overnight Financing Rate (SOFR)

In 2017, the ARRC identified the Secured Overnight Financing Rate (SOFR) as the preferred alternative reference rate to LIBOR and established the "Paced Transition Plan," a timeline for the transition from LIBOR in order to encourage broad market adoption of SOFR.[17] SOFR is an overnight interest rate based on Treasury repurchase transactions, or overnight corporate loans secured by U.S. Treasury securities. Unlike LIBOR, SOFR is calculated based on interest rates charged in real transactions in the U.S. treasury repo market.

Some stakeholders have raised concerns over replacing LIBOR with SOFR. Specifically, small- and medium-sized banks have voiced that the SOFR is much less appropriate for their institutions.[18] Unlike LIBOR, which is an unsecured rate, SOFR is a secured rate based on repo transactions that require liquid collateral such as U.S. Treasury securities. Because smaller and medium sized institutions hold fewer government securities, the transition to SOFR may force them to borrow on an unsecured basis at higher interest rates, presenting an "immediate asset-liability imbalance" that "may create distortions in times of financial stress."[19] Additionally, smaller banks are concerned that in times of market-wide financial distress, the SOFR may decrease, causing investors to "rush into the relative safety of government debt, dragging down yields, while avoiding riskier corporate bonds, pushing those yields higher."[20]

Legacy LIBOR Contracts

One of the most significant challenges associated with transitioning away from the LIBOR is the thousands of existing legacy contracts that extend beyond 2023 and reference the LIBOR, but do not contain fallback language that allows for the contract to be amended and continue to function should the LIBOR be discontinued.[21] It is estimated that as of the fourth quarter of 2020, there are $223 trillion in outstanding exposures to USD LIBOR, $74 trillion of which is slated to remain outstanding after LIBOR's discontinuation in June 2023.[22] These contracts include business loans, commercial mortgages, adjustable rate residential mortgages, floating rate notes, mortgage-backed securities, collateralized loan obligations, asset-backed securities, and collateralized debt obligations, among others.[23]

Because they lack contractual fallback language that contemplates a discontinuation of LIBOR, many of these contracts will be unable to function as intended once LIBOR is no longer published. To address

[17] Federal Reserve Bank of New York. Transition from LIBOR.
[18] Bloomberg. Small Banks Tell Fed Its LIBOR Replacement Doesn't Work for Them. Feb. 27, 2020.
[19] Bloomberg. Small Banks Tell Fed Its LIBOR Replacement Doesn't Work for Them. Feb. 27, 2020.
[20] The Wall Street Journal. Regional Banks Face Bumpy Road Away From LIBOR. Dec. 4, 2019.
[21] American Banker Association. The Transition From LIBOR: A Report on the Halfway Mark. Nov. 1, 2019.
[22] Alternative Reference Rates Committee. Progress Report: The Transition from U.S. Dollar LIBOR. Mar. 2021.
[23] The Alternative Reference Rates Committee. Second Report. March 2019.

this problem, the ARRC published model contract language for several broad categories of financial instruments. The model language ensures that each contract has a clear process for transitioning to a new reference rate if at any point LIBOR can no longer be used.[24]

Legislative Solutions

ARRC members [25], government officials [26], and interest groups[27] have suggested that there may be a role for Congress and state legislatures in ensuring a smooth transition away from LIBOR. In the minutes of its November 15, 2019 monthly meeting, the ARRC indicated that it had reached a "basic consensus" to begin pursuing a legislative solution for LIBOR-linked contracts that do not otherwise allow for a transition away from the LIBOR.[28] On March 6, 2020, the ARRC released the text of the proposed legislation, noting that legislative action in New York is most urgently needed because many of the financial instruments that reference LIBOR are governed by New York state law.[29] According to the ARRC, the New York legislation would provide relief for parties to contracts lacking sufficient fallback language by "(1) prohibit[ing] a party from refusing to perform its contractual obligations or declaring a breach of contract as a result of the discontinuance of LIBOR or the use of the statute's recommended benchmark replacement; (2) definitively establish[ing] that the recommended benchmark replacement is a commercially reasonable substitute for and a commercially substantial equivalent to LIBOR; and (3) provid[ing] a safe harbor from litigation for the use of the recommended benchmark replacement."[30] However, it remains unclear what percentage of LIBOR contracts are not governed by New York law, thusneeding additional legislation at the state or federal level to facilitate the transition.

Federal Policy Response

In addition to what the Fed, NY Fed, and other federal agencies have done through ARRC, some federal regulators have taken independent steps to prepare for the transition away from LIBOR. On February 5, 2020, the Federal Housing Finance Agency announced that Fannie Mae and Freddie Mac would no longer be accepting new LIBOR-based adjustable-rate mortgages.[31] Financial regulators, including the Internal Revenue Service,[32] the Financial Accounting Standards Board,[33] and the Commodity Futures Trading Commission[34] have begun issuing guidance to facilitate the transition away from LIBOR.

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[24] The Alternative Reference Rates Committee. Fallback Contract Language.
[25] The Alternative Reference Rates Committee. Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition.
[26] American Banker. Congress May Need to Step In On LIBOR Switch, Mnuchin Warns. Dec. 5, 2019.
[27] Structured Finance Association. Legislation May Help Avoid a Messy LIBOR Transition. Here's One Option Policymakers Should Consider. Jan. 7, 2020.
[28] Federal Reserve Bank of New York. Alternative Reference Rates Committee Minutes for the November 15, 2019 Meeting. Nov. 15, 2019.
[29] The Alternative Reference Rates Committee. Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition.
[30] The Alternative Reference Rates Committee. Proposed Legislative Solution to Minimize Legal Uncertainty and Adverse Economic Impact Associated with LIBOR Transition.
[31] Federal Housing Finance Agency. LIBOR Transition.
[32] U.S. Department of the Treasury. Treasury and IRS Announce Regulatory Relief for Taxpayers. Oct. 8, 2019.
[33] Financial Accounting Standards Board. Reference Rate Reform.
[34] Commodity Futures Trading Commission. CFTC Provides Relief to Market Participants Transitioning Away from LIBOR. Dec. 18, 2019.

The federal government may eventually also play a role in addressing the legal uncertainty associated with legacy-LIBOR contracts. While steps being taken in New York are intended to address this issue, it remains unclear whether this effort will be successful and, if so, what percentage of contracts a New York statute would help address.

Legislation

H.R. _____, the Adjustable Interest Rate (LIBOR) Act of 2021: would establish a process for certain financial contracts that reference LIBOR and do not contain sufficient language that would allow them to continue to function as originally intended after LIBOR is discontinued, to instead reference SOFR or an appropriately adjusted form of SOFR without the need to be amended or subject to litigation. The bill directs the Federal Reserve Board to issue regulations regarding the appropriate SOFR or adjusted SOFR replacement reference interest rate that should be used for specific categories of LIBOR-based contracts that fall within the scope of the legislation.