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In Depth: Federal Reserve Issues Final Rule Implementing LIBOR Act

Article By:

Lary Stromfeld

Jeffrey Nagle

David Burkholder

On December 16, 2022, the Board of Governors of the Federal Reserve System (the "Board") adopted a final rule (the "Final Rule") to implement the Adjustable Interest Rate (LIBOR) Act[1] (the "LIBOR Act"). The Final Rule follows the Board's publication of a proposed rule (the "Proposed Rule") in July 2022 and invitation for public comment. The Final Rule addresses many of the comments received on the Proposed Rule and sets forth the Board's final decision on a number of substantive and technical issues related to the planned cessation of USD LIBOR on a representative basis. The Final Rule will become effective 30 days after publication in the Federal Register.

A discussion of the Final Rule is set forth below.

A. Categorization of Legacy Contracts

The Proposed Rule used the terms "covered contract" and "non-covered contract" to describe LIBOR contracts that would be subject to the Proposed Rule and those that generally would not be subject to the Proposed Rule. Several commenters indicated that this bifurcation did not fully align with the LIBOR Act and was confusing. Therefore, the Board did not include these terms in the Final Rule. Instead, in the Final Rule the Board identified three categories of contracts encompassing legacy LIBOR contracts.

The first category of LIBOR contracts includes those contracts that contain fallback provisions identifying a specific benchmark replacement not based in any way on LIBOR values[2] and that do not require the conducting of a poll, survey, or inquiries for quotes to determine the replacement rate. Contracts in this first category are generally expected to transition to the contractually agreed-upon benchmark replacement as provided in their fallback provisions on or before the LIBOR replacement date.[3]

The second category of LIBOR contracts includes (i) contracts that contain no fallback provisions and (ii) contracts that do not identify a determining person[4] and that only (A) identify a benchmark replacement that is based on LIBOR or (B) require the conducting of a poll, survey, or inquiries for quotes to determine the replacement rate. Contracts in this second category are expected to transition on the LIBOR replacement date to the "Board-selected benchmark replacement" for the particular type of LIBOR contracts as described below.

The third category of LIBOR contracts includes contracts that contain fallback provisions authorizing a determining person to determine a benchmark replacement. The application of the LIBOR Act to these contracts will depend on the benchmark replacement selection, if any, made by the determining person. Contracts in this third category are expected to transition to the benchmark replacement selected by the determining person, or to the Board-selected benchmark replacement if no benchmark replacement is selected by the determining person.

The description of these categories in the Board's commentary provides a helpful roadmap for implementation of the LIBOR Act and the Final Rule.

B. Board-selected Benchmark Replacement

The central feature of the Final Rule is the selection of the "board-selected benchmark replacement" that will be applicable to various types of LIBOR contracts. The Board-selected benchmark replacement identifies what benchmark replacement certain legacy LIBOR contracts will transition to on the LIBOR replacement date, the benchmark replacement that certain contracts with a "determining person" may transition to, and the benchmark replacement that, if used, will receive the benefit of protective provisions in the LIBOR Act, such as a safe harbor. The Board-selected benchmark replacement varies based on the type of LIBOR contract.

The Final Rule sets forth the following benchmark replacements for the following types of contracts:

- <u>Derivatives</u>

    - The Final Rule selects the "Fallback Rate (SOFR)" identified in the ISDA 2020 IBOR Fallback Protocol published by ISDA on October 23, 2020 (the "ISDA Protocol") as the fallback benchmark rate for all derivative transactions. The Fallback Rate (SOFR) is a rate equal to SOFR, compounded in arrears for the applicable tenor, plus the stated spread adjustments for the applicable tenor (which are the same as the statutory spread adjustments specified in the LIBOR Act). This will align derivatives transitioning pursuant to the LIBOR Act with many derivatives that have or will transition pursuant to the ISDA Protocol.

    - Consistent with the request of some commenters, the Final Rule addresses some technical amendments to ensure alignment with the ISDA Protocol, including by defining "derivative transaction fallback observation day" in the same way as ISDA.

    - Notably, the Board declined requests from some commenters to select a different benchmark replacement for certain derivatives linked to certain cash transactions and transition them to the benchmark replacement used by the relevant underlying transactions. The Board recognized that this may give rise to basis risk for these transactions, but opted instead to emphasize a simple, clear, and manageable benchmark replacement for all derivative transactions consistent with the ISDA Protocol.

- Cash Transactions

  - For most cash transactions, with the exceptions set forth below, the Board selected (x) SOFR plus the statutory spread to replace overnight LIBOR and (y) 1-, 3-, 6- and 12-month CME Term SOFR plus the statutory spread to replace the corresponding tenor of LIBOR. These selections are consistent with ARRC recommendations and the Proposed Rule.

  - Consumer loans will transition to the same fallback rates as set forth above; however, the spread adjustment will be implemented on a gradual basis over a one-year period after the LIBOR replacement date and will be fully implemented on the first year anniversary of the LIBOR replacement date. The transition spread adjustments[5] is intended to prevent consumer borrowers from experiencing significant shifts in borrower rates on and immediately following the LIBOR replacement date.

  - FHFA[6]— FHFA-regulated-entity contracts, other than Federal Home Loan Bank advances, will transition to (x) SOFR plus the statutory spread to replace overnight LIBOR and (y) 30-day Average SOFR[7] to replace 1-, 3-, 6- and 12-month LIBOR. Federal Home Loan Bank advances will transition to Fallback Rate (SOFR).

  - FFELP — Under the Final Rules, the Board created a fallback rate specific for certain asset-backed securities in response to comments to the Proposed Rule. A "Federal Family Education Loan Program (FFELP) asset-backed securitization (ABS)" is any asset-backed security for which more than 50 percent of the collateral pool consists of FFELP loans, as reported in the most recent servicer report available on the LIBOR replacement date. Any FFELP asset-backed securitization (ABS) will transition as follows: (i) one-month LIBOR will be replaced with 30-day Average SOFR plus the tenor spread adjustment specified in the LIBOR Act; (ii) three-month LIBOR will be replaced with 90-day Average SOFR plus the tenor spread adjustment specified in the LIBOR Act; and (iii) six- or 12-month LIBOR will be replaced with 30-day Average SOFR plus the statutory tenor spread adjustment for six- or 12-month tenors, respectively.

C. Synthetic LIBOR

With the recent publication of a proposal by the United Kingdom's Financial Conduct Authority ("FCA"), the regulator of the ICE Benchmark Administration ("IBA"), LIBOR's administrator, to require publication of 1-, 3-, and 6-month USD LIBOR settings on a "synthetic" basis through end-September 2024, it appears likely that these tenors of USD LIBOR will continue to exist on a synthetic, or non-representative, basis for some period after June 30, 2023. The Board recognizes that this could have an impact on a number of legacy contracts, including those that contain fallbacks that are not expressly triggered where a benchmark called "LIBOR" is available but is not representative, and has included in the Final Rule a few provisions and clarifications to address this point, while declining to incorporate other suggestions relating to synthetic LIBOR.

- The Proposed Rule requested comment on whether the Final Rule should provide that a LIBOR contract containing fallback provisions that identify a clear and practicable benchmark (*e.g.*, the prime rate) but lack an express non-representative trigger would transition on the

LIBOR replacement date notwithstanding such lack of express trigger. The Final Rule incorporates clarifying language regarding certain related provisions of the LIBOR Act, but does not purport to make clarifications about contracts that are outside the scope of the LIBOR Act.

- The Board reiterated in the commentary and in the actual Final Rule, consistent with the LIBOR Act, that any LIBOR contract containing fallback provisions that identify a benchmark replacement not based in any way on any LIBOR value (*e.g.*, the prime rate or federal funds rate) is not subject to automatic transition to the Board-selected benchmark replacement on the LIBOR replacement date. As a result, certain LIBOR contracts that do not contain a non-representativeness trigger but do contain non-LIBOR fallback rates could be required, pursuant to their terms, to utilize applicable synthetic LIBOR tenors. Contract counterparties should carefully analyze provisions in their legacy LIBOR contracts to determine whether a benchmark transition trigger has been implicated.

- The Final Rule also clarifies the treatment of certain contracts with a "determining person" if synthetic LIBOR is published, as described below.

D. Determining Persons

The Final Rule clarifies two potential ambiguities in the interpretation of the term "determining person" raised by commenters to the Proposed Rule.

- The definition of "determining person" was clarified to note that it refers to a person with "sole" authority, right, or obligation to determine a benchmark replacement. This clarifies the treatment of a LIBOR contract whose fallback provisions require the consent or agreement of multiple parties. Multiple parties cannot, collectively, be a "determining person." As a result, if those parties are unable to reach agreement, and the contract does not contain a specific benchmark (nor, as a result of this clarification, a "sole" determining person), it will be subject to automatic transition to the Board-selected benchmark replacement under Section 104(a)(2) of the LIBOR Act.

- The definition of "determining person" was also clarified to provide that a person would qualify as such even if their authority, right, or obligation to determine a benchmark replacement is contingent (*e.g.*, when the non-representative, synthetic version of LIBOR is not available). Therefore, so long as the applicable LIBOR contract does not contain a fallback provision that identifies a non-LIBOR based benchmark replacement, like the prime rate or effective Federal funds rate, a "determining person" has the statutory authority pursuant to Section 104(c)(1) and (2) of the LIBOR Act to select the Board-selected replacement benchmark by, at the latest, the LIBOR replacement date. If the determining person under any such LIBOR contract does not select a benchmark replacement by the LIBOR replacement date, the applicable Board-selected benchmark replacement will be the benchmark replacement for the LIBOR contract pursuant to section 104(c)(3) of the LIBOR Act.

E. Technical Revisions and Notice Requirements

The Final Rule includes a number of technical changes, including clarification of certain language commonly used in legacy LIBOR contracts. Many legacy LIBOR contracts used the wording “Eurodollar deposit and lending rates” or similar phrases, oftentimes interchangeably with “interbank lending or deposit rates.” The Final Rule clarifies that “Eurodollar deposit and lending rates” are “interbank lending or deposit rates” for purposes of the LIBOR Act and the Final Rule.

In the Proposed Rule, the Board also invited comment as to whether the Final Rule should require a determining person to provide notice regarding the selection of a replacement benchmark. Consistent with the comments received, the Final Rule does not impose any notice requirements.

F. Conforming Changes

The LIBOR Act allows the Board to determine, in its discretion, conforming changes that would address issues affecting the implementation, administration and calculation of the Board-selected benchmark replacement. These conforming changes will become an integral part of any LIBOR contract for which the Board-selected benchmark replacement becomes the benchmark replacement pursuant to the LIBOR Act and the Final Rule. The conforming changes addressed by the Final Rule are as follows:

- Many legacy LIBOR contracts referenced a specific source for LIBOR (such as a particular newspaper, website, or screen). The Final Rule replaces any such specified source with the publication of the Board-selected benchmark replacement (including a spread adjustment, if applicable) by either the relevant benchmark administrator or any third party authorized to publish such rate.

- Many legacy LIBOR contracts specified a particular time of day (*e.g.*, 11:00 a.m. London time) for sourcing LIBOR. The Final Rule replaces any such time with the standard publication time for the applicable Board-selected benchmark replacement, as established by the relevant benchmark administrator.

- If a LIBOR contract requires the use of a combination of LIBOR values over a period of time that spans the LIBOR replacement date (*e.g.*, an average of LIBOR every month during 2023), such provision would use LIBOR prior to the LIBOR replacement date and the applicable Board-selected benchmark replacement for any date on or after the LIBOR replacement date.

- The Final Rule provides that (with certain exceptions), to the extent that a Board-selected benchmark replacement is not available for a particular day as required in a contract, the most recently available publication of the Board-selected benchmark replacement will apply. This is designed to address concerns about referencing certain defined business days (*e.g.*, London business days) in a LIBOR contract for determining benchmark rates that may not be applicable to the Board-selected benchmark replacement; if the Board-selected benchmark replacement would not be available on such day, the calculation party would look back to the most recent day on which it were available.

The conforming changes listed above are not exclusionary. The Final Rule clarifies that, with respect to any LIBOR contract that is not a consumer loan, a calculating person may make additional technical, administrative, or operational changes, alterations, or modifications that, in that person’s reasonable judgment, would be necessary or appropriate to permit the implementation, administration, and calculation of the Board-selected benchmark replacement without consent from any other person.

The Board has reserved the right to publish, in its discretion, additional conforming changes.

G. Scope of Section 105 of the LIBOR Act

The LIBOR Act provides for certain statutory protections related to the selection and use of the Board-selected benchmark replacement. In response to comments on the Proposed Rule, the Board included a new section in the Final Rule expressly stating that the provisions of Section 105(a)-(d) of the LIBOR Act shall apply to any LIBOR contract for which the Board-selected benchmark replacement becomes the benchmark replacement pursuant to Section 253.3(a) or (c) of the Final Rule.

Under Section 105(a)-(d), the selection of a Board-selected benchmark replacement and implementation of related benchmark conforming changes in the circumstances described below:

- constitute a commercially reasonable replacement for, and a reasonable, comparable, or analogous rate, index, or term for LIBOR and substantial performance relating to or based on LIBOR;
- may not be deemed to impair or affect rights of parties under a contract or have the effect of discharging, excusing performance, giving rise to a termination right, or constituting a breach under a LIBOR contract;
- are provided a safe harbor from any claims, causes of action, requests for equitable relief, or liability from damages for the use of a Board-selected benchmark replacement or the implementation of benchmark replacement conforming changes; and
- are deemed not to be an amendment or modification of a LIBOR contract or prejudice, impair, or affect the rights, interests, or obligations of any person under or with respect to any LIBOR contract.

Sections 253.3(a) and (c) of the Final Rule, which align with Sections 104(a) and 104(c) of the LIBOR Act, address situations where the applicable Board-selected benchmark replacement replaces the existing benchmark (i) automatically as a result of a LIBOR contract containing no fallback language or containing neither a specific benchmark replacement nor a determining person, (ii) automatically as a result of a determining person having not selected a benchmark replacement by the applicable benchmark replacement date, or (iii) as a result of the selection of such rate by the determining person.

The Final Rule also separately provides that nothing in the Final Rule is intended to alter or modify Section 105(e) of the LIBOR Act, which states that subject to certain specific provisions in the LIBOR Act, nothing in the LIBOR Act may be construed to create any negative inference or negative presumption regarding the selection of a benchmark replacement or changes related thereto that is different than the Board-selected benchmark replacement.

FOOTNOTES

[1] Pub. L. 117-103, div. U, codified at 12 U.S.C. 5801 *et seq*.,

https://www.congress.gov/117/plaws/publ103/PLAW-117publ103.pdf (pp. 777-786).

[2] This does not include references to LIBOR values used to account for the difference between LIBOR and the selected benchmark replacement.

[3] "LIBOR replacement date" means the first London banking day after June 30, 2023, unless the Board determines that any LIBOR tenor will cease to be published or cease to be representative on a different date.

[4] A "determining person" means, with respect to any LIBOR contract, any person with the sole authority, right, or obligation, including on a temporary basis (as identified by the LIBOR contract or by the governing law of the LIBOR contract, as appropriate) to determine a benchmark replacement, whether or not the person's authority, right, or obligation is subject to any contingencies specified in the LIBOR contract or by the governing law of the LIBOR contract.

[5] Refinitiv Limited will publish and provide rates for consumer loans that sum (i) CME Term SOFR and (ii) the transition spread adjustment.

[6] In response to comments to the Proposed Rule suggesting that the terms "GSE" and "Covered GSE contract" used in the Proposed Rule were too broad, the Final Rule replaced those terms with "FHFA-regulated entity" and "FHFA-regulated-entity contract".

[7] "30-day Average SOFR" is defined in Section 253.2 of the Final Rule.

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