Going Through Changes: Transitioning to a LIBOR-less World for Consumer Loans (Part II)

In our January 27, 2020, Legal Update ("Part I"), we discussed the legal and regulatory issues faced by US consumer lenders and servicers as they prepare for the eventual transition away from LIBOR. In Part I, we noted that the question of how holders and servicers of adjustable-rate loans that use LIBOR as an index should proceed was largely unanswered at the time. Since then, Fannie Mae, Freddie Mac, and the Consumer Financial Protection Bureau ("CFPB") have all issued guidance to help ease the transition for originators, holders, and servicers as they navigate the quickly approaching post-LIBOR world. Below, we summarize this guidance.

I. GSE LIBOR Transition Playbook

To help lenders, servicers, and other market participants prepare for the transition away from LIBOR, Fannie Mae and Freddie Mac (the "GSEs") jointly issued a *LIBOR Transition Playbook* (the "Playbook") in May 2020 (which they subsequently updated in June 2020).[1] The Playbook contains transition milestones and recommendations for a host of mortgage products using a LIBOR-based index, including single-family residential adjustable-rate mortgages ("ARMs"), collateralized mortgage obligations ("CMOs"), multi-family adjustable-rate mortgages, and mortgage-backed securities. For purposes of this Legal Update, we focus on single-family residential mortgage loans and other consumer loans.

The GSEs

According to the Playbook, the GSEs have taken a number of steps under the FHFA's guidance to prepare for the LIBOR transition. First, the GSEs have designed new single-family ARMs that use the 30-day Average SOFR published by the Federal Reserve Bank of New York as the underlying index.[2] With respect to new LIBOR originations, the GSEs have updated the existing uniform Fannie/Freddie ARM notes and riders to include the Alternative Reference Rates Committee's ("ARRC") recommended "fallback" and trigger language, which contemplates the noteholder adjusting the margin to mimic the economics of LIBOR.[3]

The new GSE SOFR ARMs will be indexed to the 30-day SOFR Average and carry initial fixed rate periods of 3, 5, 7, or 10 years (as opposed to LIBOR ARMs, which also allowed for 1-year initial fixed rate periods).[4] Unlike the GSEs' LIBOR ARMs, interest rate adjustments under GSE SOFR ARMs will occur every 6 months, with no cap at the first adjustment and a 1 percent cap on increases or decreases upon subsequent adjustments.[5] The GSE SOFR ARMs will use a margin of up to 3 percent, for Fannie Mae ARMs and a margin from 1 to 3 percent for Freddie Mac ARMs.[6]

Transition Milestones

The Playbook sets forth transition timelines to reach a number of incremental milestones in the successful transition away from LIBOR. The Playbook provides that lenders should prepare to begin offering Fannie Mae single-family ARMs indexed to SOFR on August 3, 2020, and cease offering LIBOR products by December 31, 2020.[7] Sellers may begin delivering SOFR-indexed ARMs to Freddie Mac on November 16, 2020.[8] Freddie Mac will fund LIBOR loans sold for cash until December 31, 2020, and will cease issuing weighted average coupon participation certificates for LIBOR loans after December 1, 2020.[9]

Recommended Actions for SFR Lenders

The Playbook provides a number of recommendations to single-family residential adjustable-rate mortgage originators.

- **Documentation:** The GSEs recommend that originators update any FAQs and borrower-facing ARM disclosures; update closing instructions and/or train closing agents, escrow agents and closing lawyers; review updated procedures for printed and electronic promissory notes; test printing of all updated documents, such as notes, riders, and Closing Disclosures; update training manuals for origination staff including originators, processors, underwriters, closers, post-closers, and quality control, and update broker and correspondent lending training manuals, policies and documentation.[10]
- **Lender Systems, Processes, and Training:** The GSEs recommend that originators update their loan origination systems (and any vendor systems) to accommodate new SOFR ARM originations, and update product, eligibility, and pricing rules.[11] The Playbook also recommends that originators develop and implement pricing, hedging, and execution strategies, and provide training to staff on the differences between SOFR ARMs and LIBOR ARMs, including on the fact that SOFR ARMs will adjust every six months and the minimum initial fixed-rate period will be three years.[12] The Playbook also recommends that originators provide training for vendors and third parties, including brokers, correspondents, eNote vaults, electronic registries, and document preparation vendors.[13]
- **Document Custodians:** The Playbook notes that the GSEs will require document custodians to verify for revised ARM notes that the lifetime rate floor is equal to the ARM's note margin; if there is a discrepancy, then the note will not be certified for sale.[14] This requirement will be incorporated into Fannie Mae's ARM Plans and in the annually updated Freddie Mac Document Custody Procedures Handbook.[15]

Servicing Existing ARMs

Unfortunately, the Playbook does little to clarify how servicers and noteholders should transition existing LIBOR ARMs. The Playbook recommends that servicers update and test their systems, reporting and processes or activities related to interest rate adjustment calculations to incorporate SOFR product parameters, including the initial fixed period, current index value, margin, lookback period, rounding method, and initial, subsequent and lifetime caps, underlying index, reset periods and subsequent caps.[16] The Playbook also recommends that servicers ensure that any subsequent transferee servicers have the capability to service SOFR loans.[17]

The Playbook notes that the GSEs "are continuing to work with the ARRC to define the timing and strategy for transitioning legacy LIBOR ARMs" to an alternative rate.[18] The Playbook provides that the GSEs will provide additional details around servicing requirements, legal and document updates, and other items "as the timeline and strategy are finalized."[19]

As we discussed in our May 27, 2020, Legal Update, the ARRC recently issued several "best practices" for market participants, which provide some semblance of guidance for servicers of consumer loans using LIBOR as the index.[20] The ARRC recommends that, by December 31, 2020, servicers should develop "robust" programs to proactively reach out to borrowers, educate them on the transition, and provide notifications that are compliant with relevant consumer regulations.[21]

II. CFPB Actions

On June 4, 2020, the Consumer Financial Protection Bureau (the "CFPB" or the "Bureau") announced that it is taking several steps to facilitate the LIBOR transition. These steps include updates to the Consumer Handbook on Adjustable Rate Mortgages (the "CHARM booklet"), a notice of proposed rulemaking suggesting a number of clarifying amendments to the Truth-in-Lending Act's Regulation Z, and the issuance of FAQs on other LIBOR transition topics.

Updated CHARM booklet

The CHARM booklet provides consumers with key information about ARM features and risks, and generally must be provided by a creditor no later than three days after the creditor's receipt of an ARM application. The Bureau has updated the CHARM booklet by including a new table to compare fixed-rate and adjustable mortgages, reducing the number of pages from 41 to 21 in order to reduce the overall complexity of the document, and removing references to the LIBOR benchmark index.

Notice of Proposed Rulemaking

The CFPB also has proposed a number of revisions to Regulation Z related to the LIBOR transition. The Bureau is proposing that any final rule implementing these changes would take effect on March 15, 2021, except for the updated change-in-term disclosure requirements for HELOCs and credit card accounts, which would apply as of October 1, 2021.

Open-End Credit

First, the Bureau has proposed a roadmap for HELOC creditors and card issuers to choose a compliant replacement index. Regulation Z already permits HELOC creditors and card issuers to change an index and margin they use to set the annual percentage rate ("APR") on a variable-rate account under certain conditions, when the original index is no longer available. In order to allow creditors and card issuers to transition away from LIBOR before it becomes unavailable, the Bureau is proposing new provisions that detail specifically how HELOC creditors and card issuers may replace a LIBOR index with a replacement index for accounts on or after March 15, 2021.

Under the proposal, creditors and issuers must ensure that the APR calculated using the replacement index is "substantially similar" to the rate calculated using the LIBOR index, based on the values of these indices on December 31, 2020. The replacement index either may be newly established and have no history, or be an established index, but only if the index has historical fluctuations substantially similar to those of LIBOR. The Bureau is proposing to determine that: (i) SOFR; and (ii) the prime rate published in the Wall Street Journal (Prime) have historical fluctuations substantially similar to those of certain US Dollar (USD) LIBOR indices.

Second, the Bureau is proposing to make clarifying changes to the existing provisions on the replacement of an index when the index becomes unavailable. These proposed changes are in proposed Section 1026.40(f)(3)(ii)(A) for HELOCs and in proposed Section 1026.55(b)(7)(i) for credit card accounts. The Bureau's proposed Sections 1026.40(f)(3)(ii) and 1026.55(b)(7) clarify that if a variable rate on a HELOC subject to Section 1026.40 or a credit card, as applicable, is calculated using a LIBOR index, then a creditor may replace the LIBOR index and change the margin for calculating the variable rate on or after March 15, 2021, as long as the historical fluctuations in the LIBOR index and replacement index were substantially similar, and the replacement index value in effect on December 31, 2020, and replacement margin will produce an APR substantially similar to the rate calculated using the LIBOR index value in effect on December 31, 2020, and the margin that applied to the variable rate immediately prior to the replacement of the LIBOR index used under the plan.[22] The proposed sections also provide that a replacement index may be used even if it is newly established and does not have any rate history, so long as the replacement index value in effect on December 31, 2020, and replacement margin will produce an APR substantially similar to the rate calculated using the LIBOR index value in effect on December 31, 2020, and the margin that applied to the variable rate immediately prior to the replacement of the LIBOR index used under the HELOC or credit card account.[23]

Third, the Bureau is proposing to revise change-in-terms notice requirements for HELOCs and credit card accounts to ensure that consumers know how the variable rates will be determined after the LIBOR transition. Change-in-terms notices for these accounts would disclose the index that is replacing LIBOR and any adjusted margin that will be used to calculate the rate (regardless of whether the margin is being reduced or increased).

Fourth, the Bureau is proposing to add an exception from the rate reevaluation provisions applicable to credit card accounts. When a card issuer increases a rate on a credit card account, the card issuer generally must complete an analysis reevaluating the rate increase every six months until the rate is reduced to a certain degree. The proposal would add an exception from these requirements for increases that occur as a result of replacing LIBOR through the transition provisions described above (or as a result of LIBOR becoming unavailable). The exception would not apply to rate increases that already are subject to the rate reevaluation requirements prior to the LIBOR transition. The proposal also would address cases where the card issuer already was required to perform a rate reevaluation review prior to transitioning from LIBOR and LIBOR was used as the benchmark for comparison for purposes of determining whether the card issuer can terminate the six-month reviews. These proposed changes would address how a card issuer can terminate the obligation to review where the rate applicable immediately prior to the increase was a variable rate calculated using a LIBOR index.

Finally, the Bureau is proposing several technical edits to Comments 9(c)(2)(iv)-2 and 59(d)-2 to replace LIBOR references with references to SOFR.

Closed-End Credit

The Bureau also proposes to identify specific indices as examples of a "comparable index" for purposes of the closed-end refinancing provisions. Currently, if a creditor changes the index of a variable-rate closed-end loan to an index that is not "comparable," the index change may constitute a refinancing, triggering additional disclosure requirements. The Bureau is proposing to add an illustrative example to identify the SOFR-based spread-adjusted replacement indices recommended by the ARRC as examples of indices that are comparable to LIBOR.

The Bureau also proposes technical edits to several portions of the regulation and Commentary to replace references to LIBOR with references to SOFR, and to make related changes and corrections.

FAQs

Finally, the CFPB issued several FAQs[24] to address various matters not covered by Regulation Z. The FAQs cover the following topics:

- An itemization of specific regulatory or statutory requirements that creditors need to consider in connection with LIBOR transition;
- The extent to which the LIBOR transition will affect ARM and HELOC origination and servicing disclosures;
- With respect to ARM and HELOC origination disclosures, how to disclose historical examples for indices (like SOFR) that do not yet have 15 years of values;
- How the CHARM booklet has been affected by the LIBOR transition;
- Whether the LIBOR transition will trigger ARM interest rate adjustment notices for existing loans (generally no, except if the creditor changes the interest rate or the schedule for the interest rate adjustments at the same time it changes the index from LIBOR);
- Whether information may be added to the ARM interest rate adjustment notices to notify the consumer of the LIBOR transition for existing loans (no, although such information may be provided *with* the adjustment notice);
- Whether a creditor may add information to the periodic statement to notify the consumer of the LIBOR transition for existing loans (generally, yes);
- What index a creditor should identify in the ARM interest rate adjustment notices if the interest rate is scheduled to change while the creditor is transitioning the account to a new index for existing loans;
- Whether there are Regulation D alternative mortgage transaction ARM and HELOC index requirements to be considered in the LIBOR transition (yes); and
- The extent to which HELOC origination disclosures are impacted by the LIBOR transition.

Conclusion

The proposed Regulation Z amendments, CFPB FAQ, and GSE Playbook provide much-needed guidance to originators, holders, and servicers preparing for the eventual LIBOR transition. In addition to taking actions based on applicable guidance, market participants should continue to assess the types of loans originated, held, or serviced; survey the contractual language related to the index and margin; plan for communications with affected borrowers of existing loans or prospective borrowers of new originations; and continue to monitor issuances from regulators, the GSEs, and the ARRC.

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[1] Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, *LIBOR Transition Playbook* (June 2020), *available at* https://www.fanniemae.com/resources/file/libor/pdf/playbook.pdf.
[2] *Id*. at 11.
[3] *Id*. at 10.
[4] *Id*. at 11.
[5] *Id*. at 12.
[6] *Id*.
[7] *Id*. at 8.
[8] *Id*.
[9] *Id*.
[10] *Id*. at 15.
[11] *Id*.
[12] *Id*.
[13] *Id*.
[14] *Id*. at 16.
[15] *Id*.
[16] *Id*. at 20.
[17] *Id*.
[18] *Id*. at 23.
[19] *Id*.
[20] Alternative Reference Rate Committee, *ARRC Recommended Best Practices for Completing the Transition from LIBOR* (June 2020).
[21] *Id*. at 5.
[22] https://files.consumerfinance.gov/f/documents/cfpb_proposed-rule_amendments-to-facilitate-libor-transition_2020-06.pdf
[23] *Id*.
[24] https://files.consumerfinance.gov/f/documents/cfpb_libor-transition_nprm-frequently-asked-questions.pdf.

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