

# MARKET BRACES FOR TRANSITION AS LIBOR PHASE OUT BEGINS

Financial institutions in Australia, the US and Europe have for years used LIBOR as a common benchmark for various adjustable-rate loan products. This is set to change in 2022 as LIBOR is effectively phased out. **Mayer Brown** partners **Amanda Baker**, **Stuart Litwin** and **Jon Van Gorp** explore preparedness for the transition.

**O**n 27 July 2017, and in a subsequent speech by its chief executive on 12 July 2018, the UK Financial Conduct Authority (FCA), which regulates LIBOR, confirmed it would no longer persuade or compel banks to submit rates for the calculation of the benchmark after 2021. As a result, the FCA warned there could be no guarantee LIBOR would be determined after 2021.

With the transition underway and less than two years to go until LIBOR is no longer quoted, the final phase-out of LIBOR as a quoted benchmark is looming.

Transition preparedness will be an increasing area of supervisory focus and review in the market and, on a more granular level, in new transactions.

On 20 October 2021, in a joint statement on managing the LIBOR transition, the board of governors of the US Federal Reserve System, Consumer Financial Protection Bureau (CFPB), Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency and state bank and credit union regulators emphasised their expectations that supervised institutions in the US will transition away from LIBOR in an orderly fashion by the end of 2021.

## TRANSITION PROGRESS SO FAR

The US regulators summarised prior guidance then clarified several key supervisory considerations, including the following:

- Entering new financial contracts, including derivatives, that use LIBOR as a reference rate after 31 December 2021 would create safety and soundness risks. Importantly, for this purpose, “new contract” includes an agreement that: (a) creates additional LIBOR exposure for a supervised institution (with limited defined exceptions) or (b) extends the term of an existing LIBOR contract. A draw on an existing enforceable agreement will not be viewed as a new contract in this context.
- A new contract for purposes of LIBOR transition.
- Contracts executed on or before 31 December 2021 should use a reference rate other than LIBOR or incorporate LIBOR fallback language that refers to a strong and clearly defined alternative reference rate (ARR). Thus far, market participants appear to be tepidly embracing variations of the SOFR benchmark.
- Supervised institutions should ensure alternative rate selections are appropriate for their “products, risk

**“AS OF 1 JANUARY 2022 THE FCA WILL NO LONGER COMPEL BANKS TO QUOTE LIBOR AND ITS VARIATIONS AS A BENCHMARK LENDING RATE. THE REQUIRED TRANSITION IS SHAPING UP TO BE ONE OF THE MOST FUNDAMENTAL CHANGES TO THE FINANCIAL SERVICES INDUSTRY IN RECENT TIMES.”**

However, other types of contract changes are not as clearly delineated and remain open to interpretation and uncertainty. For example, if an amendment increases the contractual spread, either directly or by the operation of a specified financial matrix, there is an open question regarding whether this creates additional LIBOR exposure and, as a result, constitutes a new contract.

Similarly, other amendments to existing contracts might be deemed by an applicable regulator to constitute such additional LIBOR exposure and be

profile, risk management capabilities, customer and funding needs, and operational capabilities,” and understand “any fragilities associated with that rate and the markets that underlie it”.

Over the past couple of years, large financial institutions have started developing model LIBOR fallback language. However, the provisions tend to be highly negotiated as the market is currently struggling to swallow and adjust to the new backward-looking SOFR rate, which is a departure from LIBOR.

- Supervised institutions should identify all LIBOR-referencing contracts that mature after the relevant tenor ceases and fail to include adequate fallback language. It is worth noting that this trend has generally been the case in private transactions as well as in the capital market.
- All new and updated financial contracts should include fallback language that refers to a strong and clearly defined ARR that can be used if the initial reference rate is discontinued.
- Supervised institutions are encouraged to communicate their transition plans to appropriate parties – including customers, clients and counterparties – and should ensure systems and operational capabilities are in place

With respect to closed-end credit, the rule identifies SOFR-based spread-adjusted indices recommended by the Alternative Reference Rates Committee (ARRC) as an example of a “comparable index” for the LIBOR indices they are intended to replace.

The commentary lists factors – such as whether identified aspects of the two indices are comparable and whether the new index is publicly available – to assist in determining whether a replacement index meets Regulation Z standards.

With respect to open-end credit, the final rule provides guidance on transitioning away from a LIBOR index on a home equity line of credit. It also identifies examples of replacement indices, which include the prime rate published by the *Wall Street Journal* and

recommendations and are incorporated into the final rule.

Finally, it should be emphasised that as of 1 January 2022 the FCA will no longer compel banks to quote LIBOR and its variations as a benchmark rate.

## MARKET GUIDANCE

The required transition is shaping up to be one of the most fundamental changes to the financial services industry in recent times. While it is not necessarily yet fully embraced by industry participants, regulators in the US and UK are making it abundantly clear that transactions and market participants will have no choice but to comply with the transition away from LIBOR.

It is estimated that there is more than US\$300 trillion of LIBOR-referencing mortgages, commercial loans, bonds and derivatives in the market today. It is clear that the problem is global, complex and not going away. Banks, insurers and other financial market participants need to act quickly and effectively to resolve it.

While the global markets may not yet have fully embraced SOFR, most transactions use a formulation of SOFR as a fallback for the LIBOR benchmark. We are also starting to see floating-rate tranches in transactions using variations of SOFR as the benchmark.

While this trend was slow to materialise, it had started to take hold by late 2021. As market participants have justifiably been hesitant to consent to changes without robust LIBOR replacement mechanics, we expect to see many more transactions start to embrace SOFR at the inception of the transaction or at least as the clear fallback when LIBOR is no longer available. ■

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## “IT IS ESTIMATED THAT THERE ARE MORE THAN US\$300 TRILLION OF LIBOR-REFERENCING MORTGAGES, COMMERCIAL LOANS, BONDS AND DERIVATIVES. THE PROBLEM IS GLOBAL, COMPLEX AND IS NOT GOING AWAY. AFFECTED BANKS, INSURERS AND OTHER FINANCIAL MARKET PARTICIPANTS NEED TO ACT QUICKLY, AND EFFECTIVELY, TO RESOLVE IT.”

and ready for transition. While the market has not necessarily fully embraced SOFR, participants are moving toward this aim.

In connection with the foregoing, on 7 December 2021 the CFPB issued a final rule to facilitate LIBOR transition via amendments to Regulation Z. The amendments take effect on 1 April 2022 and compliance becomes mandatory on 1 October 2022.

The final rule makes numerous related amendments. In doing so, while it does not require institutions to adopt particular replacement indices in place of LIBOR, broadly speaking, the final rule outlines the standards replacement indices are expected to meet and provides examples to help ensure creditors are able to meet the revised index standards.

the SOFR-based spread-adjusted indices recommended by the ARRC.

What the final rule does not do is include reference to a one-year US dollar LIBOR index or its specific replacement. The CFPB reserved judgment on this issue until it reviews the index recommended by the ARRC and measures it against other open-end credit rate requirements.

In a further related development, also on 7 December 2021, the *Adjustable Interest Rate (LIBOR) Act 2021* was reported in the US House of Representatives by the Committee on Financial Services and placed on the union calendar. The proposed *LIBOR Act* would mandate a statutory benchmark replacement, spread adjustment and one-year transition period for consumer loans – as defined in the *Truth in Lending Act* or Regulation Z – that mirror the ARRC