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Consumer Financial Contracts and the Transition from LIBOR

US and UK financial authorities have signaled that the London Interbank Offer Rate (LIBOR) is likely to be discontinued as of 2021. Since 95% of all financial contracts that reference LIBOR are derivatives, financial firms and financial authorities have been focused on identifying a replacement for LIBOR for such contracts.

Yet, LIBOR also is a reference rate for some US$1.3 trillion in mortgages and other consumer financial contracts issued in the US, including private student loans, credit cards, auto loans, certificates of deposit and annuities. The transition from LIBOR to some new reference rate for these consumer financial contracts poses reputational and legal challenges and deserves greater attention.

The Problems With LIBOR

Between 1996 and 2014, LIBOR reference rates were published by the British Bankers Association.[1] The rates were derived by panels of banks based upon unsecured inter-bank loans and the expected judgment of the banks participating in the panels. In 2012, it was alleged that the LIBOR rate was subject to manipulation and one of the banks on the panel, Barclay's Bank, entered into a US$360 million settlement with the Department of Justice and the Commodity Futures Trading Commission. In response to this settlement, the UK's HM Treasury commissioned Martin Wheatley, then CEO-designate of the UK's Financial Conduct Authority, to conduct a review of LIBOR. That review resulted in a 10-point plan for reforming the process of setting the benchmark, including governmental oversight of the process and the selection of a new administrator for LIBOR.[2] In 2014, ICE Benchmark Administration Limited (IBA) was selected as the new administrator for LIBOR.

IBA has instituted a series of reforms designed to ensure the integrity of LIBOR and permit its continued use as a benchmark beyond 2021.[3] However, these administrative reforms may not be enough to maintain LIBOR. The inter-bank lending market upon which LIBOR rates are derived has diminished significantly since the financial crisis. Major banks no longer fund their operations through short-term unsecured loans, but, increasingly, rely upon oversight secured repurchase transactions and funds raised in the capital markets. As a result, there is no longer a sufficiently sizable and liquid market in unsecured inter-bank lending underpinning the LIBOR rates. UK financial authorities have said that this lack of an active market in unsecured inter-bank lending is "not only potentially unsustainable, but also undesirable," and they have announced that they will not compel banks to participate in the LIBOR rate process as of year-end 2021.[4] This has promoted CFTC Chairman J. Christopher Giancarlo to conclude that "The discontinuation of LIBOR is not a possibility. It is a certainty. We must anticipate it, we must accommodate it and we must adapt to it."[5]

SOFR as a Replacement for LIBOR

International efforts are underway to devise one or more reference rates to replace LIBOR. In the US, a private sector working group (the Alternative References Rates Committee or ARCC) was convened by the Federal Reserve Board and other financial regulatory authorities to identify alternative reference rates, best practices for contract terms, and to establish an implementation plan and timeline for an alternative to LIBOR.[6] ARCC has proposed that LIBOR be replaced by an index called the Secured Overnight Financing Rate or SOFR. In 2018, the New York Federal Reserve Bank started to publish a daily SOFR rate based upon data collected on more than US$700 billion in secured overnight repurchase transactions. Some firms have started to issue obligations that reference SOFR[7] and the Chicago Mercantile Exchange has launched futures based on the SOFR rate.

Since derivatives contracts constitute roughly 95% of the US$200 trillion in financial contracts that reference LIBOR,[8] most of the ARCC's work has focused on the transition from LIBOR to SOFR for such contracts. The International Swaps and Derivatives Association (ISDA) also has initiated an effort to develop so-called "fallback" provisions in derivatives contracts tied to LIBOR. These provisions would address legal ambiguities in the event LIBOR disappears. Yet, LIBOR also is a reference rate for some US$1.3 trillion in mortgages and other consumer financial contracts, including private student loans, credit cards, auto loans, certificates of deposit and annuities.[9]

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1 The rates were quoted on a daily basis in various currencies and for different maturities, ranging from overnight to 12 months.

2 The Wheatley Review of LIBOR: Final Report, September 2012.

3 ICE Libor Evolution, April 2018 ("As part of LIBOR's ongoing development, IBA will continue to work with regulators, banks, market participants and other stakeholders regarding the future of the benchmark beyond the end of 2021.")

4 The Future of LIBOR, Speech by Andrew Bailey, Chief Executive of the FCA, Bloomberg London, July 27, 2017.

5 Statement of CFTC Chairman J. Christopher Giancarlo before the Market Risk Advisory Committee Meeting, Washington, D.C., July 12, 2018.

6 See https://www.newyorkfed.org/arrc. In addition to the Federal Reserve Board, the other federal authorities that participate in ARCC are the Federal Reserve Bank of New York, the Bureau of Consumer Financial Protection, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Office of Financial Research, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, the Securities and Exchange Commission and the US Department of the Treasury. These federal authorities participate as ex-officio members of the Committee.

7 In July 2018, Fannie Mae issued a US$6 billion SOFR-linked floating-rate note.

8 https://www.cftc.gov/sites/default/files/2018-07/mrac071218_AlternativeReferenceRates.pdf.

9 Id.

Applying SOFR to Consumer Financial Contracts

ARCC has established a working group to address the application of SOFR to mortgages and other consumer financial contracts. It also has announced plans for the development of a term reference rate that would accommodate financial contracts with varying terms, such as adjustable rate mortgages. However, ARCC's the transition plan postpones the development of the term rate until 2021 because it is envisioned that the term rate would be based upon the SOFR-derivatives market that has just started and that needs time to develop.[10]

More importantly, there are significant differences between SOFR and LIBOR that will impact the application of SOFR to consumer financial contracts. SOFR is risk-free oversight that is secured by US Treasury securities, while LIBOR is based upon unsecured interbank loans that include some degree of bank credit risk. Because LIBOR is unsecured, LIBOR rates are likely to be higher than a SOFR rate. This means that a conversion from a LIBOR rate to a SOFR rate could require that a new SOFR-based contact include some upward rate adjustments to equate with LIBOR rates. This presents some significant reputational and legal risks for firms that issue consumer financial contract. As one consulting group has suggested, upward adjustments in rates as a result of the transition could be "problematic" and result in a "field-day for anti-bank advocacy group lawyers selling class action suits".[11]

Presumably, ARCC will invite public comment on the application of SOFR to consumer financial contracts, just as ARCC has invited comment on the application of SOFR to commercial loans. This will permit consumer finance firms an opportunity to provide input on the transition from LIBOR to SOFR for consumer financial contracts. However, consumer financial services firms may find it advantageous to become engaged on this issue sooner rather than later.

10 https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2017/October-31-2017-ARRC-minutes.pdf.

11 "Making the World's Most important Number Less Important: LIBOR Transition," Oliver Wyman, July 2018 Edition, p. 16.

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