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LIBOR'S LAST LEG: LEGISLATION AND SYNTHETIC LIBOR EASE THE TRANSITION TO SOFR

On July 3, 2023, LIBOR, the standard used for decades to set variable interest rates for trillions of dollars in financial instruments, will disappear. The authors describe actions taken by the U.S. government and regulators to mitigate the potential effects of the transition to a new benchmark and some of the remaining sources of uncertainty concerning the end of LIBOR.

By Amy McDaniel Williams, Michael Kruse, and Tina Locatelli *

Since the 1980s, the London Interbank Offered Rate ("LIBOR") has served as the benchmark for variable interest rates in contracts of all kinds — including commercial loans, swaps and derivatives, CDOs, mortgage-backed securities, and consumer loans — earning it the title of "the world's most important number."[1]

LIBOR was developed to provide a measure of the rates for unsecured, interbank loans. The published values are based on submissions from panels of large banks concerning the rates that they believe they would have to pay for unsecured loans over various periods.

Over the past several years, however, regulators and financial institutions have sought to transition away from LIBOR because of concerns as to its resiliency, its reliance on expert judgments instead of actual transactions (which undermines its objectivity and ability to represent the market accurately), and high-profile scandals exposing its vulnerability to manipulation. In 2021, the UK Financial Conduct Authority ("FCA"), which regulates the publication of LIBOR by ICE Benchmark Administration ("IBA"), announced that publication of overnight and one-, three-, six-, and 12-month USD LIBOR would cease on June 30, 2023.

This process of transitioning trillions of dollars' worth of contracts and instruments away from LIBOR has required regulatory bodies the world over to develop robust and practical alternative benchmark rates to

[1] David Enrich, THE WALL STREET JOURNAL, "Libor: A Eulogy for the World's Most Important Number" (July 27, 2017).

AMY MCDANIEL WILLIAMS is a partner in Hunton Andrews Kurth LLP's Richmond, VA office. Her practice focuses on structured finance, and has extensive experience advising clients on LIBOR and SOFR transition issues. MICHAEL KRUSE is counsel in Hunton Andrews Kurth LLP's New York, NY office. His practice focuses on financial services and commercial litigation. TINA LOCATELLI is counsel in Hunton Andrews Kurth LLP's Miami office. Her practice focuses on asset-based lending, residential mortgage-backed securities, and LIBOR transition. Their e-mail addresses are awilliams@huntonAK.com, mkruse@huntonAK.com, and tlocatelli@huntonAK.com.

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replace the currency- and tenor-specific LIBOR values still published daily, and to design and promote procedures for ensuring that parties actually adopt those new benchmarks. In the United States, that transition process has resulted in the Adjustable Interest Rate (LIBOR) Act, 12 U.S.C. § 5801 *et seq.*, enacted on March 15, 2022. There is also a rulemaking pursuant to the LIBOR Act by the Board of Governors of the Federal Reserve ("Board") and other regulators, which are intended to head off what many feared would be a "DEFCON 1 litigation event" when the last "representative" LIBOR values are published on June 30, 2023.[2]

Here, we present an overview of what the LIBOR Act and its related regulations mean, on a practical level, for market participants.

I. LIBOR ACT

The LIBOR Act, broadly conceived, was designed to replace references to LIBOR as a benchmark, i.e., "an index of interest rates or dividend rates that is used, in whole or in part, as the basis of, or as a reference for, calculating or determining any valuation, payment, or other measurement,"[3] with an alternative rate, the Secured Overnight Funding Rate ("SOFR"), which was developed by the Federal Reserve Bank of New York. SOFR is based on approximately $1 trillion in daily transactions, published daily since April 2018, and provides a measure of the cost of borrowing cash overnight, secured by U.S. Treasury securities. SOFR is nearly risk-free, unlike LIBOR, which reflects credit risk. For this reason, tenor-specific spread adjustments have been developed for SOFR's one-, three-, six-, and 12-month tenors to bring SOFR in line with LIBOR.[4]

To achieve that objective, the LIBOR Act was written to apply to any "LIBOR contract" — essentially, any contract or instrument governed by U.S. law that uses LIBOR in any way to determine a valuation or payment — that does not contain any "fallback provision" sufficient to determine what interest rate will replace LIBOR, once it is discontinued. "LIBOR Contracts" include:

> any contract, agreement, indenture, organizational document, guarantee, mortgage, deed of trust, lease, security (whether representing debt or equity, including any interest in a corporation, a partnership, or a limited liability company), instrument, or other obligation or asset that, by its terms, uses [USD] LIBOR as a benchmark.[5]

Under the Act, on July 3, 2023 (the "LIBOR replacement date," defined as the first London banking day after June 30, 2023), any references to LIBOR in the fallback provisions of any LIBOR contract governed by the Act are, by operation of law, null and void, as is any provision saying that in the event LIBOR is not available, any person must conduct a poll or survey concerning rates.[6] The Act further automatically replaces the benchmark for any LIBOR contract with a Board-selected SOFR replacement if the contract does not contain any fallback provisions, or if it has a fallback provision that does not specify a benchmark replacement that is wholly unrelated to LIBOR and does not identify a "determining person" who is authorized to select a benchmark replacement.

So, for example, if a LIBOR contract does not include a fallback provision, then LIBOR will automatically be replaced with the SOFR-based benchmark on July 3,

[2] Michael Held, Executive Vice President and General Counsel of the Federal Reserve Bank of New York, "SOFR and the Transition from LIBOR" (Feb. 26, 2019), *available at* https://www.newyorkfed.org/newsevents/speeches/2019/hel190226.

[3] 12 U.S.C. § 5802(1).

[4] 12 U.S.C. § 5802(20) (establishing spread adjustments of 0.00644 percent for overnight LIBOR, 0.11448 percent for one-month LIBOR, 0.26161 percent for three-month LIBOR,

footnote continued from previous column…

0.42826 percent for six-month LIBOR, and 0.71513 percent for 12-month LIBOR).

[5] 12 USC § 5802(16).

[6] The LIBOR Act expressly preempts any state or local statute or regulation relating to the selection of benchmark replacements, such as the statute New York enacted in April 2021. 12 U.S.C. § 5806.

2023. If the contract contains such a fallback provision, for instance, a provision stating that, in the event LIBOR is discontinued, the benchmark will be the prime rate or identifying a determining person who is authorized to select a new benchmark, the contract will be enforced according to its terms. The Act further provides that if the determining person identified in the contract fails to select a benchmark replacement by the earlier of the date required under the contract or the LIBOR replacement date, the applicable Board-selected benchmark replacement will automatically replace the LIBOR-based benchmark on the LIBOR replacement date.

While parties are able to contract around the LIBOR Act should they wish to, the Act also creates a powerful incentive for determining persons to use their discretion to choose the Board-selected SOFR-based benchmark replacement, since doing so provides a "safe harbor" for any person against "any claim or cause of action in law or equity or request for equitable relief, or [for] liability for damages" arising out of the selection of SOFR as the benchmark replacement. The Act thus encourages parties and determining persons to adopt a Board-selected SOFR-based benchmark to replace LIBOR by shielding them from liability under any potential breach of contract claim or breach of fiduciary duty claim that might be alleged when the benchmark is changed.[7]

II. FEDERAL REGULATIONS

The LIBOR Act charged the Board with promulgating regulations enacting the LIBOR Act. In its final LIBOR rule, which became effective January 15, 2023, the Board proposed several different SOFR-based benchmark replacement rates for different types of contracts:

A. Derivative Transactions

- These are LIBOR contracts that would satisfy the criteria to be a "Protocol Covered Document" under the 2020 LIBOR Fallbacks Protocol published by the International Swaps and Derivatives Association ("ISDA Protocol") but for the fact that one or more parties to such contracts are not an "Adhering Party" to the ISDA protocol.

- Board-Selected Benchmark Replacement is Compounded SOFR in arrears per the "Fallback Rate (SOFR)" defined in the ISDA Protocol, plus applicable Statutory Spread Adjustments.

[7] 12 U.S.C. § 5804(c).

B. Federal Housing Finance Agency ("FHFA")-Regulated-Entity Contracts

- These are LIBOR contracts involving Freddie Mac, Fannie Mae, and Federal Home Loan Banks.

- Board-Selected Benchmark Replacement for Federal Home Loan Bank advances is the Fallback Rate (SOFR), per the ISDA Protocol.

- For all other FHFA-regulated entity contracts:

  — For overnight LIBOR, the Board-Selected Benchmark Replacement is SOFR, plus applicable Statutory Spread Adjustment.

  — For one-, three-, six-, and 12-month LIBOR, the Board-Selected Benchmark Replacement is a 30-day compounded average SOFR published by the Federal Reserve Bank of New York, plus applicable Statutory Spread Adjustments.

C. Federal Family Educational Loan Program ("FFELP") Asset-Backed Securitizations

- These are securitized LIBOR contracts that are federally backed student loans originally funded by private and state lenders.

- For one-, six-, and 12-month LIBOR, the Board-Selected Benchmark Replacement is the 30-day Average SOFR, plus applicable Statutory Spread Adjustment.

- For 3-month LIBOR, the Board-Selected Benchmark Replacement is the 90-day compounded average SOFR published by the Federal Reserve Bank of New York, plus applicable Statutory Spread Adjustment.

D. Consumer Loans

- These are LIBOR contracts that are consumer credit transactions.

- For overnight LIBOR, the Board-Selected Benchmark Replacement is SOFR, plus one-year linear addition of applicable Statutory Spread Adjustment.

- For one-, three-, six-, and 12-month LIBOR, the Board-Selected Benchmark Replacement is one-, three-, six-, and 12-month CME Term SOFR published by CME Group Benchmark

Administration, Ltd., plus one-year linear addition of applicable Statutory Spread Adjustment.

- Rates published or provided by Refinitiv Limited as "USD IBOR Cash Fallbacks" for "Consumer" products equate to the required rates plus one-year linear addition of applicable Statutory Spread Adjustment.

E. Other

- These are all other LIBOR contracts not included in the categories above.

- For overnight LIBOR, the Board-Selected Benchmark Replacement is SOFR, plus the applicable Statutory Spread Adjustment.

- For one-, three-, six-, and 12-month LIBOR, the Board-Selected Benchmark Replacement is one-, three-, six-, and 12-month CME Term SOFR published by CME Group Benchmark Administration, Ltd., plus applicable Statutory Spread Adjustment.

III. POTENTIAL IMPLICATIONS OF THE LIBOR ACT

The LIBOR Act has undoubtedly smoothed the transition away from LIBOR in many contracts and has significantly mitigated the risk of litigation that many anticipated. For any LIBOR contract that neither has a fallback provision that specifies a non-LIBOR-based benchmark nor identifies a determining person, the LIBOR Act provides an automatic remedy in the form of the Board-approved version of SOFR appropriate for the type of contract involved that will be triggered on the LIBOR replacement date of July 3, 2023. If the LIBOR contract identifies a determining person, that person can either select a new benchmark rate in accordance with the contract before the LIBOR replacement date — including the Board-selected SOFR replacement, with the protection of the statute's safe harbor — or simply do nothing and allow the Board-selected SOFR replacement to take effect on that date through operation of law.[8]

Parties to LIBOR contracts should, however, be aware that the LIBOR Act does not — indeed, cannot — account for every type of LIBOR contract and mitigate every type of risk involved in the transition away from LIBOR. In particular, because the scope of the LIBOR Act is limited to contracts governed by U.S. law, it cannot apply to the significant amount of U.S. dollar instruments in the bond market that are governed by English law, not U.S. law. For that reason, it will be particularly important for parties to those LIBOR contracts to attempt to negotiate acceptable replacement benchmarks after USD LIBOR is no longer available after June 2023, since without the automatic benchmark replacement provided by the LIBOR Act, they may find themselves subject to the uncertainty and risk of litigation that the Act was intended to prevent.

Parties to such legacy contracts have been given additional time to work out the conversion from LIBOR by the FCA's recent decision to require the continued publication of an "unrepresentative synthetic" USD LIBOR. On April 3, 2022, the FCA announced that while overnight and 12-month USD LIBOR would, as previously announced, permanently cease after June 30, 2023, the FCA would require the IBA to continue publication of one-, three-, and six-month tenors of a synthetic USD LIBOR through September 30, 2024. As a synthetic LIBOR, it would be based not on the traditional panel of banks, but on CME Term SOFR plus the ISDA tenor-specific spread adjustment, which means that the published values of this synthetic LIBOR should be identical to the values of the Board-selected SOFR benchmark under the LIBOR Act (except for consumer loans, for which there is a one-year transition period for the spread adjustment under the LIBOR Act, but not with synthetic LIBOR).[9] USD LIBOR will thus continue to be published after the LIBOR replacement date for another 15 months, albeit in a *non-representative* form based on an entirely different methodology from that used to calculate representative LIBOR. Synthetic LIBOR is intended for use only in legacy contracts; new uses of synthetic LIBOR will be prohibited.[10]

Except with respect to consumer loans, the effect of the FCA's decision will be essential to swap out representative LIBOR for non-representative LIBOR that is equal to the Board-selected SOFR benchmark replacement. As the FCA has stressed, the purpose of mandating the temporary publication of synthetic LIBOR is to give parties time to reach a permanent replacement benchmark for existing contracts. Synthetic

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[8] 12 U.S.C. § 5803(c)(3) ("If a determining person does not select a benchmark replacement by [July 3, 2023], the Board-selected benchmark replacement, on and after the LIBOR replacement date, shall be the benchmark replacement for the LIBOR contract.").

[9] FCA, "FCA announces decision on synthetic US dollar LIBOR" (April 3, 2023), *available at* https://www.fca.org.uk/news/news-stories/fca-announces-decision-synthetic-us-dollar-libor.

[10] *Id.*

LIBOR is thus "only a temporary bridge and synthetic settings will not continue simply for the convenience of those who could have transitioned their contracts but have not done so."[11]

While parties to LIBOR contracts not governed by U.S. law may welcome this temporary publication of a non-representative synthetic LIBOR, that remedy may also have unwanted implications for a far broader range of LIBOR contracts, including those governed by U.S. law. Under the LIBOR Act and the Board's final rule, if a contract identifies a non-LIBOR-based benchmark replacement (e.g., prime rate or one of the Board's SOFR-based replacements), the contract will be enforced according to its terms and not be affected by the LIBOR Act or the regulation.

The effect of the continued publication of synthetic LIBOR on a particular LIBOR contract will, therefore, depend on its terms — specifically, on the terms in its fallback provision. If that fallback provision is triggered when *representative* LIBOR ceases to be published, the parties' benchmark replacement (however defined under the applicable contract) will become operative on the LIBOR replacement date, just as the parties should expect, since the FCA has stated that any LIBOR published after that date will be deemed non-representative. If, however, that fallback provision is triggered only by the cessation of LIBOR — and makes no reference to whether any published LIBOR is representative or not — the existence of synthetic LIBOR after the LIBOR replacement date may create uncertainty as to which benchmark — the contractually agreed one or synthetic LIBOR — actually applies.

In some circumstances, that uncertainty may have no practical effect. If, for instance, the LIBOR contract had a fallback provision triggered by the cessation of LIBOR and identified the Board-selected SOFR as the replacement benchmark, the fact that synthetic LIBOR based on CME Term SOFR will be published through the end of September 2024 should be immaterial, since the replacement benchmark identified in the contract will be the same as synthetic LIBOR.

In other instances, however, the continued publication of synthetic LIBOR may make a dramatic difference to the applicable benchmark, and so generate the uncertainty and litigation that the LIBOR Act was intended to prevent. If, for example, the parties agreed to use the prime rate — which, as of April 2023 was 8% — as the benchmark replacement instead of the Board-selected SOFR replacement — which has been averaging only about 4.5% between January and April 2023 — the party that expected to benefit from a switch from LIBOR to prime on the LIBOR replacement date may be sorely disappointed, while its counterparty might regard that as a windfall.

IV. CONCLUSION

It appears that the most pessimistic fears concerning the transition from LIBOR have been averted, both because of the actions of Congress and regulators and private parties who, with the June 30, 2023 deadline approaching, have focused on amending existing contracts so as to minimize the risk of uncertainty, market disruption, and litigation arising from the end of LIBOR.

As indicated above, however, the effects of the LIBOR Act and of LIBOR transition may vary, depending on the specific features of the LIBOR contract involved. In many cases, the LIBOR Act provides a smooth and predictable transition to a new rate. In other cases, the features of a particular contract — its governing law, the benchmark replacement selected by the parties, or the particular events that are intended to trigger the replacement of LIBOR with that benchmark replacement — may be likely to generate uncertainty and risk that can only be addressed by amending the contract to tailor the terms to their needs, rather than to rely on fallbacks or the LIBOR Act. ■

[11] *Id.*; *see also* FCA, "Consultation on 'synthetic' US dollar LIBOR and feedback to CP22/11" (November 2022) ¶ 3.19 (warning that its intention was to provide parties time for "an orderly wind-down" of those legacy contracts, and reminding parties "not to rely on a temporary, synthetic US dollar LIBOR").