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Legal Update

Going Through Changes: Transitioning to a LIBOR-less World for Consumer Loans

It is widely anticipated that the London Interbank Offered Rate ("LIBOR") will be discontinued in 2021. As LIBOR commonly is used as an index rate for both residential mortgage and consumer loans, its discontinuance has the potential to have a significant impact on lenders, servicers, and consumers. Since 2014, industry leaders have been working to settle on an alternative index and transition plan to minimize the disruption of the move away from LIBOR. Through its efforts, the Alternative Reference Rates Committee ("ARRC")[1] has identified a newly created rate, the Secured Overnight Financing Rate ("SOFR"), as a suitable LIBOR replacement and has established a SOFR implementation framework.

Significantly, however, ARRC has primarily focused on future originations. The question of how holders and servicers of the roughly $1.2 trillion of legacy consumer purpose adjustable-rate mortgages that use LIBOR as the index should proceed in a LIBOR-less world has largely gone unanswered.[2] Concerns over the coming transition have prompted the New York Department of Financial Services ("NYDFS") to request that regulated entities prepare and deliver a plan to address LIBOR cessation and transition risk, with a deadline of March 23, 2020.[3]

In this Legal Update, we discuss the legal and regulatory issues that industry participants, regulators, and courts will face in order to navigate the transition away from LIBOR, both with respect to new originations and legacy loans.

SOFR Implementation in New Originations

SOFR is a broad measure of the cost of borrowing cash overnight collateralized by US Treasury securities. The Federal Reserve Bank of New York publishes SOFR on its website each business day at approximately 8:00 a.m.[4] The ARRC described several of the benefits of SOFR in a published whitepaper, including that it is produced for the public good, is based on an active and well-defined market and is produced in a transparent manner based on observable transactions, rather than on estimates or models.[5] These traits make SOFR an attractive option, from a consumer protection standpoint, for consumer and residential mortgage loans, particularly in comparison to LIBOR, which has proven to be subject to manipulation.

The ARRC presented a number of recommendations with respect to the use of SOFR in newly originated, consumer purpose adjustable rate mortgages ("ARMs"), including:

- Using either a 30- or 90-day SOFR average to set rates, which will mitigate the risks of unusual single day fluctuations. While these averages are not currently being published, the Federal Reserve Bank of New York has indicated it will begin publishing SOFR averages in the first half of 2020.[6]
- Setting the adjusted interest rate by reference to an average of SOFR observed in advance of the period to which such adjusted interest rate pertains.[7]
- Adjusting the rate of SOFR-based ARMs twice a year, rather than the once per year common to current ARMs based on a LIBOR index.[8] Allowing rates to adjust on a more frequent basis should address potential investor concerns that setting the interest rate in advance may result in off-market interest rates.
- Restructuring interest rate caps to have a one percent periodic adjustment cap (rather than the two percent periodic adjustment cap most common today) to offset the potential increased payment shock risk to borrowers related to the increase in adjustment frequency.[9] As, under the ARRC model, interest rates will adjust twice per year, a one percent cap per adjustment under the new system will essentially equate to the current system's two percent cap annually.

In order to better accommodate future index substitutions, ARRC has suggested changes to standard agency (i.e., Fannie Mae and Freddie Mac) ARM agreements that can be implemented in new originations in order to clarify when and how index references can be amended.[10] ARRC has identified two "triggers" that would permit replacement of an index: (i) the administrator of the index called for by the note has permanently stopped providing the index to the public or (ii) the administrator (or the regulator with authority over such administrator) issues an official public statement that the index is no longer reliable or representative.[11] If either of these triggering events were to occur, the new index would be an index selected by the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of New York (or a committee endorsed or convened by one of those entities). If one of those entities has not selected a new index, the note would provide for the holder to "make a reasonable, good faith effort to select" a replacement index and margin that, taken together, the holder of the note "reasonably expects will minimize any change in the cost of the loan, taking into account the historical performance of" both the original index and the replacement index.[12]

SOFR Substitution

One of the difficulties raised by the discontinuance of LIBOR is the sheer number of existing agreements that use LIBOR as an index, but do not clearly describe what should happen if the rate is no longer available. ARRC has noted that most contracts referencing LIBOR do not contemplate a permanent end to a published LIBOR.[13] Fortunately, residential mortgage loans – particularly "agency" mortgage loans that are eligible to be purchased by government-sponsored enterprises – typically give the noteholder the authority to name a successor index so long as it is based on "comparable information," although they provide little procedural guidance on how to identify and implement such a replacement.

There is no federal consumer financial law that expressly prohibits a servicer or noteholder from substituting one index for another. The CFPB's Regulation Z merely provides that a servicer must provide the borrower advance notice of a change in payment as a result of a rate adjustment, and disclose the index used and any adjustments to it.[14] Regulation Z does not bar a servicer or noteholder from changing the index nor does it impose any duty to use a replacement index and margin that provides for a similar rate of interest as the original index.[15] Nevertheless, servicers and noteholders should be mindful of legal and regulatory issues in the transition process. In a December 2019 letter to regulated financial institutions, the NYDFS noted that "changing the interest rate basis of any consumer loan presents various risks, such as legal, reputational and operational risks, that need to be carefully considered and managed."[16]

The road to a successful transition from LIBOR may be less bumpy for servicers of ARMs that are based on the FNMA/FHMLC uniform instruments. The uniform notes provide the holder a contractual right to substitute a new index based on "comparable information" should the original contracted-for index become unavailable.[17] However, the notes do not define "comparable information" or provide greater color as to when an index is based on "comparable information" to the original index. It is expected that Fannie Mae and Freddie Mac will resolve this uncertainty by issuing guidance that SOFR (or a spread-adjusted variant thereof) constitutes an index that is based on "comparable information," which would provide a contractual basis for servicers and noteholders of agency loans to transition existing ARMs from LIBOR to SOFR. This guidance also would be persuasive (although not binding) with respect to legacy ARMs that are not agency loans, but nonetheless use the uniform documents.

Even the presence of the contractual language in the uniform notes does not completely eliminate roadblocks to the transition away from LIBOR. The uniform notes grant noteholders the right to change the index, but do not expressly address the margin in the event the contracted-for index ceases to exist. SOFR is a secured rate, whereas LIBOR is unsecured; the consequence is that "because SOFR is secured and nearly risk-free, it is expected to be lower than LIBOR and may stay flat (or potentially even decline) in periods of severe credit market stress."[18] Thus, were a noteholder to substitute SOFR by itself, without amending the margin, it likely would receive interest at a lower rate than under LIBOR. Aggregated across the entire universe of adjustable-rate mortgage debt, the potential shortfall between expected returns on LIBOR-indexed loans and those under SOFR is an issue to consider.[19] The ARRC has addressed this issue through its anticipated issuance of a "spread-adjusted" SOFR index "that reflects and adjusts for the differences between LIBOR and SOFR; thus, minimizing the impact to the borrower's interest rate at resets."[20] In addition, the ARRC's proposed "fallback" language, which lenders may include in their promissory notes in future ARM originations, contemplate the noteholder adjusting the margin to mimic the economics of LIBOR.[21]

Noteholders and servicers whose adjustable-rate mortgage notes do not provide contractual authority to replace the index face a more difficult transition. In the absence of "fallback" language in the note that specifically authorizes the noteholder to substitute a comparable index, noteholders and servicers could amend the original loan agreement, with the borrower's consent, to provide for SOFR as the index. That said, drafting amendments to each adjustable-rate mortgage loan held by the noteholder (or serviced by the servicer), obtaining each borrower's consent, and tracking which borrowers have authorized the servicer or noteholder to substitute SOFR is likely to be a burdensome administrative and business process effort. And it is possible that a borrower will withhold his or her consent or refuse to accept an amendment designating SOFR as the replacement index.

Significantly, however, noteholders and servicers of contracts governed by New York law may have an additional "out" even if the ARM loan agreement is silent on whether the index may be substituted. The ARRC noted in November 2019 that it will explore a legislative fix under New York state law to address the LIBOR transition for loans that lack contractual provisions addressing cessation of LIBOR.[22] However, the scope of this proposed legislation is limited to contracts that provide for New York law as governing the loan agreement, and many legacy consumer loan promissory notes likely are not governed by New York law. Because the legislation has not yet been drafted, noteholders and servicers may wish to monitor the process and provide comments to the ARRC as necessary.

Finally, the Mortgage Bankers Association ("MBA") has adopted a model disclosure for consumers *applying* for an adjustable-rate mortgage in advance of the transition; the MBA is developing a separate template disclosure for use by lenders to provide borrowers with existing ARMs indexed to LIBOR.[23] It is unclear whether this model disclosure will be purely informational or tailored to borrowers on loans without "fallback" language.

Transition Planning

In December 2019, the NYDFS sent a letter to regulated financial institutions requesting that the institutions describe their transition plans in writing by February 7, 2020. In January 2020, the NYDFS extended that deadline by 45 days to March 23, 2020.

The NYDFS has requested that institutions address the following:

- Programs that would identify, measure, monitor and manage all financial and non-financial risks of transition;
- Processes for analyzing and assessing alternative rates, and the potential associated benefits and risks of such rates both for the institution and its customers and counterparties;
- Processes for communications with customers and counterparties;
- A process and plan for operational readiness, including related accounting, tax and reporting aspects of such transition; and
- The governance framework, including oversight by the board of directors, or the equivalent governing authority, of the regulated institution.[24]

Other state regulators may follow NYDFS's lead and demand that servicers and/or noteholders assess their LIBOR risk and create a transition plan. It does not appear that the NYDFS intends to prescribe how regulated institutions should transition from LIBOR; instead, the focus appears to be on the need to engage in robust transition planning with the development and implementation of well-considered policies and procedures.

Conclusion

LIBOR will continue to be a valid index up to its termination in 2021. Nonetheless, lenders, servicers, and noteholders should plan for an orderly transition well in advance. This may include assessing the types of loans held or serviced, surveying the contractual language related to the index and margin, and planning for communications with affected borrowers. In the meantime, servicers and noteholders with legacy adjustable-rate loans should carefully monitor issuances from the ARRC and guidance from regulators and government-sponsored entities.

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[1] ARRC is a group convened by the Federal Reserve Board of New York, comprising both public and private sector entities. ARRC has been tasked with ensuring a successful transition from US dollar LIBOR to a more robust reference rate.

[2] *See Second Report,* Alternative Reference Rates Committee (Mar. 2018) at 33, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report.

[3] Industry Letter: Request for Assurance of Preparedness for LIBOR Transition, New York Department of Financial Services (Dec. 23, 2019), available at https://dfs.ny.gov/system/files/documents/2019/12/il191223_libor_letter.pdf and Re: Request for Assurance of Preparedness for LIBOR Transition (Update), New York Department of Financial Services (Jan. 23, 2020), available at https://www.dfs.ny.gov/system/files/documents/2020/01/il20200123_libor_update.pdf.

[4] Available at https://apps.newyorkfed.org/markets/autorates/sofr.

[5] Options for Using SOFR in Adjustable Rate Mortgages, Alternative References Rates Committee (Jul. 2019) at 5, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-indexed-ARM-Whitepaper.pdf.

[6] Statement Requesting Public Comment on a Proposed Publication of SOFR Averages and a SOFR Index (Nov. 4, 2019), available at https://www.newyorkfed.org/markets/opolicy/operating_policy_191104.

[7] Options for Using SOFR in Adjustable Rate Mortgages, Alternative References Rates Committee (Jul. 2019) at 8, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-indexed-ARM-Whitepaper.pdf.

[8] *Id.* at 9.

[9] *Id.* at 11.

[10] *See* ARRC Recommendations Regarding More Robust LIBOR Fallback Contract Language For New Closed-End, Residential Adjustable Rate Mortgages, Federal Reserve Bank of New York (Nov. 15, 2019), available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARM_Fallback_Language.pdf.

[11] *Id.* at 7.

[12] *Id.* at 10.

[13] *Second Report*, Alternative Reference Rates Committee (Mar. 2018) at 27, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report.

[14] 12 C.F.R. § 1026.20(c).

[15] Of course, the lender must have accurately disclosed the index in the original TILA disclosures at consummation.

[16] Industry Letter: Request for Assurance of Preparedness for LIBOR Transition, New York Department of Financial Services (Dec. 23, 2019), available at

https://dfs.ny.gov/system/files/documents/2019/12/il191223_libor_letter.pdf.

[17] *See* https://www.fanniemae.com/singlefamily/notes for relevant examples.

[18] ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language For New Closed-End, Residential Adjustable Rate Mortgages, Federal Reserve Bank of New York (Jul. 12, 2019) at 4, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-ARM-consultation.pdf.

[19] The ARRC's model projected SOFR ARMs to have a margin between 2.75% and 3%, versus 2.25% for LIBOR ARMs. *See* Options for Using SOFR in Adjustable Rate Mortgages, Alternative References Rates Committee (Jul. 2019) at 13 ("based on historical data, a margin in the range of 2.75 to 3 percent would have resulted in SOFR-based loans resetting to a rate approximately equivalent to that of current products.").

[20] *Id.* at 8.

[21] *See* ARRC Recommendations Regarding More Robust LIBOR Fallback Contract Language For New Closed-End, Residential Adjustable Rate Mortgages, Federal Reserve Bank of New York (Nov. 15, 2019) at 15, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARM_Fallback_Language.pdf.

[22] https://www.newyorkfed.org/medialibrary/microsites/arrc/files/2019/ARRC-Minutes-Nov-2019.pdf.

[23] *MBA Releases Lender Disclosure Template for Adjustable-Rate Mortgage Borrowers in Preparation for LIBOR Sunset*, Mortgage Bankers Ass'n (Jun. 6, 2019), available at https://www.mba.org/2019-press-releases/june/mba-releases-lender-disclosure-template-for-adjustable-rate-mortgage-borrowers-in-preparation-for-libor-sunset.

[24] Industry Letter: Request for Assurance of Preparedness for LIBOR Transition, New York Department of Financial Services (Dec. 23, 2019), available at https://dfs.ny.gov/system/files/documents/2019/12/il191223_libor_letter.pdf.