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US Federal Reserve Adopts Final LIBOR Act Rule

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TO: ICI Members
LIBOR Transition Working Group SUBJECTS: Compliance
Disclosure
Fixed Income Securities
Fund Accounting and Financial Reporting
International/Global
Investment Advisers
Operations
Trading and Markets RE: US Federal Reserve Adopts Final LIBOR Act Rule

On December 16, 2022, the Board of Governors of the Federal Reserve System (the "Board") issued a final rule ("Final Rule")[1] implementing the US Adjustable Interest Rate (LIBOR) Act, which was enacted on March 15, 2022. The Final Rule establishes the benchmark replacements that will apply for existing US law-governed contracts that currently reference certain tenors of US dollar LIBOR (USD LIBOR) and do not have terms that provide for the use of a clearly defined and practicable replacement benchmark following the first London banking day after June 30, 2023 (i.e., the LIBOR replacement date).

The Final Rule also requires certain conforming changes to a LIBOR contract to facilitate the transition from USD LIBOR to the Board-selected benchmark replacement and, among other things,[2] seeks to provide clarification on how synthetic LIBOR would affect certain LIBOR contracts. The Final Rule will become effective on February 27, 2023.

Benchmark Replacements

As required by the LIBOR Act, the Final Rule identifies Board-selected benchmark replacements to replace references to the overnight and one-, three-, six-, and 12-month USD LIBOR in certain contracts and instruments that do not contain effective fallbacks, or for which the relevant "determining person"[3] has not determined a replacement rate.[4] The Final Rule largely adopts the benchmark replacements that the Board proposed in July 2022.

Specifically, the Final Rule identifies different Board-selected benchmark replacements for (1) derivative transactions and (2) for certain cash transactions. Consistent with the LIBOR

Act, the benchmark replacements noted below are based upon the Secured Overnight Financing Rate (SOFR)[5] and incorporate tenor spread adjustments for each relevant tenor of LIBOR.[6]

Derivative Transactions

For derivatives transactions, the benchmark replacement is the "Fallback Rate (SOFR)" in the International Swaps and Derivatives Association (ISDA) protocol for each day on which LIBOR would ordinarily be observed occurring on or after the LIBOR replacement date.[7]

Cash Transactions

For contracts that are not consumer loans, Federal Housing Finance Agency (FHFA)-regulated-entity contracts, or a Federal Family Education Loan Program (FFELP) Asset-Backed Securitization (ABS):

- In place of overnight LIBOR, the benchmark replacement is SOFR plus the applicable tenor spread adjustment.
- In place of one-, three-, six-, or 12-month LIBOR, the benchmark replacement is the corresponding one-, three-, six-, or 12-month CME Term SOFR plus the applicable tenor spread adjustment.[8]

For consumer loans:

- Consistent with the LIBOR Act, during the one-year period beginning on the LIBOR replacement date, the benchmark replacements incorporate a "transition tenor spread adjustment"[9] as follows:
    - In place of overnight LIBOR, the benchmark replacement is SOFR plus a transition tenor spread adjustment.
    - In place of one-, three-, six-, and 12-month LIBOR, the benchmark replacement is the corresponding CME Term SOFR plus a transition tenor spread adjustment.
- The Final Rule otherwise identifies the same benchmark replacements for consumer loans as for other cash transactions (i.e., SOFR for overnight LIBOR, and CME Term SOFR for one-, three-, six-, and 12-month LIBOR; each plus the applicable tenor spread adjustment).
- The benchmark replacements for consumer loans will also be deemed equal to the rates published by Refinitiv Limited as "USD IBOR Cash Fallbacks."

For FHFA-regulated entity contracts that are not Federal Home Loan Bank advances:

- In place of overnight LIBOR, the benchmark replacement is SOFR plus the applicable tenor spread adjustment.
- In place of one-, three-, six-, and 12-month LIBOR, the benchmark replacement is the "30-day Average SOFR" (i.e., a 30-calendar-day compounded average of SOFR, published by FRBNY) plus the applicable tenor spread adjustment.

For FHFA-regulated entity contracts that are Federal Home Loan Bank advances:

- The benchmark replacement is the "Fallback Rate (SOFR)" in the ISDA protocol for each day on which LIBOR would ordinarily be observed occurring on or after the LIBOR replacement date.

For FFELP ABS:

- In place of one-month LIBOR, the benchmark replacement is the 30-day Average SOFR plus the applicable tenor spread adjustment.
- In place of three-month LIBOR, the benchmark replacement is the 90-day Average SOFR plus the applicable tenor spread adjustment.
- In place of six- or 12-month LIBOR, the benchmark replacement is the 30-day Average SOFR plus the applicable tenor spread adjustment.

Benchmark Replacement Conforming Changes

The Final Rule requires certain conforming changes to LIBOR contracts related to the implementation, administration, and calculation of the Board-selected benchmark replacements. Although the proposed rules did not include any benchmark replacement conforming changes, the Board reconsidered its position in response to commenters' concerns. Consistent with the LIBOR Act, the Final Rule provides that (i) the Board may, in its discretion, publish additional benchmark replacement conforming changes by regulation or order; (ii) a calculating person may make certain conforming changes with respect to a LIBOR contract that is not a consumer loan;[10] and (iii) the conforming changes will become an integral part of any LIBOR contract for which a Board-selected benchmark replacement replaces the references to LIBOR.

Under the Final Rule, the specific conforming changes for any LIBOR contract will:

- Replace any references to a specific LIBOR source with the publication of the applicable Board-selected benchmark replacement by either a relevant benchmark administrator or an authorized third party.
- Replace references to a particular time of day for determining LIBOR (e.g., 11:00 am, London Time) with the standard publication time for the applicable Board-selected benchmark, as established by the relevant benchmark administrator.
- Modify any contractual provision that requires the use of a combination (such as an average) of LIBOR values over a period of time that spans the LIBOR replacement, to provide that the combination must be calculated consistent with that provision using the applicable LIBOR for any date prior to the LIBOR replacement date and (ii) the applicable Board-selected benchmark replacement for any date on or following the LIBOR replacement date, respectively.
- Provide that if a Board-selected benchmark replacement is not available or published on a day indicated by the LIBOR contract as the determination date, the most recently available publication of the Board-selected benchmark will apply.

Synthetic LIBOR

The Board's proposal sought feedback on whether the final rule should clarify how the LIBOR Act would apply if the UK Financial Conduct Authority (FCA) requires the ICE Benchmark Administrator (IBA) (or any successor administrator) to publish synthetic LIBOR on and after the LIBOR replacement date.[11] Specifically, the proposal asked how synthetic LIBOR might affect LIBOR contracts that contain fallback provisions that either identify a clear and practicable benchmark replacement or authorize a person to select a benchmark replacement, but where these fallback provisions are triggered only where LIBOR is unavailable (and are not expressly triggered where a benchmark called "LIBOR" is available but is not representative of the market that LIBOR is intended to measure).

The Board considered comments on this issue and explains that LIBOR contracts containing fallback provisions that identify a specific benchmark replacement are outside the scope of the LIBOR Act, even if these fallback provisions lack an express non-representativeness trigger. In response to commenters' suggestions, however, the Final Rule provides clarification on synthetic LIBOR by defining a determining person to include a person with a contingent authority, right, or obligation to determine a benchmark replacement. Specifically, under the Final Rule, a person who has the authority, right, or obligation to select a benchmark replacement when LIBOR is unavailable is a "determining person." Such person has a statutory right under the LIBOR Act to select the Board-selected benchmark replacement by the earlier of (i) the LIBOR replacement date and (ii) the latest date for selecting a benchmark replacement according to the terms of the LIBOR contract. If the determining person does not select a benchmark replacement by the LIBOR replacement date, the applicable Board-selected benchmark replacement will be the benchmark replacement for the LIBOR contract under section 104(c)(3) of the LIBOR Act.

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Notes

[1] Regulation Implementing the Adjustable Interest Rate (LIBOR) Act, Docket No. R-1775 (Dec. 16, 2022), 88 Fed. Reg. 5204 (Jan. 26, 2023) ("Adopting Release"), available at https://www.govinfo.gov/content/pkg/FR-2023-01-26/pdf/2023-00213.pdf.

[2] Notably, the Final Rule also (i) expressly provides that the LIBOR Act's protections related to the selection or use of the Board-selected benchmark replacement apply to any LIBOR contract for which the Board-selected benchmark replacement becomes the benchmark replacement; and (ii) indicates that, under the LIBOR Act, the Final Rule preempts any state or local law or standard relating to the selection or use of a benchmark replacement or conforming changes. See Adopting Release at 5217, Sections 253.7(a) and 253.6 of the Final Rule.

[3] The Final Rule amends the LIBOR Act's definition of "determining person" to clarify that the ability to determine the benchmark replacement may be contingent. Consequently, under the Final Rule, a determining person is "any person with the sole authority, right, or obligation, including on a temporary basis to determine a benchmark replacement, whether or not the person's authority, right, or obligation is subject to any contingencies specified in the LIBOR contract or by the governing law of the LIBOR contract." Section 253.2 of the Final Rule.

[4] Specifically, the Board-selected benchmark replacements that are included in the Final Rule would apply to (i) LIBOR contracts that contain no fallback provisions; (ii) LIBOR contracts that contain fallback provisions that identify neither a specific benchmark replacement nor a determining person; and (iii) LIBOR contracts that contain fallback provisions that identify a determining person, but where the determining person has not selected a benchmark replacement by the earlier of the LIBOR replacement date and the latest date for selecting a benchmark replacement according to the terms of the LIBOR contract. Section 254.4(a) of the Final Rule.

[5] SOFR is a broad measure of the cost of borrowing cash overnight collateralized by US

Treasury securities, which the Federal Reserve Bank of New York (FRBNY) publishes daily.

[6] Section 253.4(c) of the Final Rule lays out the spread adjustments, which mirror those specified in the LIBOR Act.

[7] The ISDA protocol replaces references to USD LIBOR in adhering parties' derivative transaction contracts with a rate equal to (i) SOFR, compounded in arrears for the appropriate tenor plus (ii) a stated spread adjustment based on the appropriate tenor (the "Fallback Rate (SOFR)"). Bloomberg publishes the Fallback Rate (SOFR). ISDA, ISDA 2020 IBOR Fallbacks Protocol (Oct. 23, 2020), available at https://assets.isda.org/media/3062e7b4/08268161-pdf. The Final Rule also states that "[f]or clarity, the reference to 'spread relating to U.S. dollar LIBOR' in the definition of 'Fallback Rate (SOFR)' in the ISDA protocol is equal to the applicable tenor spread adjustment identified in [Section 253.4(c) of the final rule]." Adopting Release at 5222.

[8] CME Term SOFR is a forward-looking term rate based on SOFR administered by CME Group.

[9] The transition tenor spread adjustment is an amount that transitions linearly for each business day during that period from (i) the difference between the Board-selected benchmark replacement and the corresponding LIBOR tenor determined as of the day immediately before the LIBOR replacement date to (ii) the applicable tenor spread adjustment specified in Section 253.4(c) of the Final Rule. See Section 253.4(b)(2)(i)(A) and (B) of the final rule.

[10] The LIBOR Act defines a "calculating person" as any person, including the determining person, responsible for calculating or determining any valuation, payment, or other measurement based on a benchmark. 12 U.S.C. 5802(7). Under the LIBOR Act, all benchmark replacement conforming changes (whether determined by the Board or, if applicable, a calculating person) become an integral part of the LIBOR contract, and a calculating person must not be required to obtain consent from any other person prior to adopting such conforming changes. 12 U.S.C. 5803(d).

[11] See Adopting Release at 5210-5211. On March 5, 2021, the FCA announced that, after December 31, 2021, IBA would cease publishing 24 currency and tenor pairs (known as settings). The discontinued LIBOR settings included one-week and two-month USD LIBOR. To allow most legacy USD LIBOR contracts governed by non-US law to mature without disruption, the FCA also announced that the panels for the remaining five tenors of USD LIBOR would continue through, but cease after, June 30, 2023. Additionally, on November 2022, the FCA proposed to require IBA to continue publishing one-, three-, or six-month USD LIBOR on a synthetic basis until the end of September 2024 (synthetic LIBOR). The FCA notes that synthetic LIBOR settings are "not representative of the markets that the original LIBOR settings were intended to measure." See Adopting Release at 5204-5205.