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LIBOR Transition – Its History and Potential Issues Going Forward

This article describes the history to date of the transition away from the London Interbank Offered Rate ("LIBOR") and highlights some concerns that mortgage lenders should take into account with regard to the phase-out of LIBOR. This article focuses on concerns primarily regarding the servicing of existing legacy LIBOR-indexed single-family adjustable-rate mortgage ("ARM") loans and the origination of new single-family ARM loans. However, it touches on other mortgage loan products as well, such as home equity lines of credit ("HELOCs"). This paper also provides an overview of the recently proposed revisions to Regulation Z by the Consumer Financial Protection Bureau ("CFPB") addressing LIBOR transition issues.

Background of the LIBOR Transition

LIBOR is a reference rate representing the average interest rate at which a panel of banks doing business in London report that they can borrower unsecured short-term wholesale funds from other banks in the interbank market.[1] During the 2008 financial crisis a number of panel banks were fined for manipulating LIBOR submissions, and unsecured interbank lending also significantly declined.[2] After a subsequent review of LIBOR submission practices, LIBOR became subject to the regulatory authority of the United Kingdom's Financial Conduct Authority ("FCA"), and the ICE Benchmark Administration Limited ("IBA") was appointed as LIBOR's administrator.[3] The IBA has taken steps to strengthen LIBOR, and currently continues to publish LIBOR at several maturities ranging from overnight to one year. However, the scarcity of underlying transactions creates a continuing risk of permanent cessation of the rate.[4] Accordingly, in the United States, the Federal Reserve Board ("FRB") established the Alternative Reference Rates Committee ("ARRC") to create a plan to transition away from LIBOR, including by identifying and selecting a replacement rate for LIBOR.[5] In June 2017, the ARRC identified the Secured Overnight Financing Rate ("SOFR") as its recommended

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[1] *See* David Hou & David Skeie, *LIBOR: Origins, Economics, Crisis, Scandal, and Reform*, FED. RES. BANK N.Y. (Mar. 2014), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr667.pdf.
[2] *See* ICE BENCHMARK ADMIN. LTD., ICE LIBOR EVOLUTION 4 (Apr. 25, 2018), https://www.theice.com/publicdocs/ICE_LIBOR_Evolution_Report_25_April_2018.pdf [hereinafter ICE BENCHMARK ADMIN. LTD.].
[3] *Id.*
[4] *Id.*, at 6 – 7; ALT. REFERENCE RATES COMM., SECOND REPORT 1, 33 (Mar. 2018), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Second-report [hereinafter SECOND REPORT].
[5] *See* SECOND REPORT, *supra* note 4, at 4–5. It should be noted that similar efforts to replace LIBOR with alternative reference rates are underway globally. *See* ALT. REFERENCE RATES COMM., FREQUENTLY ASKED QUESTIONS 7–8 (Jan. 31, 2019), https://web.archive.org/web/20190718062812/https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/ARRC-faq.pdf [hereinafter FAQS].

alternative.[6] Shortly thereafter, the FCA announced that because panel banks are increasingly making LIBOR submissions based on "expert judgment" due to the declining number of underlying transactions, it would not compel LIBOR submissions beyond 2021, and that LIBOR's end should be treated as something that will occur.[7] Consequently, it is anticipated that LIBOR may not exist beyond 2021.[8]

The ARRC's current membership is comprised of private sector participants, such as, among others, Fannie Mae and Freddie Mac ("GSEs"), and ex officio members including, for example, the Federal Deposit Insurance Corporation ("FDIC"), the Federal Housing Finance Agency ("FHFA"), the FRB, and the Federal Reserve Bank of New York ("FRBNY").[9] The ARRC also has eleven working groups, such as the consumer products working group and the securitizations working group, which may include additional interested parties.[10] In July 2019, the ARRC's consumer products working group released proposed fallback language for new closed-end ARMs that reference LIBOR, and in November 2019, following the close of the comment period, released the recommended fallback language.[11] The recommended fallback language includes triggers that would require the note holder to convert to a new reference rate, including when an index becomes unavailable or when the administrator or regulator of the index announces that it is no longer reliable or representative.[12] The recommended language also provides a waterfall methodology if the index is no longer available. Its first step is the selection or recommendation of a replacement index for use in consumer products,

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[6] *See* SECOND REPORT, *supra* note 4, at 7. SOFR is published by the Federal Reserve Bank of New York in cooperation with the Office of Financial Research. *Id.* at 6.

[7] Andrew Bailey, Chief Exec., Fin. Conduct Auth., Speech (as drafted) at Bloomberg London: Interest Rate Benchmark Reform: Transition to a World Without LIBOR (July 12, 2018), https://www.fca.org.uk/news/speeches/interest-rate-benchmark-reform-transition-world-without-libor; *see* FAQS, *supra* note 5, at 2.

[8] *See* Press Release, Alt. Reference Rates Comm., ARRC Announces Recommendation of a Spread Adjustment Methodology for Cash Products (Apr. 8, 2020) [hereinafter ARRC Spread Adjustment Methodology Recommendation], https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Spread_Adjustment_Methodology.pdf.

[9] *See* About—Members, N.Y. FED., https://www.newyorkfed.org/arrc/about#members (last visited June 24, 2020).

[10] *See* About—Working Groups of the ARRC, N.Y. FED., https://www.newyorkfed.org/arrc/about#workinggroups (last visited June 24, 2020).

[11] *See* ALT. REFERENCE RATES COMM., CONSULTATION REGARDING MORE ROBUST LIBOR FALLBACK CONTRACT LANGUAGE FOR NEW CLOSED-END, RESIDENTIAL ADJUSTABLE RATE MORTGAGES at app. I (July 12, 2019), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-ARM-consultation.pdf [hereinafter CONSULTATION]; ALT. REFERENCE RATES COMM., ARRC RECOMMENDATIONS REGARDING MORE ROBUST LIBOR FALLBACK LANGUAGE FOR NEW CLOSED-END, RESIDENTIAL ADJUSTABLE RATE MORTGAGES (Nov. 15, 2019), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARM_Fallback_Language.pdf [hereinafter RECOMMENDATIONS].

[12] *Id.* at 7–8.

including residential ARMs, by the FRB, the FRBNY, or a committee endorsed or convened by the FRB or FRBNY at the time of the replacement event.[13] As its second step, the waterfall methodology provides that if a replacement index has not been selected or recommended as outlined in the first step, the note holder must make a reasonable, good-faith effort to select a replacement index and a replacement margin that, when added together, the note holder reasonably expects will minimize any change in the cost of the loan, taking into account the historical performance of the original index and the replacement index.[14] Notwithstanding the recommendation, however, the ARRC has clarified that the implementation or adoption of the suggested contract language is completely voluntary and that each market participant should "make its own independent evaluation and decision about whether or to what extent any suggested contract language is adopted."[15]

In February 2020, the FHFA issued a news release highlighting certain changes affecting, among other things, single-family ARM products that the GSEs announced they are implementing as they transition away from LIBOR to SOFR.[16] The GSEs' announcements, which were issued the same day, provided notice of the publication of revised single-family uniform ARM instruments incorporating the ARRC's recommended fallback language.[17] The announcements also stated that the revised instruments must be used for single-family ARM loans closed on or after June 1, 2020, and encouraged lenders to begin using the revised instruments immediately.[18] The announcements further stated, among other things, that to be eligible for purchase by the GSEs, all LIBOR-based single-family ARM loans must have loan application dates on or before September 30, 2020, and that the GSEs will not purchase LIBOR-based single-family ARM loans after December 1, 2020.[19] In May of 2020, the GSEs issued further

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[13] RECOMMENDATIONS, *supra* note 11, at 5.
[14] *Id.*
[15] *Id.* at 3.
[16] News Release, FHFA Announces Fannie Mae and Freddie Mac Update on LIBOR Transition (Feb. 5, 2020), https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Fannie-Mae-and-Freddie-Mac-Update-on-LIBOR-Transition.aspx.
[17] *See* Lender Letter (LL-2020-01), Fannie Mae, to All Fannie Mae Single-Family Sellers (Feb. 5, 2020), https://singlefamily.fanniemae.com/media/21831/display; Bulletin 2020-1, Freddie Mac, to Freddie Mac Sellers (Feb. 5, 2020), https://guide.freddiemac.com/app/guide/bulletin/2020-1; *see also, e.g.,* MULTISTATE ADJUSTABLE RATE NOTE – WSJ One-Year LIBOR – Single-Family – Fannie Mae UNIFORM INSTRUMENT Form 3526 6/01 (rev. 2/20), https://singlefamily.fanniemae.com/media/11516/display; MULTISTATE ADJUSTABLE RATE NOTE-1-Year LIBOR Index (Assumable after Initial Period)--Single Family--Freddie Mac UNIFORM INSTRUMENT Form 5531 3/04 (rev. 2/20), https://sf.freddiemac.com/tools-learning/uniform-instruments/all-instruments.
[18] *Id.*
[19] *Id.* The announcements also indicate, in relevant part, that the GSEs anticipate being able to accept single-family ARMs based on a 30-day SOFR average during the second half of 2020 and the fourth quarter of 2020, respectively and that additional details about these plans will be released in the coming months. Further, the announcements provide that the GSEs, under FHFA guidance, will cease purchasing constant maturity Treasury ("CMT") – indexed ARM loans at some point during 2021, and that details and requirements, including timing, will be announced as they become available. The

guidance on the SOFR transition in the form of the "LIBOR Transition Playbook."[20] This was updated in June of 2020. The LIBOR Transition Playbook clarifies, among other things, that the GSEs will cease whole-loan purchases of LIBOR-based single-family ARM loans on December 31, 2020, and that December 1, 2020 is the last issue date for LIBOR-indexed ARM pools.[21]

On April 1, 2020, the GSEs announced the publication of new SOFR-indexed single-family uniform ARM notes, as well as guidance regarding eligibility, underwriting, and delivery requirements.[22] The new SOFR-indexed notes will use the 30-day average of the SOFR index as published by the FRBNY, which began publishing the rate on March 2, 2020, and contain the same fallback language as the revised LIBOR-indexed single-family uniform ARM instruments.[23] Fannie Mae has advised that whole loan and mortgage-backed securities ("MBS") pricing and deliveries of single-family SOFR ARM loans will begin on August 3, 2020, and that lenders may begin delivery of whole loans on this date and delivery of loans in MBS with issue dates beginning August 1, 2020.[24] Freddie Mac has advised that sellers will be able to take out 30-day average SOFR contracts in Loan Selling Advisor to deliver SOFR-indexed ARM loans beginning November 16, 2020, and that sellers will be able to take out 30-day average SOFR guarantor contracts in Loan Selling Advisor to deliver mortgages into weighted average coupon ARM participation certificates beginning November 16, 2020 for mortgages with settlement dates on or after December 1, 2020.[25]

Additionally, because a forward-looking term rate based on SOFR does not yet exist, the ARRC released a white paper in July 2019 demonstrating how SOFR, as it currently exists, can be used in new ARM loans in a manner similar to LIBOR.[26] While certain

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announcements also state that the GSEs do not recommend that lenders increase their CMT-indexed loan deliveries to deal with the cessation of LIBOR ARM purchases. *Id.*

[20] *Available at* https://www.fanniemae.com/resources/file/libor/pdf/playbook.pdf [hereinafter PLAYBOOK] (last visited June 24, 2020).

[21] *See* PLAYBOOK, *supra* note 20, at 10.

[22] *See Selling Guide* Announcement (SEL-2020-02), Fannie Mae (Apr. 1, 2020) [hereinafter Fannie Mae Selling Guide Announcement], https://singlefamily.fanniemae.com/media/22436/display; Bulletin 2020-9, Freddie Mac, to Freddie Mac Sellers and Servicers (Apr. 1, 2020) [hereinafter Freddie Mac Bulletin 2020-9], https://guide.freddiemac.com/app/guide/bulletin/2020-9.

[23] *Id.*; *See also*, *e.g.*, MULTISTATE ADJUSTABLE RATE NOTE – 30 day Average SOFR – Single Family – Fannie Mae /Freddie Mac Uniform Instrument Form 3441 04/20, https://singlefamily.fanniemae.com/media/22416/display; FRBNY, Operating Policy, Statement Regarding Publication of SOFR Averages and a SOFR Index (Feb. 12, 2020), https://www.newyorkfed.org/markets/opolicy/operating_policy_200212#footnote1.

[24] *See* Fannie Mae Selling Guide Announcement, *supra* note 22.

[25] *See* Freddie Mac Bulletin 2020-9, *supra* note 22.

[26] *See* ALT. REFERENCE RATES COMM., OPTIONS FOR USING SOFR IN ADJUSTABLE-RATE MORTGAGES (July 2019), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-indexed-ARM-Whitepaper.pdf.

structural aspects would remain the same, others would differ.[27] According to the model described in the white paper, SOFR-based ARM loans would: (1) be based on a thirty- or ninety-day SOFR average, rather than one-year LIBOR, because the margin for new SOFR-based ARM loans would likely require an upward adjustment; (2) adjust following the fixed-rate period once every six months, instead of annually (the current market standard for LIBOR-based ARM loans), to ensure that SOFR-based ARMs are competitive with other market rates; and (3) cut the periodic adjustment cap to 1 percent so that even in periods of rapidly rising interest rates, payments would not change by more than 2 percent over a twelve-month period, which is in accord with current LIBOR-based ARM market conventions.[28] Following suit, the LIBOR Transition Playbook, in turn, states that the GSEs will base future single-family ARMs on a 30-day SOFR average, that such loans will have interest rate adjustment periods of six months, and will have interest rate adjustment caps of 1 percent (further, such loans will have initial fixed periods of at least three years).[29] Additionally, while the loan lifetime cap will stay at 5 percent for Fannie Mae, the Freddie Mac cap will be 5 percent.[30] Further, Fannie Mae's margin on SOFR-based single-family ARMs will have a maximum of 3 percent, and Freddie Mac's margin will have a minimum of 1 percent and a maximum of 3 percent.[31]

In January 2020, the ARRC released a consultation seeking comments from market participants on the spread adjustment methodology it intends to recommend as part of its fallback provision recommendations for cash products, including ARMs, referencing LIBOR.[32] In the consultation, the ARRC indicated that it was considering publishing a SOFR-based replacement index, that would already incorporate the recommended spread adjustment, for use in LIBOR contracts that have incorporated the ARRC's recommended fallback language or for legacy LIBOR contracts in which the parties are able to, and do, select an ARRC-recommended spread-adjusted rate as a fallback.[33] More recently, on April 8, 2020, following the close of the comment period, the ARRC announced that it had agreed on a recommended spread adjustment methodology for ARM loans referencing LIBOR.[34] In the announcement, the ARRC stated that its recommended methodology can be used to produce spread adjustments for LIBOR contracts that have incorporated the ARRC's recommended fallback language, or for

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[27] *See* ALT. REFERENCE RATES COMM., OPTIONS FOR USING SOFR IN ADJUSTABLE-RATE MORTGAGES, *supra* note 26, at 2–3.
[28] *See id.* at 13.
[29] *See* PLAYBOOK, *supra* note 20, at 11.
[30] *See id.* at 12.
[31] *See id.*
[32] *See* ALT. REFERENCE RATE COMM., CONSULTATION ON PROPOSED SPREAD ADJUSTMENT METHODOLOGIES FOR CASH PRODUCTS REFERENCING LIBOR (Jan. 21, 2020), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Spread_Adjustment_Consultation.pdf.
[33] *Id.*
[34] *See* ARRC Spread Adjustment Methodology Recommendation, *supra* note 8.

legacy LIBOR contracts where a spread-adjusted SOFR can be selected as a fallback, such that the spread-adjusted SOFR would be comparable to LIBOR.[35] Specifically, the ARRC has recommended a spread adjustment methodology for cash products based on a historical median over a five-year lookback period calculating the difference between LIBOR and SOFR, and for consumer products, such as ARMs, additionally has recommended a 1-year transition period to this five-year spread adjustment methodology.[36] The announcement also stated that the ARRC will release a more detailed final recommendation of the spread adjustment methodology, and that the ARRC is committed to ensuring its recommended spread adjustments and the resulting spread-adjusted rates are published and made publicly available.[37]

In May of 2020, the ARRC published its "Recommended Best Practices for Completing the Transition from LIBOR" (the "Best Practices").[38] As the ARRC notes, the Best Practices "do not constitute binding rules or regulatory guidance, and market participants must decide for themselves whether, or to what extent, they will adopt and apply them consistent with the size and complexity of their activities and institutions, and with the nature of their engagement in relevant transactions, taking into account relevant supervisory and regulatory policy."[39] Among the guidance offered in the Best Practices, the ARRC recommends the following:

- Including ARRC-recommended (or substantially similar) fallback language in new LIBOR-based cash products (by June 30, 2020 for closed-end residential mortgage loans and securitizations);
- Completion by third-party technology and operations vendors of all necessary technological enhancements to support SOFR by the end of 2020;
- Stopping new use of LIBOR-based products;
- If a contract specifies that a party will select a replacement rate at their discretion after the LIBOR transition, that party should disclose the planned selection to the other relevant parties at least six months prior to the effective date of the replacement; and
- Implementation of clear internal programs to prepare for transition away from LIBOR across all relevant financial activities, referencing the ARRC's "Practical Implementation Checklist for SOFR Adoption" as applicable.[40]

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[35] *See* ARRC Spread Adjustment Methodology Recommendation, *supra* note 8.
[36] *Id.*
[37] *Id.*
[38] *Available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC-Best-Practices.pdf (last visited June 24, 2020).
[39] *See id.* at 2.
[40] *Available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-SOFR-Checklist-20190919.pdf (last visited June 24, 2020).

The ARRC has yet to propose model index replacement fall back language for HELOCs, although such proposed model language is expected to be forthcoming. In any event, not all HELOCs use LIBOR as an index, and many such programs use the prime rate as published in the Wall Street Journal as an index. Further, Regulation Z provides for HELOCs that a creditor may change the index and margin used under the plan if the original index becomes unavailable, as long as historical fluctuations in the original and replacement indices were substantially similar, and as long as the replacement index and margin will produce a rate similar to the rate that was in effect at the time the original index became unavailable. If the replacement index is newly established and therefore does not have any rate history, it may be used if it produces a rate substantially similar to the rate in effect when the original index became unavailable.

Further, on June 4, 2020, the CFPB issued a Notice of Proposed Rulemaking (NPRM) to amend Regulation Z (which implements the Truth in Lending Act).[41] The recently issued NPRM proposes amendments to Regulation Z to assist creditors with transitioning away from use of LIBOR, which as noted above is expected to be discontinued after 2021, as an index for open-end and closed-end variable-rate credit products. Comments on the NPRM are due by August 4, 2020.

In relation to closed-end credit, Regulation Z currently provides that if the creditor changes the index of a variable-rate closed-end loan to an index that is not a "comparable index," the index change may constitute a refinancing for purposes of Regulation Z, triggering certain additional requirements. The NPRM identifies specific indices as an example of a "comparable index" for purposes of the closed-end refinancing provisions. In this regard, the CFPB proposes that changing the reference rate from LIBOR to SOFR does not constitute adding a variable-rate feature to the loan, because SOFR is a comparable rate to LIBOR. The NPRM also makes technical edits to certain adjustable-rate mortgage sample forms in Appendix H of Regulation Z, including replacing LIBOR references with references to a SOFR index and making related changes and corrections.

In relation to open-end credit, the NPRM revises change-in-terms notice requirements to ensure consumers know how the variable rates on their accounts will be determined going forward after the LIBOR index is replaced, including by requiring the disclosure of the index replacing the LIBOR index and any adjusted margin used to calculate a consumer's rate. The NPRM also provides a roadmap for creditors to choose a compliant replacement index. While creditors currently may change an index and margin they use to set the annual percentage rate ("APR") on a variable-rate account when the original index "becomes unavailable" or "is no longer available," the amendments detail how a creditor may replace a LIBOR index with a replacement index

[41] *Available at* 85 Fed. Reg. 36,938.

on or after March 15, 2021, based on the CFPB's determination that creditors would benefit substantially by being able to transition away from a LIBOR index before LIBOR becomes unavailable. Creditors would be required to ensure the APR calculated using the replacement index is substantially similar to the rate calculated using the LIBOR index, based on the values of these indices on December 31, 2020. Creditors can select a replacement index that is newly established or has no history, or an index that is not newly established and has a history so long as such index has historical fluctuations substantially similar to those of the LIBOR index. The NPRM provides that the prime rate published in the in the Wall Street Journal has historical fluctuations substantially similar to those of certain LIBOR indices, and that certain spread-adjusted indices based on SOFR have historical fluctuations substantially similar to those of certain LIBOR indices.

Simultaneously with the NPRM, the CFPB also issued Fast Facts for 2020 LIBOR Transition Rule, LIBOR Transition FAQs, and an updated CHARM Booklet on Adjustable-Rate Mortgages.

In summary, among the changes the proposed rule would make are the following:

- With respect to HELOCs and other open-end products, requiring creditors to include in the LIBOR-related change-in-terms notice the replacement index and any margin adjustment, regardless of whether the margin is being increased or decreased;
- With respect to HELOCs and open-end reverse mortgages, providing that the creditor must change the LIBOR index and margin on or after March 15, 2021 to a replacement index and margin whose historical fluctuations were similar to those of LIBOR (provided that the replacement index was in effect on December 31, 2020, and further provided that the replacement margin will produce an annual percentage rate substantially similar to the rate calculated using the LIBOR index in effect on December 31, 2020);
    - The proposed Official Commentary to this provision identifies both SOFR and the prime rate published in the Wall Street Journal as meeting these requirements;
- With respect to closed-end ARMs, clarifying that changing the reference rate from LIBOR to SOFR does not constitute adding a variable-rate feature to the loan, because SOFR is a comparable rate to LIBOR.

Potential Issues Going Forward

Servicing Existing Loans

For existing legacy LIBOR-indexed single-family closed-end ARM loans and open-end variable rate HELOCs, the contract language in the loan documents will control the

relationship between the parties. On existing LIBOR-based single-family ARM loans, the contract typically states that if the reference rate is no longer available, the note holder has the right to choose a new, comparable index.

However, existing ARM loan contracts often do not specify how to determine if the index – in this case, LIBOR – is "no longer available," or if a new index is comparable to LIBOR. Additionally, such ARM loan contracts typically do not address explicitly whether the note holder can adjust the *margin* that is added to the reference rate to determine the interest rate. The absence of express authority in the notes to adjust the margin can become an issue if the replacement index is lower or higher than LIBOR.[42] If LIBOR, which is unsecured and includes an element of bank credit risk, is replaced by SOFR, which is a secured nearly risk-free rate, a margin increase generally would be needed to make the SOFR-based index perform similarly to the LIBOR-based index. If the note holder cannot increase the margin, it is expected that the SOFR-based index typically will produce a lower interest rate than the LIBOR-based index, potentially resulting in payments and valuations that differ from expectations.[43] This is why it will be important for ARRC to recommend a methodology to produce a version of SOFR that already includes within it the necessary margin adjustment (or so-called "synthetic SOFR") to make the interest rate results comparable to those under LIBOR.

As stated above, however, Regulation Z provides that for HELOCs a creditor may change the index and margin used under the plan if the original index becomes unavailable, as long as historical fluctuations in the original and replacement indices were substantially similar, and as long as the replacement index and margin will produce a rate similar to the rate that was in effect at the time the original index became unavailable. However, for some agency insured or guaranteed loans, the agency is tasked with selecting a new index if the current index is no longer available. Thus, lenders and servicers will need to review their HELOC programs and loan documents in order to further determine any contractual index and margin replacement language.

With respect to the question of how to determine when LIBOR is "no longer available," we understand, based on communications with representatives at Fannie Mae and the ARRC, that they do not view the lack of specificity in this regard as a significant issue in connection with ARM loans, as there is a general expectation and belief that the IBA will stop publishing the LIBOR rate, or otherwise announce when it is no longer representative.

With respect to the question of how to determine if a new index is based on "comparable information," we note that, as discussed above, the GSEs in their LIBOR

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[42] *See* ARRC, Consultation Regarding More Robust LIBOR Fallback Contact Language for New Closed-End, Residential Adjustable Rate Mortgages, at 4 (July 12, 2019), https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC-ARM-consultation.pdf.

[43] *Id.*

Transition Playbook, and the CFPB in its NPRM, have identified SOFR as a comparable replacement index for LIBOR. However, thus far neither the GSEs nor the CFPB have issued written guidance on how the margin can be adjusted on existing loan contracts. However, as noted above, the ARRC has announced that its recommended methodology to address this issue is to produce a version of SOFR that already includes within it the necessary margin adjustment to make the interest rate results comparable to those expected under LIBOR. It is expected that following the publication of this spread-adjusted SOFR, the GSEs will issue guidance clarifying that the spread-adjusted SOFR is based on "comparable information" to LIBOR, establishing a contractual basis for servicers and note holders to transition legacy GSE ARM loans to a SOFR-based index while minimizing the expected change in the value arising from the move to a replacement benchmark based on SOFR. In the unlikely event that this does not occur by the time LIBOR is discontinued, a different replacement index such as, for example, 30-day average SOFR, if and as directed by the GSEs, may be required to be used. In such a circumstance, lenders should not plan to adjust the margin. Such guidance from the GSEs, while not binding, would arguably be viewed as being persuasive, by analogy, in relation to non-agency loans that use GSE LIBOR-indexed single-family uniform ARM notes. We note, however, that if a replacement rate and margin result in increased costs to consumers (i.e., they produce interest rates that are higher than what LIBOR would have produced), there is a potential risk of consumer-led litigation.

Additionally, the issue of when, and how, to disclose the transition from LIBOR to SOFR is an outstanding issue for servicers. As described above, the CFPB's NPRM, when finalized, hopefully will provide servicers with some clarity in this area.

Moreover, beyond the guidance from the ARRC, the CFPB, and the GSEs, mentioned above, guidance that is directly relevant to the aforementioned issues, as a general matter, has not yet been forthcoming from other federal agencies such as the Federal Housing Administration ("FHA"), Ginnie Mae, and the U.S. Department of Veterans Affairs ("VA"), or from state agencies. We note, however, that the FDIC previously provided certain limited, but potentially relevant, guidance toward the end of 2019, stating that the FHFA was, at that time, developing contract language for residential ARMs intended to be sold on the secondary market, and that institutions may want to consider waiting to change interest rate language for such mortgage loans until FHFA recommends or adopts standard language, which has now occurred.[44] In light of the above, it appears that controlling guidance that is directly relevant to the issues identified above, other than the limited FDIC guidance, has not yet been forthcoming for servicers and note holders of non-agency ARM loans held in portfolio by lenders. In the absence of such guidance, however, guidance from the ARRC, the CFPB, and the

[44] Judy E. Gross & Lynn B. Dallin, *Transitions in Financial Instrument Reference Rates*, SUPERVISORY INSIGHTS, Winter 2018, https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin18/si-winter-2018.pdf.

GSEs, while not binding, would arguably be viewed as being persuasive, by analogy, in relation to loans that (for example) are insured by FHA or guaranteed by VA.

New Originations

Regarding originating new single-family ARM loans, lenders should consider using the revised GSE LIBOR-indexed single-family uniform ARM notes, which incorporate the ARRC's recommended fallback language, for all new originations of GSE single-family ARM loans until the earlier of the remaining period of time during which LIBOR-based single-family ARM loans remain eligible for purchase by the GSEs, or the date on which Fannie Mae or Freddie Mac, as applicable, begins accepting delivery of SOFR-indexed ARM loans, and use the new GSE SOFR notes thereafter (the timelines for this process are discussed above). The timelines, however, are not applicable to non-agency ARM loans that will be held in portfolio, and for such loans, the decision of which index to use is generally a business decision.

Additionally, lenders should take into account that in some jurisdictions, they may be limited in the reference rates that they can select. Pursuant to the Alternative Mortgage Transaction Parity Act (the "Parity Act")[45] and its implementing Regulation D,[46] a licensed mortgage lender generally can make "alternative mortgage transactions" (such as an ARM secured by residential property that is for personal, family, or household purposes) without being limited by state restrictions that otherwise would apply to such transactions (subject to certain requirements set forth in Regulation D). However, several states (Maine, Massachusetts, New York, South Carolina, and Wisconsin) opted out of the Parity Act. Accordingly, in those states requirements regarding alternative mortgage transactions may apply. For example, lenders in Wisconsin must use an index that is approved by the Wisconsin Department of Banking.[47] Similarly, New York requires the use of an index approved by the Superintendent of Banks of the New York State Department of Financial Services for junior lien mortgage loans of less than $250,000.[48]

As this article demonstrates, the issues surrounding the LIBOR transition are complex and challenging, and further developments are expected. WBK is monitoring these developments and would be pleased to answer any questions you may have concerning the LIBOR transition.

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[45] 12 U.S.C. § 3803.
[46] 12 C.F.R. Part 1004.
[47] Wis. Stat. § 138.056(1)(a)(4)(d), (2).
[48] N.Y. Comp. Codes R. & Regs. tit. 3, § 80.6(b).