



**National
Consumer Law
Center**

*Fighting Together
for Economic Justice*

Adjustable Rate Mortgages:

Transitioning From LIBOR to Alternate Indices

Comments

to the

Department of Housing & Urban Development

regarding

24 CFR Parts 203, 206

Docket No. FR-6151-A-01, RIN 2502-AJ51

86 Fed. Reg. 54,876 (Oct. 5, 2021)

by the

National Consumer Law Center,

on behalf of its low income clients

Filed on Dec. 6, 2021

Summary: To ensure that consumers are protected in the transition from the LIBOR index, HUD should:

- 1) require noteholders to use the spread-adjusted SOFR index, as recommended by the Alternative Reference Rate Committee, to replace the LIBOR, and
- 2) prohibit noteholders from strong-arming consumers into unwarranted loan modifications or refinancing.

1. Introduction

The National Consumer Law Center (NCLC) on behalf of its low-income clients, appreciates the opportunity to comment on this advance notice of proposed rulemaking. Our comments focus on the essential rules that should be required for replacing the LIBOR in existing forward and reverse mortgages. This includes descriptions of the risks facing consumers in the LIBOR transition that illustrate the importance of HUD's affirmative requirements to prevent industry abuse or mismanagement of this event.

As most of the questions posed in HUD's Federal Register notice seek information from industry, we are responding only to questions 1-3 and 7. Our comments are based on what would be best for consumers.

2. The transition away from the LIBOR poses significant risk to consumers.

The LIBOR is the most widely used index for adjustable-rate FHA forward and reverse mortgages, but after June 2023, it will no longer be available. At that time, there will exist an estimated \$74 trillion of LIBOR-based contracts.¹ Informal estimates include \$800 billion in consumer debt—mostly mortgages. All those "legacy" LIBOR contracts will need to be converted to a new index. The mortgage industry has never before experienced an index replacement on this scale.

While FHA mortgage contracts authorize noteholders to replace the index, the standard contract language provides little guidance on how to select a new index. The current model contract merely says "If the Index is no longer available, the Note Holder will choose a new index which is based upon

¹ Alternative Reference Rate Committee, Frequently Asked Questions at 18 (Aug. 27, 2021), available at <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/ARRC-faq.pdf> (hereinafter "ARRC FAQs").

comparable information.” There is no definition or point of reference for what is “comparable information.” This sentence, which is referred to as the “fallback language,” is grossly inadequate for the task soon at hand.

Without clear governing requirements from HUD, the transition to a new index poses a significant risk to homeowners.² Selecting the wrong index could make the monthly payments on forward mortgages unaffordable or more volatile, driving borrowers into default and foreclosure. In addition to the toll this will pose to families, the Mutual Mortgage Insurance Fund will bear the financial cost of any mismanagement in the LIBOR transition.

Unfortunately, in the past several decades there have been numerous examples of FHA mortgagees engaged in sloppy – or predatory—servicing behaviors that have triggered unnecessary foreclosures.³ This history underlies our concern that some FHA mortgagees may abuse or mismanage the transition in ways that gouge consumers. Unscrupulous, or even just sloppy, mortgagees could—

- Use a replacement index that trends at a higher rate than the LIBOR, or is too volatile;
- Try to replace the margin with a new one that is too high, creating a windfall for the noteholder, and a higher risk of unaffordability for the homeowner;
- Use the transition as an opportunity to make other inappropriate and harmful changes to the contract, such as changing the method by which payments are calculated or changing the due date for payments;
- Fail to replace the LIBOR altogether, leaving the loan stuck at the last LIBOR and locking in a higher-than-market rate; or

² Congressional Research Service, The LIBOR Transition (July 26, 2021), available at <https://sgp.fas.org/crs/misc/IF11315.pdf>.

³ See *generally*, Geoff Walsh, Nat'l Consumer Law Center, Opportunity Denied: How HUD's Note Sale Program Deprives Homeowners of the Basic Benefits of Their Government Insured Loans (May 2016), available at <https://www.nclc.org/images/pdf/pr-reports/opportunity-denied-report.pdf>.

- Botch the mechanics of replacing the LIBOR, such as by using a different date to measure the applicable index in a way that unfairly benefits the lender.

Consumers have no control over what happens in this process and mortgage contracts provide them with no say in which index the noteholder selects. Their only recourse will be to complain or initiate litigation. To avoid these problems HUD must clearly tell noteholders and servicers which replacement index to use and how to implement it.

3. HUD should require noteholders to follow the Alternative Reference Rate Committee's recommendation to replace the LIBOR with the spread-adjusted Secured Overnight Financing Rate. (*Response to Q. 1*)

3.1 A brief overview of the Alternative Reference Rate Committee and its recommendations.

Because the LIBOR transition affects so many contracts of such significant value, major institutions on Wall Street, the Federal Reserve Board, and New York Federal Reserve Bank convened the Alternative Reference Rate Committee (ARRC) in 2014 to work on a replacement.⁴ A subcommittee, including NCLC, focused specifically on consumer products and developed a list of guiding principles designed to ensure for fairness for consumer borrowers.⁵ Notably, the ARRC is only an advisory committee. Its recommendations are voluntary, and it may not compel any noteholder to follow them. That is why HUD must issue regulations requiring noteholders to do so.

A major part of the ARRC's mission has been to address two issues central to replacing the LIBOR: 1) how to deal with inadequate fallback language in many LIBOR contracts;⁶ and what to replace the LIBOR with for legacy and

⁴ Alternative Reference Rate Committee, About the ARRC, available at <https://www.newyorkfed.org/arrc/about>.

⁵ Guiding Principles and Scope of Work for the ARRC Consumer Products Working Group, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC_Consumer_Products_Guiding_Principles.pdf.

⁶ This is a problem that affects many financial instruments—not just FHA notes.

new contracts. The ARRC has answered the second question but has only partially addressed the first.

For legacy mortgages the ARRC recommends using the spread-adjusted SOFR. The details of how the SOFR and how the spread adjustments are calculated are beyond the scope of these comments, but we discuss why the SOFR is the best replacement for FHA loans in sections 3.4-3.5.

The ARRC has also issued model fallback language to use in *new* adjustable-rate contracts. Fannie Mae and Freddie Mac have adopted this language for their uniform instruments.⁷ To preserve flexibility (because these forms will be used many years into the future), the model language does not specify a replacement index. Instead, it requires the noteholder to use a replacement endorsed by the Federal Reserve Board, the Federal Reserve Bank of New York, or a committee convened by them (such as the ARRC). Currently that endorsement is for the SOFR. The ARRC was unable to resolve the problem of inadequate fallback language in legacy contracts, so Congress is now addressing it.

3.2 A brief detour to discuss related pending federal legislation.

The problem of inadequate fallback language is a serious one. Some complex, Wall Street financial instruments offer no realistic way to replace the index. Many others, including consumer contracts, lack any contractual guidelines for how to replace the existing index. Compounding the problem is that no index is identical to the LIBOR, so any replacement will affect the value of the contract: borrowers will pay more if the new interest rates are higher, and investors will receive less if rates are lower. As a result, industry fears a tsunami of litigation regardless of what they do.

To address these problems, Congress is expected to pass a bipartisan bill (H.R. 4616) now being debated. This bill is only tangentially relevant to FHA mortgages because FHA contracts do not have some of the problems addressed in the bill and, unlike most Wall Street LIBOR contracts, FHA

⁷ Press release, Fannie Mae to Use ARRC Recommended Fallback Language for Single-Family ARMs (Nov. 15, 2019), available at <https://www.fanniemae.com/newsroom/fannie-mae-news/fannie-mae-use-arrc-recommended-fallback-language-single-family-arms>; Freddie Mac, Important Single-Family Updates on the LIBOR-SOFR Transition (Nov. 15, 2019), available at <https://sf.freddiemac.com/articles/news/important-single-family-updates-on-the-libor-sofr-transition>.

noteholders are subject to HUD's authority. Nevertheless, two components of this bill must be discussed to help HUD decide how to proceed.

H.R. 4616 offers noteholders a safe harbor from liability if they chose the ARRC-recommended replacement index. So, if a mortgage noteholder replaces the LIBOR with the spread-adjusted SOFR, no consumer or investor may sue the noteholder over that decision. NCLC supports this decision because, as explained in sections 3.4-3.5, the SOFR is the best choice for consumers. But nothing in H.R. 4616 requires noteholders to chose the SOFR. So HUD must require them to do so.

A related component of H.R. 4616 is the concept of "conforming changes." Because alternatives to the LIBOR differ from the LIBOR in many ways, Congress envisions that some noteholders will need to change more than just the name of the index. They may need to change other parts of the contract to bring performance of the contract into conformity with the way the new index works. So, the safe harbor also extends to making those conforming changes. This should not apply to FHA mortgages because the model note does not permit the noteholder to make any changes except to the index. But it is relevant to the pending ANPR because HUD must remind noteholders of that fact. Even if the new safe harbor could be construed as permitting other changes regardless of whether they might violate the contract, HUD should specifically prohibit such changes because they are not necessary. As explained below, the replacement index recommended by the ARRC (the spread-adjusted SOFR) is a "plug-and-play" replacement for FHA notes and eliminates the need for any conceivable conforming change.

3.3 A description of the "spread-adjusted SOFR."

The SOFR "is a broad measure of the cost of borrowing cash overnight, collateralized by U.S. Treasury securities in the repurchase agreement (repo) market."⁸ Due to differences between the SOFR and the LIBOR, the SOFR has historically averaged slightly lower than LIBOR.⁹ The difference between the two rates is referred to as "the spread."

⁸ Alternative Reference Rate Committee, How SOFR Works, available at https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2020/ARRC_Factsheet_2.pdf

⁹ See Alternative Reference Rate Committee, An Updated User's Guide to SOFR at 8, Fig. 2 (Feb. 2021) (comparing 90-day average SOFR with 3-month LIBOR from 2014 to 2020), available at

The “spread-adjusted SOFR” is a version of the SOFR that has the historical average spread added to it. The resulting rate matches the average LIBOR over the same historical period. The spread-adjusted SOFR was developed specifically for the purpose of replacing the LIBOR in contracts that do not allow changes to the margin—like FHA ARMs. The spread-adjusted rate is designed to be “comparable to LIBOR in a fair and reasonable way, thereby minimizing the impact to borrowers and lenders.”¹⁰ This is the replacement index that HUD should require all FHA noteholders to use.

3.4 The spread-adjusted SOFR is the best replacement for the LIBOR.

The ARRC recommends the spread-adjusted SOFR for legacy mortgages like FHA ARMs. This decision is the result of years of analysis by top economists from the Federal Reserve system and the nation’s largest financial institutions. We are confident in their judgment that the SOFR will best serve the public, Wall Street, and consumers. HUD should be too.

There are many reasons why the ARRC selected the SOFR¹¹ and developed the spread-adjusted SOFR, but the most relevant for these comments include:

- It is the safest choice because it has a history of similar movements to the LIBOR;¹²
- It is “derived from an active and well-defined market with sufficient depth to make it extraordinarily difficult to ever manipulate or influence;”¹³

<https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/users-guide-to-sofr2021-update.pdf> (hereinafter “User’s Guide”).

¹⁰ ARRC FAQs at 17.

¹¹ See generally, Alternative Reference Rate Committee, Summary of the ARRC’s Fallback Recommendations (Oct. 6, 2021), available at <https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2021/spread-adjustments-narrative-oct-6-2021>.

¹² ARRC FAQs at 10-11.

¹³ User’s Guide at 3

- It is the option most likely to minimize any value transfer between stakeholders¹⁴ (in other words, consumers' payments will not change too much).

As a result, it is likely to produce contract rates and payments that are comparable to what legacy borrowers and investors expect of LIBOR ARMs. This will minimize the risk that changing the index will drive borrowers into default. That, in turn will minimize risk to the Mutual Mortgage Insurance Fund.

The spread-adjusted SOFR (rather than the unadjusted version) is the best replacement for FHA's legacy ARMs because it resolves a critical problem with the terms of those contracts. The contract rate for FHA ARMs is the total of the current index rate plus the margin specified in the contract. To the best of our knowledge, no legacy FHA promissory note allows the holder to change the margin when the index is replaced. Because there is no replacement index that averages the same rate as the LIBOR, that means replacing the index will result in a new average contract rate—either higher or lower than with the LIBOR, depending on which replacement index is selected. The spread-adjusted SOFR resolves that problem by accounting for the difference between the SOFR and LIBOR, resulting in an index rate that can be used without changing the margin. No other index available offers such a solution.

If the spread-adjusted SOFR is not used, noteholders will be forced to choose from alternatives that result in a higher or lower average contract rate. We believe it is unlikely that they will voluntarily choose to lower rates. And if they were to do so, they would likely face litigation from their investors, because that option would result in lower returns than those to which the investors are entitled.

Industry players may argue that a mandate to use the spread-adjusted SOFR is unnecessary because Congress may enact the pending bill that allows conforming changes. But, even though the bill has broad support, it is not yet law and its language is not final. And, even if it is enacted, it is far better for FHA noteholders to use the spread-adjusted SOFR, which has been developed with exceeding care to be the closest match possible to LIBOR,

¹⁴ Guiding Principles and Scope of Work for the ARRC Consumer Products Working Group at 2.

rather than allowing noteholders to pull some new margin out of a hat. Doing so would not only run the risk of overcharging consumers, but would create a litigation risk that would not be protected by the bill's safe harbor, and that could have a negative impact on the Mutual Mortgage Insurance Fund. HUD should not permit noteholders to change the margin (or any other part of the contract) under the guise of the "conforming changes" safe harbor.

Conversely, allowing noteholders to choose a replacement that leads to higher average contract rates would be unfair to consumers and would violate the contractual requirement to select a replacement "based upon comparable information." This would also lead to litigation challenges; and worse, in the interim, likely some additional defaults and foreclosures that will harm consumers, and cost the insurance fund.

HUD can avoid all of these problems by mandating use of the spread-adjusted SOFR for forward mortgages and HECMs. This can best be accomplished by issuing a Mortgagee Letter and by amending 24 C.F.R. § 203.49 for forward mortgages and 24 C.F.R §§ 206.3, 206.21(b)91)(ii), and 206.21(b)(2) for HECMs to specify that the spread-adjusted SOFR must be used as the index to calculate interest rate changes for all adjustable rate mortgages once LIBOR is no longer available.

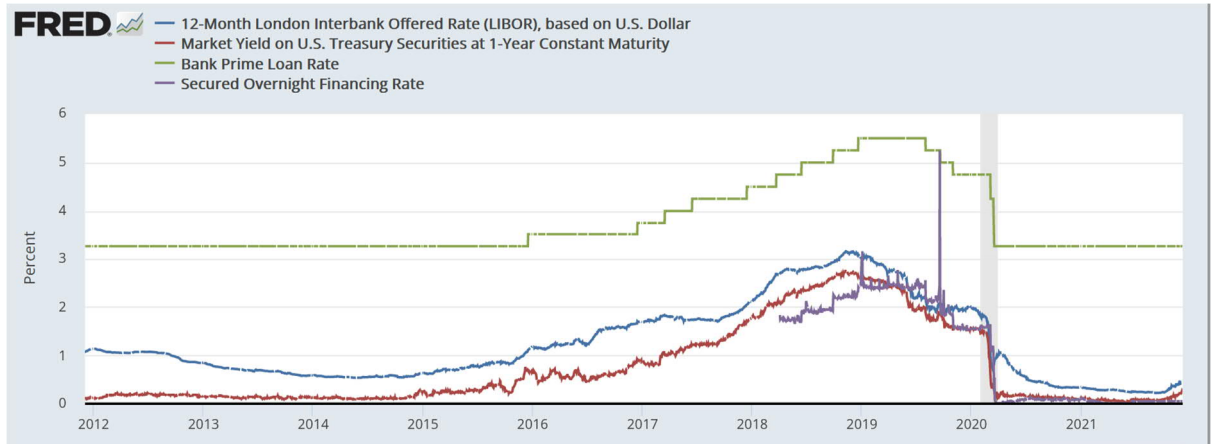
3.5 No other index is a comparable replacement for legacy FHA ARMs.

Although there are other indices used in the consumer market, such as the prime rate, the Ameribor, and U.S. Constant Maturity Treasury Index,¹⁵ none of them are appropriate substitutions for the one-year LIBOR currently used in FHA loans. As illustrated in Figure 1 below, the prime rate averages much higher than the LIBOR and would result in significant payment increases for borrowers. The one-year CMT is lower than the LIBOR. While consumers certainly would not object to a payment decrease, it is unlikely that noteholders would voluntarily adopt it, especially because investors would sue for breach of contract. Notably, the spread-adjusted SOFR compensates for the difference between the SOFR and LIBOR, but there is no equivalent spread-adjusted CMT. We could not show the Ameribor on this graph

¹⁵ 24 C.F.R. § 203.49 authorizes lenders to originate FHA loans using the weekly average yield on United States Treasury securities adjusted to a constant maturity of one year.

because it is a propriety index unavailable to the general public.¹⁶ That alone is a reason why it is inappropriate for FHA ARMs. But it is also too new to fully understand its behavior in all market conditions. Having debuted in 2015, it lacks the track record of the U.S. Treasuries market on which the SOFR is based, so there is no way to predict how it would behave under market conditions like the last foreclosure crisis.

Figure 1



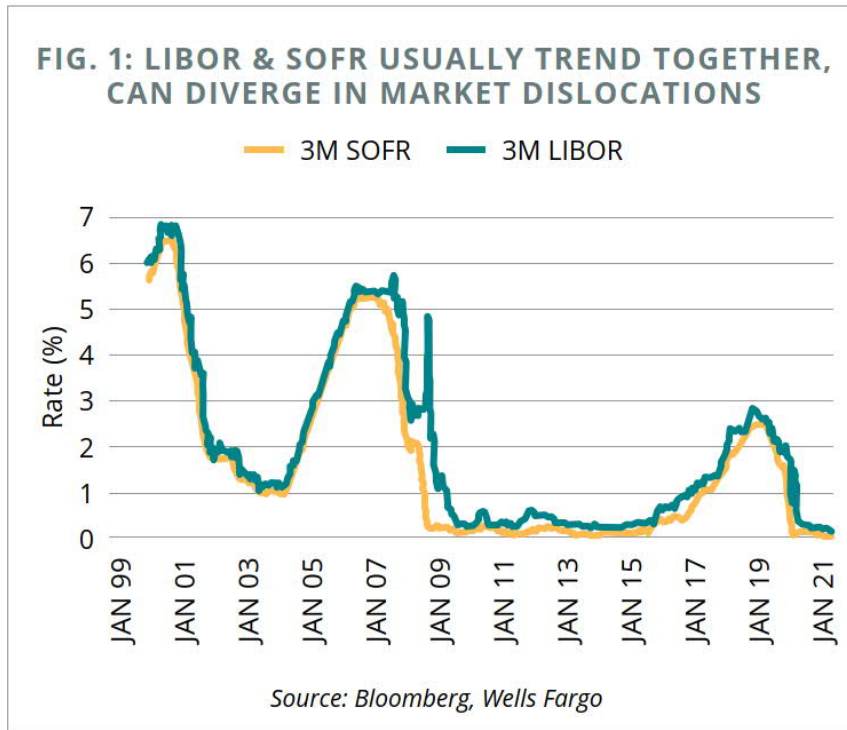
Source: <https://fred.stlouisfed.org/graph/?g=JuBU>

While the purple SOFR line in Figure 1 is “rougher” than the blue LIBOR line, that data is based on the day-to-day rate. According to the ARRC, “[i]t is important to keep in mind that the type of averages of SOFR that are referenced in financial contracts are much smoother than the movements in overnight SOFR.”¹⁷ As shown in Figure 2, over time, the three-month average LIBOR and SOFR are much closer and smoother.

¹⁶ Access to historical data costs \$10,000. See Ameribor website, <https://ameribor.net/compare-historical-ameribor-data>.

¹⁷ User’s Guide at 4.

Figure 2



Source: <https://www.lsta.org/content/in-search-of-fair-spread-adjustments-for-new-sofr-loans/>

4. HUD should prohibit noteholders from asking consumers to voluntarily modify their contracts and should prohibit mandatory modifications or refinancing. (*Response to Q. 2, 3, and 7*)

HUD asks several questions about the possibility of modifying existing loans or negotiating new contracts to replace the LIBOR. Although not explained in the Federal Register notice, we assume HUD is referring to either refinancing customer mortgages or establishing a loan modification process in which the noteholder and consumer would mutually agree to execute documents amending the terms of existing mortgage loan agreements.

Neither process would be entirely new for servicers. Permanent loan modifications are often implemented through mutually executed contract modifications. And it is already routine to market new loans to existing customers. But both solutions will create unnecessary problems.

As housing counselors, consumer attorneys, and loan servicing employees could readily attest, the loan modification process often devolves into a paperwork nightmare. It is poorly managed by servicers and confusing to consumers. Documents are routinely lost, and lengthy delays are common. This causes stress to consumers, and expense to the industry, both of which are unnecessary in this situation. Wholesale modifications or refinancing campaigns expose consumers to unwarranted risk and should be discouraged.

And even if noteholders attempt both solutions, there will still be some borrowers who refuse to modify or refinance. So noteholders will still need to address the transition by replacing the LIBOR with another index.

There is no need to modify or refinance legacy loan contracts. The standard contract already authorizes the noteholder to replace the index when it is no longer available. And the spread-adjusted SOFR is designed to be a “plug-and-play” replacement for the LIBOR. Nothing else needs to be changed.

The sole exception may be contracts that do not authorize replacement of the index. But we are not aware of any such consumer contracts for FHA loans.

Both loan modifications and refinancing require the consumer’s voluntary assent. Noteholders do not have the right to force consumers to do either. HUD should warn noteholders and servicers against using the LIBOR transition to strong-arm or deceive consumers into refinancing or modifying their loans. HUD should not allow anyone to use the LIBOR transition as an opportunity for profiteering.

5. Conclusion

In conclusion, we urge HUD to adopt regulations and issue a Mortgagee Letter that requires noteholders to follow the ARRC’s recommendation for replacing the LIBOR in legacy mortgage contracts. Adopting the recommended spread-adjusted SOFR is in the best interest of consumers, noteholders, and the insurance fund. HUD should prohibit any other changes to contracts and should prohibit noteholders and servicers from trying to use loan modifications or refinancing as tools to replace the LIBOR.

Thank you for the opportunity to comment on this matter.

Appendix

National Consumer Law Center: Since 1969, the nonprofit [National Consumer Law Center® \(NCLC®\)](#) has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people in the United States. NCLC's expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and federal and state government and courts across the nation to stop exploitative practices, help financially stressed families build and retain wealth, and advance economic fairness. These comments were written by Andrew Pizor, NCLC staff attorney.