Proposed Regulation Implementing the
Adjustable Interest Rate (LIBOR) Act

Comments
to the

Board of Governors of the Federal Reserve System

regarding

12 CFR Part 253

[Regulation ZZ; Docket No. R–1775; RIN 7100–AG34]

87 Fed. Reg. 45268
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by the

National Consumer Law Center
on behalf of its low income clients

with Americans for Financial Reform Education Fund
and
Student Borrower Protection Center

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Thank you for the opportunity to comment on this proposed rule. The National Consumer Law Center (NCLC) submits these comments on behalf of our low-income clients,[1] along with Americans for Financial Reform Education Fund, and Student Borrower Protection Center.

1. SUMMARY—We strongly support the Board's proposed rule, particularly the determination that no conforming changes are needed for consumer loans. But we recommend two clarifications for non-covered consumer contracts:

   a) declare that the Board-selected benchmark replacement for non-covered consumer contracts is the same as the replacement selected for covered consumer contracts; and

   b) adopt a rule clarifying that any fallback language dependent on the "availability" of the LIBOR shall be triggered on the earlier of the date specified in the contract (if any) or the LIBOR replacement date.

2. Introduction—A summary of the problem

The LIBOR is widely used as an index in adjustable rate consumer mortgages (ARMs),[2] as well as private student loans and credit cards. The index, when added to a "margin" written into the contract, sets the interest rate charged on the debt. But the LIBOR will largely cease to exist or become compromised after June 30, 2023.

While most adjustable-rate contracts include terms allowing the note holder to replace the index if it becomes unavailable, these terms—known as "fallback language"—were often poorly drafted. Most fallback language provides minimal guidance on how to select a replacement index and instead gives broad, and in some cases unlimited, discretion to the note holder. In some contracts—such as closed-end home mortgages—the fallback language does not allow adjusting other relevant parts of the contract, such as the margin added to the index to obtain the applicable interest

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[2] Including closed-end, open-end, forward, and reverse mortgages.

rate. And for some corporate contracts, the specified mechanism for replacing the index is entirely impractical.

These defects are important because there is no clear answer to the single biggest question raised by the end of the LIBOR: what to replace it with. There is no other index that offers a precise replacement. All possible alternatives are calculated from different underlying components and, as a result, behave differently than the LIBOR. They are more or less volatile, have a higher or lower historical average value, behave differently under certain market conditions, or differ in some other notable way.

For borrowers, these differences would manifest themselves as loan payments that average higher or lower than they had been with the LIBOR. Payment amounts might also change more significantly and unpredictably. The differences also pose problems for investors. Lower payments for borrowers, higher default rates, or faster pre-payment rates (due to borrowers refinancing to get away from the replacement index) may mean less income for investors.

As a result, regardless of which replacement index note holders choose, someone is likely to be unhappy with the result. So, while note drafters may have originally believed that the broad discretion given to note holders was a benefit, the industry now recognizes that discretion to be a significant liability and source of litigation risk. That risk is believed to be a major reason that, so far, nobody has announced a replacement index for their existing (also known as "legacy") LIBOR contracts.

Consumers face other risks too. A note holder or servicer might use the end of LIBOR as a chance to squeeze something extra out of consumers by making other contract changes under the guise of implementing the new index. There is also the risk of ministerial errors in the process of updating complex servicing platforms that are not designed to handle index replacements.

To address these risks, Congress enacted the Adjustable Interest Rate (LIBOR) Act.[3] The Act does a number of things but, for these comments and the proposed rule, the most relevant are—

- directing the Federal Reserve Board to recommend a replacement benchmark for the LIBOR;[4] and

[3] Public Law 117-103, div. U. (hereinafter the "LIBOR Act").

[4] *Id.* § 103(6).

- establishing a safe harbor for note holders that adopt the Board-selected benchmark replacement for given contracts.[5]

The Federal Reserve's proposed rule designates several benchmark replacements, all based on the Secured Overnight Financing Rate (SOFR) as its preferred alternative to the LIBOR.[6] The supplementary information in the Federal Register notice also addresses aspects of the replacement process, such as whether other changes are necessary and the trigger for replacing the LIBOR in each contract.

3. The Board has correctly determined that no conforming changes are needed for consumer contracts.

The LIBOR Act authorizes the Board to determine whether any benchmark replacement conforming changes are needed.[7] These are "technical, administrative, or operational changes, alterations, or modifications that . . . would address 1 or more issues affecting the implementation, administration, and calculation of the Board-selected benchmark replacement in LIBOR contracts . . . ."[8] In other words, conforming changes are changes—other than the identity of the index—that must be made to the terms of a LIBOR contract in order to make the benchmark replacement fully operational.

The LIBOR Act creates a safe harbor from liability for note holders that adopt the Board-selected benchmark replacement for given contracts. The safe harbor extends to certain conforming changes as well. For non-consumer contracts, conforming changes identified and made by a party under the note holder's control (called a "calculating person" in the Act), are subject to the safe harbor. But for consumer contracts, the only conforming changes eligible for the safe harbor are those determined by the Board, pursuant to the pending rulemaking. While neither the Act nor the proposed rule prevents a calculating person from making changes to a consumer contract for the purpose of implementing the SOFR (or any other replacement benchmark), that decision will not be protected by the safe harbor unless the change is listed in the final

[5] *Id.* § 105.

[6] LIBOR Act, § 103(6) (defining Board-selected benchmark replacement); Proposed § 253.4, 87 Fed. Reg. 45268, 45280 (July 28, 2022).

[7] *See* 87 Fed. Reg. at 45271 (discussing Act).

[8] LIBOR Act, § 103(4).

rule. That ensures that consumers will retain the right to seek relief if they are harmed by bad decisions or mistakes.

According to the supplementary information accompanying the proposed rule, “the Board does not [at this time,] believe any additional conforming changes would be needed for successful implementation of the Board-selected benchmark replacements indicated in . . . the proposed rule.”[9] We agree with this decision. The National Consumer Law Center, and the network of private and nonprofit attorneys we work with, have extensive experience with consumer credit contracts, particularly student loans and mortgages. And based on this experience, we see no need for the Board to identify any conforming changes for consumer contracts. The Board’s decision does not prevent note holders or their agents from making changes where needed by unusual contracts. But the lack of a safe harbor for such changes will give consumers the right to seek relief where needed.

We wish to emphasize that we take this position not because we are opposed to the safe harbor, but because we believe that the typical consumer contract needs no changes to continue functioning as the parties originally intended—so long as the note holder adopts the Board-selected benchmark replacement.

4. The Board should address ambiguities affecting the majority of consumer LIBOR contracts.

4.1 The majority of consumer LIBOR contracts will be “non-covered.”

While we generally support the proposed rule, we are concerned that it does not adequately address ambiguities affecting most consumer LIBOR contracts. The majority of consumer contracts will be considered “non-covered.” A “covered contract” is defined as having one of the following characteristics as of the LIBOR replacement date:

1) the LIBOR contract contains no fallback provision;
2) the LIBOR contract has fallback provisions that identify *neither* a specific benchmark nor a determining person; or
3) the LIBOR contract contains fallback provisions that identify a determining person, but the determining person has failed to select a benchmark by the

[9] 87 Fed. Reg. at 45276.

earlier of the LIBOR replacement date and the latest date for selecting a benchmark replacement according to the terms of the LIBOR contract.

Most LIBOR-based ARMs and student loans will be non-covered loans because the note holder is identified as a determining person, and it is anticipated that the determining person will timely select a replacement benchmark. Section 253.3(a)(2)(i)(B) and (C) exclude these loans from the definition of "covered contracts." This poses a problem because this is the most common type of consumer LIBOR contract and, as explained in the next section, the rule has two important ambiguities regarding these contracts.

4.2 The proposed rule is ambiguous in two ways when applied to non-covered consumer loans.

Most non-covered consumer loans will be affected by two significant ambiguities. One will affect all such loans and the other will affect a subset (albeit the vast majority) of non-covered consumer contracts.

Ambiguities:

- The proposed rule can be interpreted as providing a safe harbor even if the determining person selects an inappropriate replacement benchmark from those listed in § 253.4 (such as the benchmark for derivative transactions instead of the benchmark for consumer contracts). This ambiguity will affect all non-covered consumer loans and is discussed in section 4.3 of these comments.
- As recognized by the Board,[10] the fallback language in some loan contracts only refers to the LIBOR becoming *unavailable*. For these contracts, it is unclear whether the index should be replaced if the LIBOR administrator publishes a synthetic LIBOR after the replacement date.[11] As explained in section 4.4 of these comments, this ambiguity will affect the vast majority of ARMs and private student loans.

[10] 87 Fed. Reg. at 45272.

[11] The "LIBOR replacement date" is defined as "the first London banking day after June 30, 2023, unless the Board determines that any LIBOR tenor will cease to be published or cease to be representative on a different date." Proposed Rule § 253.2.

4.3 The Board should clearly state that the benchmark described in § 253.4(b)(2) is the only Board-selected benchmark replacement for non-covered consumer loans.

One of the most important components of the LIBOR Act is creation of a safe harbor for note holders that adopt the Board-selected benchmark replacement for the LIBOR. We expect the majority of consumer note holders to avail themselves of this safe harbor.

Section 253.3(b)(2) of the proposed rule is addressed to non-covered contracts and states that "a determining person may select the Board-selected benchmark replacement specified in § 253.4 of this rule as the benchmark replacement for a [non-covered] LIBOR contract." But this quoted passage from (b)(2) is ambiguous because § 253.4 does not identify a benchmark replacement for any non-covered loan. Instead, § 253.4 refers only to covered loans and specifies several different versions of the Board-selected benchmark replacement. The reference to "*the* Board-selected benchmark replacement" in § 253.3(b)(2), therefore, refers to a replacement that does not exist.

The only replacement benchmark in § 253.4 that is appropriate for any consumer LIBOR contract is the one identified for covered-contracts in § 253.4(b)(2), and not, for example, the replacement benchmark in § 253.4(a), which is only appropriate for derivative contracts. The Alternative Reference Rate Committee devoted a substantial amount of time and research to identifying the best replacement and appropriate spread adjustments for legacy consumer contracts. It would be inappropriate to grant a safe harbor to note holders that use a replacement benchmark designed for very different contracts, such as the replacement for derivatives or GSE contracts.

We strongly encourage the Board to specifically identify the replacement benchmark in § 253.4(b)(2) as the Board-selected replacement benchmark for non-covered consumer loans. Such a change will not affect any other part of the rule. Instead, it will clarify that the safe harbor only applies to note holders that adopt the replacement in § 253.4(b)(2).

4.4 The rule should provide that the fallback language in consumer contracts is triggered on the earlier of the date specified in the contract or on the LIBOR replacement date.

As the Board explains in the Federal Register, there is "a potential ambiguity regarding the application of the LIBOR Act to a subset of non-covered contracts."[12] Some of these contracts have fallback provisions that are triggered only when the LIBOR becomes unavailable. "Significantly, the fallback provisions in these LIBOR contracts are not triggered expressly when LIBOR is available but nonrepresentative." This could become a problem if the LIBOR administrator publishes a synthetic LIBOR after the LIBOR replacement date. If that occurs, note holders may face uncertainty as to whether they should replace the LIBOR with a new index or use the synthetic LIBOR.

This is a significant issue for consumers because the vast majority of ARM and private student loan contracts only refer to the *availability* of the LIBOR. For example,

- the legacy version the Fannie Mae/Freddie Mac uniform instrument includes fallback language saying "If the Index is no longer available, the Note Holder will choose a new index which is based upon comparable information[;]"[13] and
- a widely used promissory note from Discover Bank includes fallback language saying "If the 3-month LIBOR Index is no longer available, we will substitute an index that is comparable, in our sole opinion . . . ."[14]

To address this problem, the Board is considering a rule that would declare that the LIBOR "shall be replaced . . . on the earlier of (i) the date specified pursuant to the LIBOR contract or (ii) the LIBOR replacement date."[15] We share the Board's concern and urge the Board to adopt this rule. If such a rule is not adopted, and the LIBOR administrator issues a synthetic LIBOR, millions of home owners and student loan borrowers would be subject to the problem the Board anticipates.

While Fannie Mae and Freddie Mac could resolve this ambiguity by issuing new servicing guidance explaining how to proceed, that would not address the many other

[12] 87 Fed. Reg. at 45272.

[13] ¶4(B) MULTISTATE ADJUSTABLE RATE NOTE—WSJ One-Year LIBOR—Single Family—Fannie Mae UNIFORM INSTRUMENT (Form 3526, 6/01).

[14] Available at https://www.discover.com/content/dam/dfs/student-loans/pdf/PCL_Prom_Note.pdf (last accessed Aug. 17, 2022).

[15] *Id.*

loans written on the uniform instruments but not subject to Fannie or Freddie's guidelines. And there is no similar "fix" for private student loans. Therefore, we strongly urge the Board to adopt a rule specifying that the fallback language in all consumer LIBOR contracts is triggered on the earlier of the date specified in the contract or on the LIBOR replacement date.

We agree with the Board's justification for such a rule. Based on our participation in discussions leading up to the LIBOR Act, we think it is clear that Congress intended the LIBOR Act to apply when the LIBOR becomes nonrepresentative—not just when it ceases to be published. We also agree that providing certainty was a critical reason Congress adopted the LIBOR Act. The need for certainty should be contrasted with the current lack of certainty regarding whether the LIBOR administrator will issue a synthetic LIBOR. Without such clarity, it would be contrary to Congressional intent to allow contracts with the problematic "unavailable" language to remain in limbo until note holders know whether a synthetic LIBOR will be available.

And even if the administrator declares that it will issue a synthetic LIBOR, that will leave note holders with the uncertainty raised in the Board's question: is the LIBOR "unavailable" (triggering the fallback), or are they bound to use the synthetic LIBOR as a continuation of the original LIBOR. As the Board explains, a synthetic LIBOR "would be a fundamentally different rate that would not be representative of the underlying market and economic reality concerning the setting of rates at which banks may lend to, or borrow from, other banks or agents in the money markets."[16] Treating such a rate as a continuation of the LIBOR would frustrate the original purpose of the contract parties. Adopting a rule that triggers the fallback language on the earlier of the LIBOR replacement date or a date specified in the contract would better serve the parties' intent because the note holder would still have the option of selecting the synthetic LIBOR if it met the requirements of the fallback language (although they would not be able to assert the safe harbor).

5. Conclusion

In conclusion, we support the Board's determination that no conforming changes are needed for consumer LIBOR contracts. And we share the Board's concern about non-covered contracts that only address the "unavailability" of the LIBOR

[16] 87 Fed. Reg. at 45273.

without addressing unrepresented-ness. To address that ambiguity, we recommend that the Board adopt a rule stating that the fallback language in all consumer contracts is triggered on the earlier of the date specified in the contract or on the LIBOR replacement date.

We also urge the Board to clarify that the only Board-selected replacement index for *any* consumer LIBOR contract (covered or not) is the index identified in proposed § 253.4(b)(2). Nobody will be required to select this replacement index for a non-covered contract. But the Board should clarify that if a note holder or other determining person wishes to avail themselves of the safe harbor created by the LIBOR Act, they must use the replacement index identified in § 253.4(b)(2) for consumer LIBOR contracts.

6. Appendix: Description of Signatories

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.

Americans for Financial Reform Education Fund: The Americans for Financial Reform Education Fund (AFREF) is a coalition of more than 200 consumer, investor, labor, civil rights, business, faith-based, and community groups that works through policy analysis, education, advocacy, and outreach to lay the foundation for a strong, stable, and ethical financial system. Formed in the wake of the 2008 financial crisis, AFREF works to protect and strengthen consumer protections for all people, including advocacy for greater protections against predatory lending, increased access to affordable and sustainable credit, and fairness and transparency in all financial transactions.

Student Borrower Protection Center: The Student Borrower Protection Center is a a nonprofit organization focused on alleviating the burden of student debt for millions of Americans. SBPC engages in advocacy, policymaking, and litigation strategy to rein in industry abuses, protect borrowers' rights, and advance economic opportunity for the next generation of students.