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The End of LIBOR: Transitioning to an Alternative Interest Rate Calculation for Mortgages, Student Loans, Business Borrowing, and Other Financial Products

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Before the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, Committee on Financial Services, U.S. House of Representatives, Washington, D.C.

Chairman Sherman, Ranking Member Huizenga, and members of the subcommittee, thank you for the opportunity to appear today. My testimony will discuss the importance of ensuring a smooth, transparent, and fair transition away from LIBOR (formerly known as the London interbank offered rate) to more durable replacement rates, as well as some of the challenges posed by this transition. Before I delve into those issues, however, it may be helpful to review how LIBOR is used and why it will be discontinued.

LIBOR measures the average interest rate at which large banks can borrow in wholesale funding markets for different periods of time, ranging from overnight to one month, three months, and beyond. LIBOR is an unsecured rate that measures interest rates for borrowings that are made without collateral. Over the past few decades, LIBOR became a benchmark rate used to set interest rates for commercial loans, mortgages, derivatives, and many other products. In total, U.S. dollar LIBOR is used in more than \$200 trillion of financial contracts worldwide.

By now the flaws of LIBOR are well documented.¹ One of the fundamental problems is that LIBOR purported to be a representation of the actual funding costs of large banks in the London interbank market, but the evolution of that market over the years meant that, for many tenors, banks were estimating the likely cost of such funding rather than reporting the actual cost. This increasing element of subjectivity and discretion, coupled with the mechanisms that had been adopted to aggregate various banks' inputs into the determination of LIBOR, made the rate vulnerable to collusion and manipulation. Particularly after the global financial crisis of 2008, as banks sharply reduced their reliance on wholesale unsecured funding, there were few actual funding transactions on which to base a rate for many tenors of LIBOR.

While banks are, of course, not required to price their credit as a direct function of their cost of funding or on any amalgam of actual transaction data, the LIBOR mechanism—by purporting to be a measure of such costs even though there were not sufficient transactions to justify that perception—had become potentially misleading to many of those relying on it for credit pricing and other decisions. Over time, with a large number of contracts referencing a thinly traded rate, the incentive to manipulate LIBOR grew and actual manipulation of LIBOR abounded.

Following the exposure of these weaknesses, and the imposition of material legal penalties on a number of banks and individuals that engaged in misconduct related to the setting of LIBOR rates,

the great majority of the banks that had provided submissions to be used in the setting of LIBOR (the so-called panel banks) determined that they would not continue participating in the process. This was not the result of a regulatory or legal requirement to end LIBOR. It was a private sector decision to stop providing what had always been a completely voluntary service, given the firms' assessment of the costs and benefits of doing so. While regulators are appropriately focusing on whether financial firms have prepared themselves for the date when the panel banks have said they will no longer provide LIBOR, the decision to end LIBOR itself has not been a governmental decision, but a private sector development.

Last month, LIBOR's regulator in the United Kingdom announced that the one-week and two-month U.S. dollar LIBOR term rates will cease to be published at the end of 2021, while overnight and other LIBOR term rates will cease to be published on a representative basis in mid-2023.² This definitive announcement about the end of panel-based LIBOR underscores the importance of transitioning away from this moribund benchmark rate.

Efforts to Transition Away from LIBOR

Market participants, regulatory agencies, consumer groups, and other stakeholders have put in a great deal of work to prepare for life after LIBOR. Beginning in 2013, the domestic Financial Stability Oversight Council and the international Financial Stability Board expressed concern that the decline in unsecured short-term funding by banks could pose serious structural risks for unsecured benchmarks like LIBOR.³ To mitigate these risks and promote a smooth transition away from LIBOR, the Federal Reserve convened the Alternative Reference Rates Committee (ARRC) in November 2014. Recognizing that the private sector must drive this transition, the ARRC's voting members are private-sector firms. The Federal Reserve and the other agencies testifying today are ex-officio members of the ARRC.

The ARRC set about to identify alternative reference rates that were rooted in transactions from an active and robust underlying market. In June 2017, the ARRC identified the Secured Overnight Financing Rate (SOFR) as its recommended alternative to U.S. dollar LIBOR. SOFR is a broad measure of the cost of borrowing cash overnight, collateralized by Treasury securities. The Federal Reserve Bank of New York publishes SOFR each morning. Unlike LIBOR, SOFR is based on a market with a high volume of underlying transactions—regularly around \$1 trillion daily. The ARRC developed a multi-step plan in October 2017 to facilitate the transition from LIBOR to SOFR.

The Federal Reserve and other agencies also sponsored a series of workshops with lenders and borrowers that focused on the use of credit-sensitive alternative reference rates for loans. Relatedly, the Federal Reserve, Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) issued a statement last year to emphasize that a bank may use any reference rate for its loans that the bank determines to be appropriate for its funding model and customer needs.⁴ The statement also noted, however, that a bank's loan contracts should include robust fallback language that provides for a clearly defined alternative reference rate to be used if the initial reference rate is discontinued.

Supervisory Efforts

Beginning in 2018, Federal Reserve staff began outreach to supervised institutions and examiners to raise awareness about, and encourage preparation for, the transition away from LIBOR. In 2019, we established a LIBOR Transition Working Group to coordinate monitoring of the transition and develop supervisory plans to assess banks' preparation efforts.

In November 2020, the Federal Reserve, OCC, and FDIC sent a letter to the banking organizations that we regulate, noting that there are safety and soundness risks associated with the continued use of U.S. dollar LIBOR in new transactions after 2021.⁵ Accordingly, we have encouraged supervised

entities to stop using LIBOR in new contracts as soon as practicable and, in any event, by the end of this year. Federal Reserve Vice Chair for Supervision Randal Quarles emphasized in a recent speech that banking firms should be aware of the intense supervisory focus the Federal Reserve is placing on the LIBOR transition, and especially on plans to end issuance of new LIBOR contracts by year-end.⁶

Legacy Contracts

A key question is whether existing LIBOR-based contracts (legacy contracts) can seamlessly transition to alternative reference rates when LIBOR ends. The ARRC recently estimated that 35 percent of legacy contracts will not mature before mid-2023. Some of these legacy contracts have workable fallback language to address the end of LIBOR, but others do not. For example, most business loans have workable fallback language—by their terms, business loans generally fall back to an alternative floating rate, such as the prime rate. Similarly, most derivatives are governed by a master agreement published by the International Swaps and Derivatives Association (ISDA), and ISDA has published a “protocol” that allows derivative counterparties to amend their master agreements, on a multilateral basis, so that their derivative contracts fall back to a floating SOFR-based rate for counterparties that adhere to the protocol. Conversely, many floating-rate notes and securitizations have problematic fallback language—generally, these contracts convert to fixed-rate instruments at the last published value of LIBOR. Moreover, the rate terms in floating-rate notes and securitizations can typically be changed only with the unanimous consent of all noteholders, which typically would be difficult to secure.

The end of LIBOR may result in significant litigation. For example, if a legacy contract converts to a fixed rate when LIBOR ends, a party disadvantaged by that conversion might request that a court reform the contract by substituting an alternative floating rate for LIBOR.⁷ Parties also might request that a court reform or void a legacy contract that lacks any fallback language if the parties cannot agree bilaterally on a successor rate.⁸ Similarly, in instances where a legacy contract allows a person to select a replacement rate when LIBOR ends, a party disadvantaged by the replacement rate might argue that the manner in which another person—for example, a bond trustee—selected the replacement rate violates the implied covenant of good faith and fair dealing.⁹

Chair Powell and Vice Chair Quarles have publicly stated their support for federal legislation to mitigate risks related to legacy contracts. Federal legislation would establish a clear and uniform framework, on a nationwide basis, for replacing LIBOR in legacy contracts that do not provide for an appropriate fallback rate.¹⁰ Federal legislation should be targeted narrowly to address legacy contracts that have no fallback language, that have fallback language referring to LIBOR or to a poll of banks, or that convert to fixed-rate instruments. Federal legislation should not affect legacy contracts with fallbacks to another floating rate, nor should federal legislation dictate that market participants must use any particular benchmark rate in future contracts. Finally, to avoid conflict of laws problems, federal legislation should pre-empt any outstanding state legislation on legacy LIBOR contracts.

Thank you. I look forward to your questions on this important matter.

1. Jerome H. Powell, [Reforming U.S. Dollar LIBOR: The Path Forward](#) (speech at the Money Marketeers of New York University, New York, NY, September 4, 2017).

2. See <https://www.fca.org.uk/news/press-releases/announcements-end-libor>.

3. See [Financial Stability Oversight Council, 2013 Annual Report](#) (Washington: Department of the

Treasury, 2013); and Financial Stability Board, Reforming Major Interest Rate Benchmarks (Basel, Switzerland: Financial Stability Board, July 2014).

4. [SR letter 20-25: Interagency Statement - Reference Rates for Loans.](#)

5. [SR letter 20-27: Interagency Statement on LIBOR Transition.](#)

6. Randal K. Quarles, [Keynote Remarks](#) (speech via webcast at the SOFR Symposium, New York, NY, March 22, 2021). See also [SR letter 21-7: Assessing Supervised Institutions' Plans to Transition Away from the Use of the LIBOR.](#)

7. An aggrieved party might cite a variety of common law doctrines to justify judicial reformation, including mutual mistake, impracticability, and frustration of purpose. Although each of these doctrines sets a high bar for voiding or reforming contracts, it is difficult to predict how courts might rule on a contract-by-contract basis.

8. Again, parties might cite a variety of common law doctrines, including mutual mistake, impracticability, and frustration of purpose.

9. This covenant, which is implied in all contracts, generally embraces a pledge that neither party will do anything that has the effect of destroying or injuring the right of the other party to receive the fruits of the contract. See, e.g., *ABN AMRO Bank, N.V. v. MBIA Inc.*, 17 N.Y.3d 208, 228-9 (N.Y. 2011).

10. The New York State Legislature recently enacted legislation that is intended to mitigate risks related to legacy LIBOR contracts, but that bill would apply only to contracts governed by New York law.

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