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LIBOR Act Protects US Legacy Contracts; New SOFR Use Growing - Fitch

Fitch Ratings-London/Milan/New York-11 March 2022: The Adjustable Interest Rate (LIBOR) Act provides strong protection for legacy contracts without workable fallback provisions, significantly reducing transition and disruption risk upon eventual USD LIBOR phase-out, Fitch Ratings says. The shift away from LIBOR for new issuance continues apace, with SOFR dominating new floating-rate issuance in 2022. Congress passed the LIBOR Act yesterday as a part of the Consolidated Appropriations Act, 2022.

The act requires SOFR plus a set spread, depending on the LIBOR term, to be used instead of USD LIBOR starting from mid-2023. The act applies to contracts with no or impracticable LIBOR fallback provisions, contracts that lack a specific alternative rate and those for which the determining person has not replaced the benchmark by the date required under the contract or mid-2023. By providing a defined alternative to LIBOR for contracts issued under US law, the act would result in consistent rates for a substantial portion of floating-rate bond and loan markets.

The act also provides contract continuity and safe-harbor provisions to shield parties from liability under potential lawsuits due to the transition away from LIBOR. Even if ultimately unsuccessful, litigation could be disruptive for transactions with affected contracts, particularly from consumer loan class-action lawsuits.

The Federal Reserve Board must issue regulations to administer the law within 180 days of passage, and operational challenges could arise in implementation. Conforming changes necessary to apply a replacement rate, such as updating where the new rate is published, are protected under the act; therefore, we consider these changes low risk for transaction parties. However, there remains a risk that parties may delay or have difficulty making the conforming changes. For consumer loan contracts, only conforming changes approved by the Fed are allowed and would be covered under the act. Regulations should clarify how this will be implemented.

For Federal Family Education Loan Program (FFELP) student loan asset-backed securities (SL ABS) LIBOR exposure, the act amends the Higher Education Act of 1965 to allow the LIBOR rate for special allowance payments to be substituted by SOFR plus a spread. The new rate will apply following certain notifications by the holder to the Secretary of Education, but if the notification does not occur by certain dates, the SOFR rate will automatically apply. Legacy LIBOR FFELP ABS notes are also expected to convert to a SOFR reference rate, so the risk of significant interest rate mismatches between assets and liabilities is mitigated.

US banks may use any reference rate other than LIBOR for loans, provided that management determines it is appropriate based on its funding model and customer needs. We expect some banks, particularly community and regional banks, to opt to use credit-sensitive benchmarks such as the American Financial Exchange's Ameribor or Bloomberg's Short-Term Bank Yield Index in lieu of SOFR, which may result in a multi-rate environment in the US. However, as the SOFR debt pipeline builds, so does the depth and liquidity of SOFR swap trading, which may mean the market coalesces around SOFR over time.

Since the start of 2022, new issuance in several markets has overcome the challenge of determining an agreed spread adjustment when moving from a LIBOR to SOFR reference rate. We have seen increasing issuance of leveraged loans and CLO notes referencing SOFR and more are expected.

Legacy contracts with fallback provisions that reference non-LIBOR rates such as prime or federal funds are not covered by the act, but are also likely to see minimal disruption risk if they have hardwired fallback language in line with recommendations from the Alternative Reference Rate Committee (ARRC). Standard leveraged loan documents have provided for the automatic conversion to a non-Libor rate, but conversion to a higher rate could pressure corporate interest coverage.