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Libor Index Discontinuance: Impact on Residential Adjustable-Rate Mortgages

Douglas I. Youngman and Robert M. Jaworski*

The London Interbank Offered Rate Index, a common index used in residential adjustable-rate mortgages, is anticipated to be discontinued at the end of 2021. The authors of this article discuss the New York Federal Reserve Bank's Alternative Reference Rates Committee's recommendations regarding the fallback language for new closed-end, residential adjustable-rate mortgages.

The New York Federal Reserve Bank's Alternative Reference Rates Committee ("ARRC") released its recommendations regarding the London Interbank Offered Rate Index ("Libor Index") fallback language for new closed-end, residential ("ARMs").[1] As discussed in more detail in the recommendations, the Libor Index, a common index used in residential ARMs, is anticipated to be discontinued at the end of 2021. Both Fannie Mae and Freddie Mac immediately adopted the ARRC recommended fallback language, which they will require to be included in all ARMs originated for purchase by them after publication of updated uniform ARM notes (expected in the first quarter of 2020).[2]

HIGHLIGHTS OF THE RECOMMENDATIONS

Below is a summary of the key points of these recommendations.

- The ARRC created a Consumer Products Working Group in 2019 to

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1 The Recommendations, including the recommended fallback language, are available from the New York Federal Reserve Bank Alternative Reference Rates Committee, *available at* https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARM_Fallback_Language.pdf.

2 Fannie Mae and Freddie Mac to use ARRC recommended fallback language for single-family ARMs, *available at* https://www.fanniemae.com/portal/media/statements/2019/statement-fm-aarc-sf-arms-6951.html; and https://freddiemac.gcs-web.com/news-releases/news-release-details/freddie-mac-use-arrc-recommended-fallback-language-single-family.

address Libor Index fallback for consumer products, including ARMs. The working group established the following key principles, which are reflected in the recommendations:

- Replacement rates, spreads, timing and mechanics should be "easily comprehensible in order to be effectively communicated to all stakeholders in advance of the transition;"
- Replacement rates should seek to "minimize expected value transfer based on observable, objective rules determined in advance;" and
- Flexibility and discretion should be "limited to the extent possible to ensure ease of application and to minimize the potential for disputes."

- Fallback Triggers: The Libor Index will be replaced if—and only if—either of the following events (each, a "Replacement Event") occurs:
  - The Administrator (for Libor, ICE Benchmark Administration) has permanently or indefinitely stopped providing the Libor Index to the general public, or
  - The Administrator or its regulator (for Libor, the United Kingdom's Financial Conduct Authority) issues an official public statement that the Libor Index is no longer reliable or representative.
- A new index ("Replacement Index") to replace the Libor Index will be determined by the note holder pursuant to the following waterfall, which limits discretion, subject to contractual provisions:
  - If a Replacement Index has been selected or recommended for use in consumer products, including residential adjustable-rate mortgages, by the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, or a committee endorsed or convened by the Board of Governors of the Federal Reserve System or the Federal Reserve Bank of New York at the time of a Replacement Event, the note holder *will* select that index as the Replacement Index.
    - The ARRC anticipates that the replacement rate and spread adjustment will be published jointly as a single "spread-adjusted" rate and made publicly available.
    - The recommended spread-adjusted rates will be based on the Secured Overnight Financing Rate ("SOFR") index and may be either based on averages of SOFR or on a

SOFR term rate.

- If a Replacement Index has not been selected or recommended for use in consumer products at the time of a Replacement Event, the note holder will make a reasonable, good faith effort to select a Replacement Index and a replacement margin that, when added together, the note holder would reasonably expect will minimize any change in the cost of the loan, taking into account the historical performance of the Libor Index and the Replacement Index.

ADDITIONAL NOTES

- Any decision to incorporate recommended language is completely voluntary.
- The ARRC recommendations discussed above are consistent with other ARRC recommendations for other products, but reflect a simpler approach for consumer products.
- Most current ARM notes already give the note holder broad discretion to choose a new index based on comparable information. Many lenders may prefer this historical language, but the ARRC suggests that the recommended provisions provide "greater clarity to consumers on when and how a Replacement Index will be chosen."
- The replacement rate for the ARM may not match up with the replacement rate for swaps hedging the ARM. Timing of conversion may be different, based on different terms for triggers. The replacement rate itself may also be different, as the primary fallback for swap rates is expected to be a compounded average rate calculated in arrears, while the recommendations note that such a calculation for an ARM would run afoul of current consumer regulations which require advance notice of any payment change.