Testimony before the

SENATE COMMITTEE ON BANKING, HOUSING & URBAN AFFAIRS

Regarding

The Libor Transition: Protecting Consumers and Investors

Testimony written and presented by

Andrew G. Pizor
Staff Attorney
National Consumer Law Center

On behalf of
the low-income clients of the
National Consumer Law Center

November 2, 2021

Andrew G. Pizor
National Consumer Law Center
1001 Connecticut Ave., NW, Suite 510
Washington, DC 20036
202-452-6252
apizor@nclc.org
www.nclc.org

Chairman Brown, Senator Toomey, and Members of the Committee, thank you for the opportunity to testify today on the importance of protecting consumers when the benchmark LIBOR index comes to an end. I have been an attorney with the National Consumer Law Center (NCLC)[1] for twelve years. I provide my testimony here today on behalf of NCLC's low-income clients.

I. Introduction

My primary message here today is to encourage the members of this Committee, as well as the full Senate, to support H.R. 4616 but with a more limited safe harbor, as I will explain today. This bill will protect consumers and the credit industry from potentially devastating consequences that could otherwise occur as the credit world transitions away from the LIBOR index.

The LIBOR is currently written into more than a trillion dollars of outstanding consumer mortgages, student loans, and other consumer credit contracts. But it will cease to exist on June 30, 2023.[2] When that happens the companies that own and service those contracts must be ready to adapt by substituting a new index for the LIBOR. If the transition goes smoothly, few people will notice. But if they get it wrong, the consequences could force millions of consumers into default and lead to widespread litigation.

II. Replacing the LIBOR is a complex problem fraught with risk for industry and consumers.

The LIBOR is a benchmark interest rate compiled and maintained by ICE, a private corporation based in London, U.K. According to ICE, the LIBOR is "designed to

---

[1] 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, including older adults, 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 exploitive practices, help financially stressed families build and retain wealth, and advance economic fairness.

[2] Fed. Reserve. Bd., CFPB, FDIC, et.al, Joint statement on Managing the LIBOR Transition at 1 (Oct. 20, 2021), available at https://files.consumerfinance.gov/f/documents/cfpb_interagency-libor-transition_statement_2021-10.pdf

produce an average rate that is representative of the rates at which large, leading internationally active banks with access to the wholesale, unsecured funding market could fund themselves in such market in particular currencies for certain tenors."[3] Currently the U.S. Dollar version of the LIBOR is based on data submitted voluntarily by sixteen contributor banks.[4] Due to various problems with the LIBOR, the U.K.'s Financial Conduct Authority has announced that on December 31, 2023 ICE will stop publishing the versions commonly used in consumer contracts.[5]

In relation to consumer transactions, the LIBOR is commonly used as an index in adjustable rate home mortgages and student loans. Typically, a loan contract will specify a starting interest rate that will change at regular intervals over the life of the loan. The new interest rate at each change is based on the current value of a benchmark index named in the contract. The index value is then added to a "margin" (a fixed number written into the contract), and that total becomes the new interest rate on the contract. The servicer then recalculates the monthly payment based on the new interest rate.

The typical contract also has a clause, known as "fallback language," that authorizes the noteholder to replace the index if the original one becomes unavailable. The fallback language is central to replacing the LIBOR. But it has never been used before, and the standard language in almost all legacy contracts is too vague. For example, until recently the fallback language in Fannie Mae and Freddie Mac's contract forms said: "If the Index is no longer available, the Note Holder will choose a new index that is based upon comparable information." Most non-GSE and student loan contracts use similar language. A minority of contracts give the noteholder unlimited discretion to select a replacement. Significantly, there is no accepted understanding or definition of what is

[3] ICE website, available at https://www.theice.com/iba/libor.

[4] *Id.*

[5] U.K. Financial Conduct Authority, FCA announcement on future cessation and loss of representativeness of the LIBOR benchmarks (Mar. 3, 2021), available at https://www.fca.org.uk/publication/documents/future-cessation-loss-representativeness-libor-benchmarks.pdf

"comparable." And the few regulations addressing the selection of a replacement index only apply to a small portion of the market.[6]

The complexity of selecting a replacement is compounded in other ways too. Most importantly, there is no alternative index that will *perfectly* match the cost and movement of the LIBOR. As a result, any replacement will entail some compromises and will risk imposing a cost on one party to the contract. Nobody can predict future interest rates, so—even if the transition is conducted fairly—it is difficult to predict who will bear the burden and how big a burden that will be.

A related problem is that some contracts may require other adjustments to incorporate the new index. These adjustments are generically called "conforming changes," because they are intended to bring the contract into conformity with the replacement index. One of the most significant conforming changes will be to the margin. Because the new index will almost certainly have a different starting and average rate, the margin will need to be changed to result in a "comparable" contract rate. Some contracts allow the noteholder to make this change but many do not.[7] Other adjustments may be necessary too. This is another source of risk and controversy because there is no consensus on what conforming changes are appropriate or whether the fallback language authorizes noteholders to make them.

The crux of the risk for consumers and industry participants is that making the wrong decisions will lead to an unreasonable transfer of value. One party to the contract will unfairly profit and the counterparty will be harmed.

As long-time representatives of consumers, we are very familiar with the devastating consequences of predatory lending. This underlies our concern that some noteholders may abuse or mismanage their broad discretion in a way that gouges consumers. There are a number of ways this might happen. Unscrupulous, or even just sloppy, lenders or mortgage loan servicers could –

---

[6] *See, e.g.*, Reg. Z, 12 C.F.R. § 1026.40(f)(3)(ii) (replacing index for home equity line of credit); Reg. Z Off'l Interpretations, 12 C.F.R. § 1026.55(b)(2)-6 (replacing index for credit card).

[7] Regulation Z specifically allows creditors to change the margin for home equity lines of credit. 12 C.F.R. § 1026.40(f)(3)(ii). But there is no equivalent provision for closed-end mortgages.

- use a replacement index that is too volatile or that trends at a higher rate than the LIBOR;
- employ a different margin that is too high and results in a windfall for the noteholder;
- make other inappropriate and harmful changes to the contract under the guise of "conforming changes," such as by changing the method by which payments are calculated, or even 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
- 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 contracts provide them with no say in which index the noteholder selects. Their only recourse will be to complain or initiate litigation.

III. The Credit Industry should adopt the ARRC's recommended replacement: the SOFR.

For the past several years, a committee of industry participants, known as the Alternative Reference Rate Committee (ARRC)[8] has worked to prepare for this transition. NCLC and other consumer groups have participated in these deliberations. The ARRC has developed a set of well-vetted plans and recommendations that will protect consumers as well as industry. Unfortunately, their recommendations are non-binding. And, as the situation stands today, too few industry participants have committed to follow them. We believe fear of litigation is a major reason for the recalcitrance. They are worried that whatever index they choose, someone will sue them: either consumers, whose payments may increase, or investors, who may believe they are losing money.

---

[8] "The ARRC is a group of private-market participants convened to help ensure a successful transition from USD LIBOR to a more robust reference rate, its recommended alternative, the Secured Overnight Financing Rate (SOFR). It is comprised of a diverse set of private-sector entities, each with an important presence in markets affected by USD LIBOR, and a wide array of official-sector entities, including banking and financial sector regulators, as ex-officio members." Fed. Reserve Bank of N.Y. website, https://www.newyorkfed.org/arrc/about.

The refusal of a significant part of the credit industry to agree to abide by the recommendations of the ARRC endangers consumers. This refusal also endangers the stability of the economy in the United States.

Replacing the index is the primary challenge of the LIBOR transition. Fortunately, the ARRC has identified the most suitable replacement index: the Secured Overnight Refinancing Rate ("SOFR"). The technical aspects of why the SOFR is appropriate are beyond the scope of NCLC's discussion today, but there is no doubt that the ARRC and the Federal Reserve Bank of New York have sufficiently vetted the SOFR. **As a result of their work, it has become clear that the SOFR, when implemented as recommended by the ARRC,[9] will minimize any value transfer caused by the end of LIBOR. It is the best option for both industry and consumers.**

IV. Congress should mandate use of the SOFR or offer a safe harbor for voluntary use.

Despite the ARRC's recommendations, too few industry participants have announced that they will adopt the SOFR for legacy consumer contracts. Delaying this decision to the last minute will increase the risk of implementation errors and the potential for broader economic instability. NCLC and other consumer advocates have urged federal regulators to adopt strong regulations that will compel industry to adopt the ARRC's recommendations, but they have not done so. States have limited ability to adequately address the problem because of federal bank law preemption. However, leaving the transition entirely to the market poses too great a risk to the financial markets, to bank safety and soundness, and to millions of individual homeowners, student loan borrowers, and their families.

The best solution is for Congress to require noteholders to replace the LIBOR with the SOFR in all consumer contracts. But this proposal has been rejected by the credit industry, so we have agreed with industry trade groups on a suitable compromise. **As an alternative to a mandate, Congress should create a safe harbor from litigation for noteholders that voluntarily adopt the ARRC's recommended benchmark replacement index.**

[9] Including the recommended spread-adjustments.

The House of Representatives is already considering such a bill, H.R.4616, the Adjustable Interest Rate (LIBOR) Act of 2021. We support the ideas behind H.R. 4616 but only with changes to the safe harbor that will prevent abuse.

While consumer advocates generally oppose safe harbors from litigation, we believe a narrowly tailored one is appropriate for this unique situation. A safe harbor provides a company with immunity from lawsuits by anyone claiming to have been harmed by conduct within the scope of the safe harbor. Safe harbor laws are often too broad, poorly drafted, and more likely to protect wrongdoers than to accomplish anything positive for society. But in this case, we have negotiated a narrowly focused safe harbor law that—while not our first choice—will avoid the greater harm we expect if noteholders adopt indices other than the SOFR.

Specifically, we recommend that Congress adopt a safe harbor for consumer contracts that is limited to liability for:

- the *selection* or *use* of the SOFR recommended by the ARRC and Federal Reserve Board; and
- the *implementation* of necessary conforming changes.

While we support the concept of a safe harbor embodied in H.R. 4616, the language of the bill is currently too broad. In its current form, the safe harbor would also include consumer claims arising out of the *determination* and *performance* of conforming changes. We are concerned that disreputable actors could harm consumers by taking an overly broad interpretation of what conforming changes are necessary to implement a new index. If that happens, the current version of H.R. 4616 could immunize some of the misconduct I describe in section II, *supra*, of my testimony.

Based on our experience with consumer contracts, we believe that very few—*if any*—conforming changes will be needed. And those that may be needed will be so basic and ministerial that there is no reason to incentivize them with the offer of a safe harbor. Therefore, we have agreed with industry representatives that the safe harbor for consumer contracts will not include the determination of what conforming changes are necessary or the performance of conforming changes. Instead, the definition of "conforming changes" will be determined by the Federal Reserve Board (FRB). Only those changes will be within the scope of the safe harbor. Appendix A to my testimony is a document showing the changes that we and industry representatives recommend

making to H.R. 4616. This document has already been shared with House and Senate staff.

In the statutory language that we have proposed, the *selection* of the replacement index refers only to the question of whether to use one index or another. If a noteholder selects the appropriate SOFR, that decision will be protected by the safe harbor. Selecting any other index will be outside the safe harbor. This will encourage noteholders to follow the ARRC and FRB's recommendation, but will not require them to do so.

Use of the replacement index refers only to routine performance of the contract once the new index has been substituted for the LIBOR. This primarily refers to the regular rate and payment changes called for by the loan contract. So, for example, if a borrower has an ARM that calls for annual rate changes, the safe harbor would cover calculation of the new interest rate and loan payment each year based on the SOFR. Neither a consumer nor an investor could claim that they were harmed because the new payment was based on the SOFR. But if the servicer makes a mistake in doing so, for example by using the SOFR from the wrong date, making a typo when entering the value into the computer, or miscalculating the new payment, those mistakes would not be protected by the safe harbor and the consumer would retain the right to seek appropriate relief.

Conclusion

NCLC represents the interests of millions of low-income consumers who will be directly affected by the end of the LIBOR. If industry participants replace the LIBOR with an inappropriate index; if they mismanage the transition; or if they take advantage of the opportunity to make other changes that cost consumers, many people will be harmed.

That risk can only be avoided if Congress acts by passing legislation to ensure that industry participants adopt the most appropriate replacement for the LIBOR—the Secured Overnight Refinancing Rate (SOFR). After extensive discussions, we have agreed with some of the most important industry trade groups that H.R. 4616 is the best vehicle for doing so—but only if it is amended to narrowly tailor the safe harbor in a way that will protect consumers.

Recommendation: The Senate should pass a bill modeled on H.R. 4616 but with a more limited safe harbor connected to a narrow definition of "conforming changes" to be provided by the Federal Reserve Board.

I want to conclude by praising industry, the members of this Committee, and the House committee for working together to find a solution that is good for everyone. Thank you for considering the views of consumers. I am happy to answer any questions.

Respectfully submitted,

Andrew G. Pizor
Staff Attorney
National Consumer Law Center

November 2, 2021

APPENDIX A