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LIBOR, The Key Real Estate Lending Benchmark Rate, Is Nearing Its End

September 2018 • David T. Brennan

Most commercial real estate loans are made on the basis of a fixed interest rate. But a significant percentage of those loans involve floating rates, which are adjusted up or down periodically. The great majority of floating rate commercial real estate loans are based on "LIBOR," the London Interbank Offered Rate. But it appears highly likely that LIBOR will no longer be available to lenders and borrowers after December 31, 2021.

What is LIBOR?

LIBOR is a "benchmark" rate, used as a reference for determining the interest rate charged on many floating rate commercial and residential mortgage loans, as well as other products including derivatives (e.g., interest rate swaps, caps and floors), student loans and credit cards. It has been estimated that LIBOR is used as the basis for over $300 trillion of outstanding loans and other financial products.

LIBOR is determined daily by a group of twenty creditworthy international banks, and it is intended to reflect the rate that those banks would charge one another for large loans of varying maturities, from one day to one year (one-month and three-month LIBOR, in particular, are very commonly used as reference rates). In other words, LIBOR is meant to reflect the appropriate interest rate for a very low risk loan of a particular duration.

Most floating rate lenders charge an interest rate of "LIBOR plus x%," where x equals the margin that the lender determines necessary to account for factors such as the duration of the loan, the borrower's creditworthiness and the quality and value of the collateral.

The LIBOR Scandal, Reforms, and Lingering Problems

Until mid-2012, LIBOR was administered by the British Bankers' Association. Problems developed because there was a very low volume of actual loans between creditworthy international banks, which were intended to be the basis of the LIBOR rates. So, rather than providing the rate charged on an actual loan by one bank to another, the members of the panel were effectively asked the question, "What rate would you *expect* to be charged on such a loan?" This made LIBOR vulnerable to manipulation. And since many trillions of dollars of derivatives – essentially, wagers on whether LIBOR would move up or down – were being sold, there was an incentive for members of the panel to collude to influence the movement of LIBOR in one direction or another.

That kind of collusion did, in fact, occur, and when the scandal was uncovered – beginning with a Wall Street Journal investigation in 2008 – it resulted in the banks on the LIBOR panel being fined billions of dollars, and several of the bankers involved being convicted and imprisoned.

In the wake of the scandal, the administration of LIBOR was transferred to the ICE Benchmark Administration (the "IBA"), and the oversight of LIBOR was assigned to a British regulatory agency known as the Financial Conduct Authority (the "FCA"). Even with improved controls in place, the underlying problem with LIBOR remains: as Andrew Bailey, the Chief Executive of the FCA stated, "the underlying market that LIBOR seeks to measure – the market for unsecured wholesale term lending to banks – is no longer sufficiently active." He posed this question: "If an active market does not exist, how can even the best run benchmark measure it?"

The Decision to Phase Out LIBOR

In July 2017, Mr. Bailey of the FCA announced that "it is not only potentially unsustainable, but also undesirable, for market participants to rely indefinitely on reference rates that do not have active underlying markets to support them." The FCA recognized that because of LIBOR's pervasiveness as a reference rate for various kinds of transactions, a transition period of several years would be needed to wind down LIBOR. The FCA chose December 31, 2021 as the date after which "it would no longer be necessary for the FCA to persuade, or compel, banks to submit to LIBOR."

While there is a possibility that IBA could continue to publish LIBOR after 2021 based on voluntary participation by banks, that seems very unlikely. The problems with LIBOR – principally, the lack of a sufficient number of actual loan transactions on which to base it – are now widely known. And the fines and prison sentences handed out in the manipulation scandal would provide a strong disincentive for banks or bankers considering offering their opinions about rates to the IBA on a voluntary basis.

What to Do with Existing Loans Based on LIBOR

When announcing the decision to phase out LIBOR, the FCA stressed the need for users of LIBOR to begin preparing for the transition. Fortunately, the documents for most LIBOR-based floating rate loans contain language permitting the use of a different interest rate if LIBOR is no longer published. They often provide an alternative rate (e.g., “Wall Street Journal Prime Rate plus x%”), and/or permit the lender to select a reasonable alternative to LIBOR as the basis for the floating rate.

Still, it makes sense for both lenders and borrowers in outstanding LIBOR-based floating rate loans to examine their loan documents, consider appropriate amendments or other actions, and communicate with one another well in advance of December 31, 2021.

Alternative Benchmark Rates

Efforts are underway to establish new benchmark rates to replace LIBOR. It seems likely that the United States and the United Kingdom will establish separate replacement benchmarks. In Britain, the Bank of England has established a reformed version of the Sterling Overnight Index Average (SONIA), a low-risk derivatives reference rate, to replace LIBOR. In the United States, the Federal Reserve Bank of New York has introduced the Secured Overnight Financing Rate (SOFR), a rate based on overnight loans secured by U.S. government securities. Both SONIA and SOFR are based on actual transactions rather than bankers’ estimates, making them less vulnerable to manipulation.

In late July 2018, Fannie Mae issued the first securities backed by loans with SOFR-based interest rates. Fannie Mae reported that the floating rate notes attracted “strong investor demand.” It seems that life after LIBOR will be possible after all.

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