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REAL ESTATE TRANSACTIONS

Expert Analysis

LIBOR'S Replacement In the Real Estate Loan Market


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The London Interbank Offered Rate (LIBOR) and other interbank offered rates, used as reference rates in variable-rate loans, derivatives and other financial instruments, are expected to be discontinued at the end of 2021. In the United States, despite lingering uncertainty, LIBOR likely is going to be replaced by the Secured Overnight Financing Rate (SOFR). U.S. Dollar (USD) LIBOR is commonly used in floating-rate commercial real estate loan agreements as a benchmark index, putatively reflecting the lender's cost of funds, with the borrower paying interest at a rate calculated as USD LIBOR plus a margin or "spread" reflecting market conditions and the price of the borrower's credit risk to the lender.

Whereas LIBOR reflects the current market for unsecured wholesale term lending to banks in a specific currency and for various terms in the London interbank market, SOFR reflects the retrospective, actual cost of borrowing cash overnight by means of repurchase ("repo") agreements secured by U.S. Treasury securities.

Since SOFR is measured by reference to transactions secured by Treasury securities, which have a negligible risk of default, and is therefore "designed to exclude counterparty credit risk and account solely for economic factors," SOFR is a so-called "risk-free rate." Given the secured nature of the underlying financing (i.e., repo agreements secured by Treasury securities), SOFR is expected to be lower than LIBOR.

Any transition from LIBOR to SOFR therefore would require an adjustment to the spread charged to borrowers in order to maintain comparable overall rates and avoid unintended value transfers between lenders and borrowers. The discontinuance of LIBOR will affect outstanding loans and derivatives contracts, either triggering interest rate fallback provisions or, in their absence or in the event such provisions fail to adequately account for LIBOR's permanent replacement, requiring amendments to existing contracts. LIBOR's discontinuance will also require attorneys currently negotiating new loans or existing loan amendments to account for the differences between LIBOR and SOFR in a climate of uncertainty as a consensus on implementing SOFR (or another LIBOR alternative) gradually crystallizes.

The herculean task of transitioning away from LIBOR by the end of 2021 will require market participants to diligently address the many facets of this process.

The Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York convened market participants and official sector representatives to form the Alternative Reference Rates Committee (ARRC) in 2014 in order to explore alternatives to USD LIBOR and to implement an orderly transition to USD LIBOR's successor rate. The risks of financial instability caused by confusion in the market as to USD LIBOR's successor are substantial given the number of financial instruments that reference USD LIBOR. According to the Commodity Futures Trading Commission's Market Risk Advisory Committee, as of July 2018, derivatives contracts made up 95% of the estimated $200 trillion worth of financial contracts that referenced USD LIBOR, but an estimated

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$1.1 trillion in non-syndicated commercial real estate loans/mortgages, $1.3 trillion in retail mortgages and other consumer loans, and $1 trillion in mortgage-backed securities also referenced USD LIBOR. ARRC recommended SOFR as USD LIBOR's successor in 2017 and the Federal Reserve Bank of New York began publishing SOFR on a daily basis in April 2018.

Differences Between LIBOR and SOFR

LIBOR is published daily by ICE Benchmark Administration Limited ("IBA") for five currencies (namely, USD, Euro, Pound Sterling, Japanese Yen and Swiss Franc) at seven different maturities ranging from overnight to one year, but each rate is quoted as a per annum rate. USD LIBOR is also commonly referred to as the Eurodollar Rate in loan documents in order to indicate that it is the rate for deposits denominated in USD held by banks in London, as opposed to rates, such as the Federal Funds Effective Rate, used for deposits held within the United States. LIBOR is calculated by IBA by polling a panel of 16 banks active in London's interbank unsecured, wholesale term lending market.

Each such bank is asked to answer the following question, the answers to which are trimmed and averaged by IBA in order to generate LIBOR: "At what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11 a.m.?"

Although the methodology for calculating LIBOR has been revised to account for actual transactions to the extent that they are available, expert estimation often remains necessary as a result of the decline in volume of actual funding transactions in the London interbank market.[9] That decline in LIBOR usage stems in part from reputational damage caused by an evident flaw in the rate's methodology: the risk of manipulation. Far from being a hypothetical risk, investigations beginning in 2012 revealed that several banks were engaged in fixing the rate, resulting in scandal and fines in excess of $9 billion in the United States, the United Kingdom, and the European Union.

The effect of these developments is that LIBOR no longer necessarily reflects a lender's true cost of borrowing. Andrew Bailey, the Chief Executive of the UK Financial Conduct Authority commented in a July 2019 speech, "The level of LIBOR is a combination of several different factors, including expectations of central bank policy rates, but also including a credit premium seeking to reflect the cost of unsecured wholesale funding to banks. Borrowers paying LIBOR are therefore taking on an exposure to credit premiums that are determined by reference to a very thin market, which accounts for a very small portion of overall bank funding, and bank funding costs."

By contrast, from ARRC's perspective, as "a broad measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities," "SOFR is a fully transactions-based rate that will have the widest coverage of any Treasury repo rate available" and "will reflect an economic cost of lending and borrowing relevant to a wide array of market participants." Whereas LIBOR is produced by a limited number of private-sector market participants, SOFR is produced by a central banking authority, the Federal Reserve Bank of New York, "for the public good," thereby mitigating the potential for manipulation. As ARRC has highlighted, "Averaging over $1 trillion of daily trading, transaction volumes underlying SOFR are far larger than the transactions in any other U.S. money market and dwarf the volumes underlying LIBOR."

Implementing SOFR

Because LIBOR is quoted at several forward-looking maturities (including 1-month and 3-month terms, often used in loan agreements), a single day's reading of USD LIBOR at the applicable maturity can be used for a given interest period in order to establish a lender's cost of borrowing. However, because SOFR is an overnight rate, floating-rate financial instruments will have to reference an average of SOFR for a given period of time prior to the interest rate determination date in order to avoid locking in a rate that displays the "idiosyncratic, day-to-day fluctuations" typical of overnight rates. An added consideration is whether averages of SOFR should be computed on a simple basis or a compounded basis. Despite day-to-day volatility, ARRC's research suggests that compound SOFR averages in arrears are less volatile than comparable LIBOR rates. It nevertheless is not clear if SOFR will behave differently from USD LIBOR in periods of severe credit stress.

In order to allow SOFR to be applied for periods longer than one day, ARRC is planning to produce forward-looking SOFR term rates comparable to existing USD LIBOR rates by the end of 2021 based on SOFR derivatives (once the SOFR derivatives market has sufficiently developed), although ARRC has stated that the production of such rates "cannot be guaranteed." Such SOFR term rates would "reflect expectations of SOFR, rather than SOFR itself or repo markets directly," since they would be derived from SOFR futures or overnight index swaps (OIS) markets. However, indicative SOFR term rates tentatively produced by staff economists of the Board of Governors of the Federal Reserve using the limited available SOFR derivatives data "track comparable federal funds OIS rates quite closely," suggesting that it will be possible to produce SOFR term rates that can be used in commercial contexts.

The transition to SOFR may cause a basis mismatch in structured finance products due to a potential lag in the timing of the change to a new reference rate between underlying financial assets and the securitized or structured financial instruments they sustain.

For example, Freddie Mac made a new offering of approximately $765 million of Structured Pass-Through Certificates last December that included one class of senior floating-rate bonds indexed to USD LIBOR and another class of senior bonds indexed to a 30-day average of SOFR, backed by 10-year floating-rate multifamily mortgages indexed to USD LIBOR. Freddie Mac is providing a guarantee to cover any mismatch in basis if SOFR exceeds USD LIBOR until such time as the underlying USD LIBOR mortgages and the other class of USD LIBOR bonds eventually switch to SOFR.

Practical Considerations For the Transition Ahead

The herculean task of transitioning away from LIBOR by the end of 2021 will require market participants to diligently address the many facets of this process, ranging from revising form contractual language, to coordinating a contemporaneous transition across interrelated financial instruments such as loan agreements and their associated interest rate swap agreements (to the extent possible), to amending legacy contracts. The most pressing issue for lenders and borrowers is reviewing their existing contracts to assess the effect of the transition on interest rate provisions and the commercial acceptability of existing fallback provisions.

For example, an analysis of leveraged loans by Fitch suggests that common provisions requiring a transition from USD LIBOR to the higher Prime Rate upon USD LIBOR's discontinuance would result in higher interest rates and a greater potential for payment defaults and failure to meet financial covenants. ARRC has recommended fallback contractual language for bilateral business loans, floating rate notes, securitizations and syndicated loans, while the International Swaps and Derivatives Association, Inc. (ISDA) is in the process of developing protocols to facilitate the transition from LIBOR-referencing derivatives to SOFR-referencing derivatives. In anticipation of providing a recommendation as to spread adjustments, ARRC launched a consultation on January 21, 2020 seeking feedback from market participants on spread adjustment methodologies for cash products referencing USD LIBOR, requesting responses to a questionnaire on preferred spread adjustment methodologies from stakeholders by March 6, 2020.

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Although commercial loan agreements in the past have typically included interest rate fallback provisions, such as language enabling a lender to average the individual rates quoted by a specified number of reference banks in London in the event that USD LIBOR is unavailable, or providing for an alternative rate based on the Federal Funds Effective Rate or the Prime Rate (if a lender determines that (i) adequate and reasonable means do not exist for ascertaining USD LIBOR or (ii) a contingency has occurred which materially and adversely affects the London interbank Eurodollar market), recent loan agreements include provisions more specifically contemplating USD LIBOR's permanent replacement with an alternative rate commonly accepted by market participants and publicly recognized by a trade organization such as ISDA, subject to a floor to ensure a minimum interest rate.

ARRC's recommended fallback provisions propose two approaches, both triggered either by a statement from a relevant authority (e.g., the UK Financial Conduct Authority) that USD LIBOR will no longer be provided or that USD LIBOR is no longer representative: (i) a "hardwired" approach that automatically replaces USD LIBOR with a specific rate, such as SOFR (or, if such rate is not yet available, other fallback options) upon the occurrence of one of the triggers, and (ii) solely for bilateral and syndicated loans, an alternative "amendment" (or wait-and-see) approach requiring the lender and borrower further to amend the loan upon the occurrence of one of the triggers in order to adopt a new rate to be identified at such time.

However, as noted in a recent ABA report, neither approach precludes potential disputes as to "zombie LIBOR" that may arise prior to an official statement by a relevant authority that USD LIBOR is no longer representative in the event that USD LIBOR continues to be published but with the participation of so few panel banks as to be effectively unrepresentative.

In light of the challenges of transitioning away from LIBOR, regulators across the globe are pressing market participants to prepare in advance. The New York Department of Financial Services ("DFS") has underscored the need for DFS-regulated institutions to have "robust and comprehensive plans in place to address their risk" related to the LIBOR transition and is requiring such institutions to submit LIBOR transition preparedness plans by March 23, 2020. Regulators' insistence on transition planning is understandable upon consideration of the scale of the potential problems – Bloomberg tracks 12,000 USD LIBOR loans that mature after 2021.