The Impact of Phasing Out LIBOR on Portfolio and Conduit Lenders

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The authors of this article explain the impact that phasing out LIBOR will have on floating rate loans and securities.

Regulators in the United Kingdom announced in July that they intend to phase out the London Interbank Offered Rate ("LIBOR") by the end of 2021. LIBOR is the daily average rate a group of banks estimates that they would be able to borrow from each other, across several time periods and currencies and has been the benchmark for setting interest rates for floating-rate, commercial real estate loans for decades. Regulators noted that they would like to replace LIBOR with a benchmark based on actual transactions, as opposed to estimations, which is largely what LIBOR has become given the decrease in interbank lending.

Impact on Floating Rate Loans and Securities

LIBOR's phase-out will have an impact on floating rate loans and securities as banks and finance companies decide how to manage the transition with both existing floating rate loans and new loans coming to market in the short term.[1]

Any existing loan that is not paid off prior to 2022 (or new loan with a five year term (or longer)) that is based on LIBOR will have to be amended if the loan documents do not contain a satisfactory method for calculating a LIBOR alternative. This will prove to be particularly challenging for any existing floating rate deals that are currently securitized.

For securitized, floating-rate, commercial real estate loans, any change to the interest rate definition in the loan documents will require the approval of multiple parties, which may prove difficult. Once a loan is securitized and sold to investors, any change to the actual interest paid on the loan (or the benchmark used to calculate such interest) will be disruptive to the securitization party administering the loan.

Despite the difficulty, a large percentage of

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existing securitized floating rate debt will likely be retired prior to the time LIBOR is phased out.

Conduit Lenders' Challenge

While the industry begins to search for a benchmark, the challenge for conduit lenders in the short term will be to craft provisions in their loan documents for new deals that will allow lenders the greatest flexibility to switch from LIBOR to a new benchmark. This is a challenge that all lenders are facing, but the consequences for not meeting the challenge are harsher for conduit lenders given the difficulties of making substantive changes to the loan documents after the loans have closed and are placed in securitizations.

All parties to the securitization will have to agree upon the benchmark that is ultimately chosen to replace LIBOR, and getting all parties to agree on that future benchmark may prove difficult. This is why new loan documentation should be drafted with the greatest amount of flexibility allowing for the replacement benchmark.

A brief survey of loan documents used in securitized floating rate loans reveals that in most of them, in the event the LIBOR rate cannot be ascertained, the lender has the option to convert the loan so that the interest rate is based on the prime rate (or another floating index named in the loan documents).

The Need for New Language

Again, the challenge will be to include new language that allows lenders the greatest flexibility to choose the benchmark that ultimately is accepted by the market, if any. It is important to note that any provision that permits the lender to change its benchmark will likely be heavily negotiated by borrowers not only at the origination stage, but also at the implementation stage when it comes time to switch from LIBOR to something else.

In addition to the extra scrutiny from borrowers, rating agencies will likely be involved with any proposed changes to the loan documents addressing this issue, which may further increase the cost to get deals done and make a laborious process even more so. The rating agencies, while well versed in the use of LIBOR as a benchmark, will most likely have to adopt new standards to get comfortable with the replacement benchmark and the loan documentation implementing the conversion.

Impact on Portfolio Lenders

Portfolio lenders will also be inconvenienced by the change away from LIBOR, but their ability to modify their existing loan documents will not be met with the same challenges faced by conduit lenders. Portfolio lenders should examine their existing loan portfolios to determine which deals will be affected by a benchmark change.

Any changes to a borrower's interest rate index (and the consequences of such a change) will be heavily scrutinized. The impact of a higher or lower benchmark rate (as compared to LIBOR) will most likely affect debt yield and DSCR performance tests for all assets, particularly in the less stable assets found in bridge markets.

Moving away from LIBOR may affect interest rate protection products (caps, collars and swaps) if a discrepancy exists between the loan documents and the interest rate protection agreement on how to agree upon a LIBOR alternative.

Any alternative benchmark may also impact the interest rate determination date period if the business days of the replacement index do not match with the determination periods set forth in the loan documents. The costs of interest rate protection products could increase as it becomes more difficult for interest rate protection providers to price their risks and obligations with the future unknown.

Conclusion

These are all wrinkles and potential issues that will have to be dealt with over time. It is also possible (although difficult to predict with certainty) that, until an alternative is agreed upon, a slight disruption in liquidity could exist in the short term while the market deals with this issue. Deal costs for both borrowers and lenders will almost certainly increase as new provisions are added and negotiated to the loan documents, the cost of obtaining interest rate protection products become more expensive, and as deals are met with more scrutiny from rating agencies and new standards are adopted for this challenge.

Like any other large-scale changes to the market, changes will likely occur slowly and deliberately, but the time to begin thinking of the changes and potential impacts is now.

NOTES:

[1]Any reference to a loan or loans in this article specifically refers to commercial real estate, floating-rate loans based on a LIBOR index.