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Borrower Beware: The End Of LIBOR Can Be Expensive



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I write about commercial real estate negotiations, deals and legal issues.



Floating rate loans may float in weird ways. GAMMA-RAPHO VIA GETTY IMAGES

For the last 35 years, banks have made floating rate loans based on an interest rate index called the London Interbank Offered Rate (LIBOR), which was determined using interest rate quotes from a panel of money center banks. In the real estate business, LIBOR loans have historically

been priced in one-month intervals, with the rate resetting based on LIBOR published at the beginning of each interval.

After the Great Recession, it was revealed that several panel banks were manipulating these rate quotes for their own benefit. The financial world learned that LIBOR quotes weren't as reliable or systematic as everyone had believed. This triggered a scandal and permanently tainted the index.

In response to the scandal, international banking regulators decided the banking system should move away from LIBOR and find a new index for floating rate loans. Today the favored replacement for LIBOR, at least in the US, seems to be the Secured Overnight Financing Rate (SOFR), also a floating rate but not fully comparable to LIBOR. A couple of other candidates lurk in the wings, but SOFR is achieving the most traction, according to Rob Finlay, founder of Thirty Capital, LLC, a defeasance and derivative consulting firm.

US bank regulators have issued guidance that, as of January 1, 2022, no regulated US lender should issue a new loan or other credit product that uses LIBOR pricing, Finlay says. But LIBOR rates should still be quoted until mid-2023. This way if a borrower obtains a loan in 2021 with LIBOR pricing, the borrower might be able to keep that pricing for the next year and a half. For loans closed after 2021, borrowers won't have that flexibility.

Borrowers closing loans before the end of the year should pay close attention to what their loan documents say about the future transition from LIBOR to SOFR or another alternative rate. This is nothing new of course, but at today's stage in LIBOR's death spiral, Finlay says, borrowers should have a reasonably clear picture of what to expect and should try to negotiate their loan documents accordingly.

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Today, he says, SOFR interest rates are about five basis points (5/100 of 1%) per annum. LIBOR rates, meanwhile, are four basis points higher, at about nine basis points. So, if a loan switched from LIBOR to SOFR today, it might make sense to replace every reference to LIBOR with a reference to SOFR plus a spread adjustment of four basis points. In March 2021, however, the banking regulators declared that the spread adjustment should be 11.4 basis points. This means if a LIBOR-based loan were to convert to SOFR today, using the regulators' recommended spread adjustment, every reference to LIBOR would jump from nine basis points to 16.4 basis points. This would produce a considerable jump in the borrower's interest expense.

A careful borrower will try to protect itself from this sort of surprise. It can do so by negotiating a lower spread adjustment in the loan documents or pushing back against language that allows the lender to make the LIBOR-SOFR conversion whenever it wants after 2021. Instead, the borrower might insist that the conversion not occur until LIBOR actually disappears in mid-2023. In Finlay's opinion, though, a borrower might think twice about taking that position, because it would expose the borrower to the near certainty that LIBOR will rise faster than SOFR as the older index falls gradually into disuse.

Some loan documents let lenders decide when and how to convert from LIBOR to SOFR. In these cases, Finlay says, borrowers should assume the worst, and lenders should know better.

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Regardless of how these individual conversations turn out, the subject of LIBOR's upcoming demise should remain front and center in every loan document negotiation through the end of the year.



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I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**

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