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The End of LIBOR: What to Know? What to Do?

The London Interbank Offered Rate (LIBOR) is the estimated average interbank lending rate in London, England. It's an important benchmark because an estimated $350 trillion in financial instruments have interest rates based on the LIBOR, including many of the floating rate loans in the real estate industry. These loans calculate a borrower's interest rate by adding an interest rate spread to the current LIBOR. As a result, the existence of the LIBOR is essential to these loans.

Notwithstanding the heavy reliance on the LIBOR, the Financial Conduct Authority that oversees the benchmark announced it will phase out the LIBOR by the end of 2021. This decision comes after widespread rate manipulation during the 2008 financial crisis and the resulting regulatory reform imposed on the interbank lending market. In the years following the crisis and the regulatory reform, there has been a significant decrease in interbank borrowing and, as a result, the Financial Conduct Authority determined the market is no longer sufficiently active to reliably establish and continue with this benchmark.

The elimination of the LIBOR creates a challenging and potentially expensive issue for lenders and borrowers in the real estate industry because it leaves the interest rate charged on their floating rate loans in limbo. Most commonly, the standard loan documents used for years in the industry either don't address what happens in the event the LIBOR becomes unavailable or, if they do address the issue, the documents state the prime rate will be used in lieu of the LIBOR, though without adjusting the interest rate spread. In the first situation, the failure to address the issue will lead to confusion and potential disputes when the LIBOR is eliminated. In the latter situation, the borrower will face a significantly higher rate (currently, prime is about 3% higher than LIBOR), and the lender will have a very disgruntled customer. Consequently, neither situation is good for borrowers or lenders.

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A keen drafter of loan documents should not only identify a replacement benchmark for when the LIBOR becomes unavailable but should also provide for the adjustment of the interest rate spread based on the difference between LIBOR and the replacement benchmark. This adjustment is necessary to maintain the interest rate that the parties intended. In addition, to avoid disputes over when to transition away from the LIBOR, there should be objective triggers in loan documents that define when the replacement benchmark should be used. Unfortunately, though, most loan documents were not drafted to include these important provisions because many practitioners did not envision the LIBOR ever being phased out.

The industry is now working to identify and adopt a benchmark to replace the LIBOR. In the United States, over two dozen lenders and ten government agencies formed the Alternative Reference Rates Committee (ARRC) to examine the issues surrounding the replacement of the LIBOR. After considering numerous alternative rates, the ARRC selected the Secured Overnight Financing Rate (SOFR) as the benchmark it recommends to replace the LIBOR. The SOFR is the interest rate charged to borrow cash overnight when collateralized by U.S. Treasury securities. There's nearly $800 billion in daily trading in this market, so the SOFR is reliable and not likely to be manipulated. As a result, there has been strong industry support for the SOFR, but the eventual adoption of the SOFR is still completely voluntary and may vary with different market participants.

To prepare for the end of the LIBOR, all borrowers and lenders should review their loan documents (including any interest rate swap agreements) to determine which of their loans utilize the LIBOR as a benchmark. Once these loans are identified, the relevant loan documents should be reviewed to determine if they include objective triggers for switching to a replacement benchmark, identify an appropriate replacement benchmark and adjust the interest rate spread to maintain the parties' intended rate. If these provisions are not included, the parties should amend the loan documents accordingly. By being proactive now, borrowers and lenders can avoid confusion, expenses, and disputes when the

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LIBOR is finally eliminated.

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