London Interbank Offered Rate (LIBOR)

BACKGROUND

The London Interbank Offered Rate (LIBOR) is a reference rate used, for example, to establish an interest rate for a floating-rate instrument. The interest rate for the instrument may be set as a specified tenor of LIBOR plus a fixed spread.

LIBOR is based on a combination of actual transactions and judgment by certain banks. The credibility of LIBOR was eroded when it came to light that some of the participating banks manipulated LIBOR by contributing inaccurate estimates of their borrowing costs. Various efforts to reform LIBOR have failed to fully address the inherent weakness of a reference rate based in part on judgment and estimates rather than verifiable data on a sufficient volume of transactions. As a result, the current processes for establishing LIBOR are expected to cease at the end of 2021.

Because LIBOR is in broad use in floating rate commercial mortgage lending, the cessation of the production of daily LIBOR updates will have an impact on the commercial real estate finance industry for a variety of reasons, including the following:

- There is no natural successor reference rate at this time with a sufficiently established and well understood track record to serve as a ready substitute for LIBOR.
- There is not yet a common industry practice or understanding of how to address LIBOR transition. Given the number of different markets and market participants using LIBOR, there is no one size fits all approach; however, any standards or move towards standardization with respect to transition would be beneficial.
- Documentation of loans currently outstanding may not adequately address LIBOR transition.
- There is no consensus as to the most effective reference rates, interest-rate structures or loan documentation to address LIBOR transition.
- There are no legal precedents as to the enforceability of various applications of loan terms to various events likely to occur in LIBOR transition.

The Federal Reserve and the New York Fed jointly convened the Alternative Reference Rate Committee (ARRC) to help ensure a successful transition from LIBOR. Its recommended alternative is the Secured Overnight Financing Rate (SOFR). The ARRC also serves as a forum to coordinate planning across various products and market participants currently using LIBOR index. MBA will continue to review, monitor and participate in ARRC activity on behalf of its members where appropriate.

PREPARING FOR LIBOR TRANSITION

The Mortgage Bankers Association is focused on providing resources to assist our member firms in the transition away from LIBOR to a successor index. Our goal is to work across the range of stakeholders to facilitate the implementation of a successor index, as well as to help educate our members and draw attention to transition issues that are important to our membership, the borrowers with whom they partner and the communities in which they operate.

To that end, MBA has developed a Primer on Evolving Issues for LIBOR Transition and Commercial Mortgage Market Challenges. The Primer includes an initial checklist of issues that commercial real estate finance firms will need to address as they consider the LIBOR transition. Proactively focusing on these issues within the contexts of individual organizations and the overall real estate finance market is vital. It also identifies a number of evolving issues may require industry action in the near future.

RECOMMENDATION

Although the expected transition is several years away, it is important that lenders and other market participants promptly begin taking action if they have not already done so to prepare for transition away from the LIBOR index.

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