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Negotiating Variable Rate Mortgage Loans as LIBOR Phases Out

by Chad J. Richman

A FREEBORN & PETERS LLP CLIENT ALERT

ABOUT THIS CLIENT ALERT:

This article explores how the mortgage financing marketplace might replace LIBOR (a benchmark that is broadly used for trillions of dollars of contracts) and the anticipated effect of such replacement on existing mortgage loans and new originations/modifications.

LIBOR panel banks and regulators are working on a plan for a transition to alternate benchmarks by the end of 2021. At this point, a large chunk of the LIBOR market has no real trades. LIBOR is effectively an average of expert guesses by its panel banks. Uncertainty exists as to the replacement index for existing mortgage loans and new mortgage loans. The goal is to replace LIBOR with a market transaction based index grounded in actual borrowing costs. This article explores how the mortgage financing marketplace might replace LIBOR (a benchmark that is broadly used for trillions of dollars of contracts) and the anticipated effect of such replacement on existing mortgage loans and new originations/modifications.

I. Background:

When mortgage lenders make variable rate loans they do so by making the interest rate "float" a certain percentage (i.e., the "margin") over an index rate. One of the primary index rates is the London interbank offered rate ("LIBOR"). LIBOR acts as a baseline index for a substantial portion of the U.S. mortgage market's variable interest rate loans.

There have been issues concerning the accuracy of LIBOR in the wake of market manipulation as a consequence of the self-reporting nature of the index and lack of oversight, culminating in a recent statement from the Financial Conduct Authority (which has regulated LIBOR since April of 2013) that the LIBOR market is "not sufficiently active." Shockingly, in one currency–tenor combination, for which a benchmark reference rate is produced every business day, the reporting banks executed just fifteen transactions of potentially qualifying size in that currency and tenor in 2016. The FCA concluded that activity in the LIBOR markets is limited, and there seems little prospect of these markets becoming liquid in the future.

Both borrowers and lenders should negotiate index "replacement" provisions extensively going forward.

II. Effect on Existing Loan Documents:
Most existing sophisticated mortgage loan documents allow the lender to select a "comparable" or "reasonably similar" replacement index in the event that LIBOR is no longer published or becomes illegal. At what point LIBOR will no longer be published is unclear and one cannot be certain that only loans with maturity dates beyond 2021 will be impacted. Much litigation concerning the meaning of "comparable" or "reasonably similar" is sure to come. No substitute index will mimic LIBOR exactly. What is contemplated is utopian transition to an alternate index that both protects all consumers and is uniformly adopted and easily accepted by all lenders and governmental agencies backing the loans (as further discussed in Section "IV." below).

The reality may be much different. Especially in the commercial context, lenders will undoubtedly desire (and borrowers will fight to limit the ability of lenders) to switch variable rate mortgage loans to an index that results (or may result) in the borrower paying more interest than it otherwise would have under LIBOR. For existing LIBOR loan documents that do not address the potential unavailability or lack of applicability of LIBOR, borrowers may have contractual arguments that some portion of interest payments are excused by reason of the unforeseen phasing out of LIBOR making performance impossible, commercially impracticable or frustrating the purpose of the intended loan repayment obligations. Last, it is important to note that loans with variable interest rates that have been "synthetically fixed," "capped," or "collared" pursuant to interest rate swap or derivative agreements must be closely examined to determine the effect of the phasing out of LIBOR under both the mortgage documentation and the applicable derivate agreement.

III. Effect on New Originations and Loan Modifications:

1. **For mortgage lenders.** Given the uncertainty surrounding LIBOR, it seems risky to continue to originate new LIBOR loans and rely on "replacement index" provisions. For the time being, consider selecting a currently available and proven index other than LIBOR (such as U.S. Treasuries or the Wall Street Journal "prime" rate of interest). As LIBOR rates and UST/WSJ prime rates are materially different animals, Lenders will need to adjust their applicable margin in order to offer market competitive loan pricing. This will involve a detailed cost of funds analysis. The Federal Funds Rate is expected to increase based on Federal Open Market Committee statements and the implementation of quantitative tightening (i.e., gradual U.S. treasury sales). Lenders should favor a market index that will increase most rapidly in a rising interest rate environment, such as one tied directly to the Federal Funds Rate.

2. **For mortgage borrowers.** Understand the intricacies of any index that a lender might select in light of the phasing out of LIBOR. For example, in light of a recent Alternative Reference Rates Committee statement (described below), lenders may start switching to repurchase agreements or "repo" trades, collateralized by Treasury securities, to replace U.S. dollar LIBOR. Borrowers should strongly consider fixed rate alternatives, as well as "interim" and "loan life" interest rate caps (whether actual or synthetic).

A replacement index based on actual trades may be more reliable, but it could be more volatile.

3. **Replacing the replacement index.** Given the abundance of new financial products and the precedent that will be set by "LIBOR replacement law" in the future, it is not far-fetched to imagine the eventual possibility that any LIBOR replacement index may itself need to be phased out at some point over the remaining loan life. Both borrowers and lenders should negotiate index "replacement" provisions extensively going forward. Lenders should at least try to include a provision that if any such replacement index is no longer available, is not broadly used or widely accepted, or lacks liquidity and transaction volume to such an extent as to render it no longer representative of the purpose for which it was originally intended, the lender may choose a new index in its sole and absolute discretion. As an aside, it is always beneficial for the lender to include a provision that the index will never be less than zero or some higher floor. Borrowers, on the other hand, might ask a lender to agree that any replacement index selected must be used by U.S. Money Center Banks for commercial mortgage loans on a customary basis and adequately and fairly reflect the cost to the lender of making and maintaining the loan. Borrowers might seek credit for additional projected costs resulting from any increase in index interest rates at the time of the switch. This credit might be applied on an amortized basis against amounts owed by the borrower over the remaining life of the loan.

IV. Possible Uniformly Adopted Replacement Index and Potential for Volatility:

As mentioned above, in a June 22, 2017 announcement, the U.S.'s Alternative Reference Rates Committee, which was convened by the Federal Reserve and consists of an advisory board of major private market participants such as The Federal National Mortgage Association, The Federal Home Loan Mortgage Corporation, BlackRock, GE Capital, PNC Bank, and Quicken Loans, is backing a benchmark based on overnight loans known as repurchase agreements or "repo" trades, collateralized by Treasury securities, to replace U.S. dollar LIBOR. The new index would take into account the volume-weighted median of trades, in line with the calculation of the Effective Federal Funds Rate and Overnight Bank Funding Rate. Tenor is not addressed, the "repo" rate mentioned in this paragraph is overnight and does not address how longer maturity (i.e., one month) LIBOR may be replaced. The new rate may be initiated as early as next year.

Relying on estimations in setting benchmarks is probably not the most reliable approach. A replacement index based on actual trades may be more reliable, but it could be more volatile. Although Treasury "repo" trades may not ultimately act as the broadly accepted LIBOR replacement index, the new index will almost certainly rely on computer technology at the epicenter of international finance. One may recall the "flash crash" and that repurchase agreements financed institutions of various sizes leading up to the financial crisis of 2007. Experts disagree as to the extent the "run on repo" played in the mortgage crises. In an inflationary environment with rising interest rates, computer programs will automatically cause index interest rates to fluctuate immediately and without the self-interested controls that were insured by the refined and genteel bankers that self-reported LIBOR over the last thirty years.

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