



MBA's COMMERCIAL/MULTIFAMILY FINANCE

Primer on Evolving Issues for LIBOR Transition and Commercial Mortgage Market Challenges

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The LIBOR Outreach Committee represents MBA's commercial mortgage market participants that include capital sources that utilize LIBOR-based reference indices in their businesses. The goals of this Committee are to:

- Understand how various members view potential LIBOR transition challenges (legal, origination, servicing, tax, etc.) over time and how they are responding
- Elevate key issues, compare notes and share best practices
- Raise awareness and help educate the wider MBA membership
- Help MBA members and the industry to better understand the challenges facing our market with respect to what comes next for LIBOR and how MBA can be a valued resource

For more information about other MBA initiatives, contact cref1@mba.org

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The London Interbank Offered Rate (LIBOR) is set to expire by the end of 2021. A broad range of industries rely on LIBOR to conduct business and will be impacted by this change. The commercial and multifamily real estate finance industry will be affected, given the large amount of floating rate lending that references the LIBOR index in pricing loans.

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 help educate our members and garner attention for transition issues that are important to our membership, the borrowers with whom they partner and the communities in which they operate.

Below is 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.

Although the expected transition is several years away, it is important that lenders and other market participants promptly begin taking action on the items listed below if they have not already done so.

KEY ACTION ITEMS

1. Identify and assess existing LIBOR exposure in your portfolio today, including what portion of the portfolio might be expected to be refinanced or mature pre-2022.
2. Prepare adequate contract fallback language for new floating rate loans being closed today. Fallback provisions will aid in a smooth transition from LIBOR to a replacement index. Endeavor to build sufficient flexibility to address a developing but not yet fully formed consensus on the new index and the new methodologies to calculate interest rates.

3. Review operational requirements such as system integration issues for managing a new index and coordination with loan servicers, syndicate members in multi-bank facilities, and other interested parties.
4. Encourage voluntary adoption by lenders and borrowers of the successor rate at such time as all key constituencies have agreed on the means and methods of transitioning to an alternate rate. The successor index will likely co-exist with USD LIBOR as long as a LIBOR trigger event has not occurred. Be prepared for a floating rate portfolio which may include legacy LIBOR loans and new loans referenced off of the new benchmark index.
5. Join the Federal Reserve Alternative Reference Rates Committee (ARRC) email distribution for key updates on the transition away from LIBOR.

<https://www.newyorkfed.org/arrc/publications>

<https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2018/ARRC-Sept-20-2018-FAQ.pdf>

6. Monitor the ARRC and International Swaps and Derivatives Association (ISDA) regarding hedging products, as developments in ISDA are likely to drive the development of cash product indices. ISDA is also providing webinars for ISDA members that may be helpful to review.

<https://www.isda.org/2018/09/17/second-isda-ibor-fallbacks-webinar/>

7. Manage international implications of a replacement index (for instance, U.K. LIBOR transition to SONIA) to the extent your company has international floating rate exposure.

EVOLVING ISSUES:

In addition to the action items above, a number of evolving issues may require industry action in the near future. Those issues are identified below.

1. Recognize that the Secured Overnight Financing Rate (SOFR) will likely be the alternative benchmark floating rate index in the U.S. Because SOFR is a new overnight index, it will require time to develop a term rate structure to become viable for cash products, such as commercial mortgages. The ARRC's phased transition plan has outlined the development of a forward-looking SOFR term reference rate by the end of 2021, although it is possible a term SOFR rate will be developed prior to the end of 2021.
2. Be aware that because LIBOR is an unsecured rate and SOFR is a secured rate, there will likely be a spread differential between the two indices. A one-time spread adjustment will likely be required. Anticipated ISDA protocols should help with spread adjustment methodology.
3. Fall back triggers between some cash and derivatives markets are not currently aligned and should be monitored.

Reconciliation of the development of alternate rates applicable under ISDA for swap products and for various cash products will be critical. Note that ISDA is actively considering a compounded set in arrears approach to interest accrual periods, which would be a material change from current practice as period interest expenses would not be determined until the end of the relevant period.



4. We anticipate ISDA protocols will help address the existing derivatives (swaps, interest rate caps, and other hedges) associated with existing LIBOR loans.
5. Note that in structured finance (CRE CLOs, conduits, and other CRE securitizations), there is a real possibility for basis mismatch between changes in the index and the timing of the changes in index in the underlying financial assets and the resulting certificates or bonds. There is not yet a consensus on how to deal with the mismatch and mismatches are likely to exist through and beyond the anticipated date for the expiry of LIBOR (December 31, 2021).
6. Non-bank market participants, such as CLO investors and hedge providers, may prefer a more definitive approach to conversion to the alternative index (such as the "hardwired approach" under discussion by the Federal Reserve ARRC), rather than a gradual, voluntary adoption by lenders and borrowers.