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What Will the End of LIBOR Mean for the Multifamily Industry?

Learn what's happening with the switch to a new loan index.

The multifamily housing industry is moving closer to phasing out its long-standing index for adjustable-rate loans and other financial transactions.

The London Interbank Offered Rate (LIBOR), which covers five currencies and seven tenors, is on its way out after years of being a globally accepted benchmark. The Alternative Reference Rates Committee (ARRC), a group of private-market participants convened by the Federal Reserve and the New York Fed, has identified the Secured Overnight Financing Rate (SOFR) as LIBOR's replacement.

LIBOR was supposed to be retired by the end of this year, but that date has been extended to June 30, 2023, for most U.S. LIBOR values. The one-week and two-month LIBOR will still expire at the end of 2021.

"In commercial real estate, floating interest rates are commonly indexed off LIBOR," says Steven Fayne, principal at Align Finance Partners. "However, its uses span far more than just mortgages. Corporate loans, government bonds, credit cards, swaps, and myriad other financial products currently use LIBOR as a benchmark."

Citi Community Capital (CCC), a leading provider of financing for affordable housing, uses one-month LIBOR swap rates for floating-rate construction loans and other community development floating-rate loans. In addition, CCC uses LIBOR swap rates to establish fixed rates for permanent period fixed-rate loans, according to Barry Krinsky, national production manager.

Despite LIBOR's widespread use and long history, U.S. financial regulators have been pushing for the change to SOFR because it is believed to be a better and more resilient rate. One reason for this is the sample size for calculating LIBOR has been declining since the Great Recession. There's now less than $1 billion a day in transaction volume compared with $1 trillion a day for SOFR, says Blake Lanford, managing director in the trading department at Walker & Dunlop.

Other key differences are also driving the move. LIBOR is an average of interest rates reported by major banks, and some have been accused of misrepresenting their numbers to achieve better returns. SOFR, a broad measure of the borrowing of cash overnight collateralized by Treasury securities, is based on actual transactions rather than a survey.

"LIBOR is forward-looking, so the one- and three-month LIBOR is an expectation of where it would be one or three months in advance based on a forward curve," says Lanford. "SOFR is currently backward-looking, using a 30-day average."

What's Happening in Multifamily

Fannie Mae and Freddie Mac moved over to using SOFR for their variable-rate loans last September.

“There were a few months when there was some optionality, but they wouldn’t accept anything after December that was LIBOR-based,” says Lanford.

“Everything now from Fannie and Freddie is SOFR-based on new loans.”

CCC also is planning on ceasing the use of LIBOR for new loans and issuing SOFR loans in the coming months, according to Krinsky.

The firm has chosen the new index, he says, “in part because the SOFR benchmark when combined with the lending spread is expected to result in our multifamily borrowers achieving all-in borrowing rates similar to what they achieved with the LIBOR benchmark.”

In the affordable housing world, the use of LIBOR is somewhat limited. Adjustable-rate loans are uncommon in low-income housing tax credit deals because housing credit investors do not want the variable-rate exposure.

However, these loans are seen in some Section 8 transactions and during the construction phase of some affordable housing deals. Adjustable-rate loans are also seen in conventional multifamily property loans.

For the overall multifamily industry, the big unknowns are how and when will lenders transition the loans in their portfolio that use LIBOR. They’re going to have to move over to SOFR at some point.

When that transition happens there’s going to have to be a spread added to minimize any value transfer from the rate changing in favor of the investor, or borrower, says Lanford.

The good news is that many existing contracts will expire before LIBOR is phased out in mid-2023, so the parties won’t have to alter the pricing methodology currently used, according to Fayne.

“For contracts that use LIBOR as a benchmark and expire after 2023, the reference rate will need to change,” he says. “However, it’s highly likely that those contracts include ‘fallback language’ prescribing how the loan will be priced in the event LIBOR rates are no longer available.”

The next big action is expected to take place this month. “The big banks are being asked to switch over to SOFR at least on the interdealer interest-rate swaps by July 26,” says Lanford. “Once that happens, there’s going to be more progress.”

This step will cause trading activity among swap dealers on these platforms, which account for a substantially large share of trading in the interest rate swap markets, to switch from LIBOR to SOFR.

That’s going to create a more robust market, and that will be necessary to build a forward-term rate like there is for LIBOR. “We have a one-month and a three-month LIBOR,” Lanford says. “They’re trying to develop the same thing for SOFR. Right now, there’s plenty of transactions on the front end, but not as much as on longer-term futures and swaps contracts. The switch on July 26 will change that.”

Looking ahead, it’s important for developers to know what their variable-rate exposure is. “There may be some borrowers that have a schedule of real estate that’s 100% fixed rate, and they don’t have much to worry about,” he says. “For those who have some variable-rate exposure, planning in advance and matching up their loans along with any other derivatives is going to be a priority. Unfortunately, there's not much that we know yet as far as timing, but try to anticipate that switch."

Walker & Dunlop will provide lots of notice to the loans in its portfolio, and Fannie and Freddie will work to give as much lead time as possible as well, according to Lanford.

With representatives of the Federal Reserve and ARRC saying that SOFR should be used, developers should be cautious about loans that use a different benchmark. "I think the recommendation will soon be to think hard before using LIBOR or alternative indexes other than SOFR," Lanford says.

Affordable Housing Finance

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