What LIBOR’s demise means for hotels

hotelsmag.com/Industry/Blogs/Details/88642

What’s the Deal By Daniel Lesser
Daniel Lesser, president and CEO, LW Hospitality Advisors, New York City

(The views and opinions expressed in this blog are strictly those of the author.)

Along with the prime rate, LIBOR (the London interbank offered rate), is the most frequently used global interest rate benchmark for unsecured interbank lending, and it has been since the 1980s. Although the exact timing is not yet definitive, LIBOR is anticipated to cease being calculated and published past the end of 2021. Reported estimates of outstanding LIBOR benchmarked product currently totals more than US$200 trillion.

LIBOR, which is used worldwide in a wide variety of financial products, is essentially an average interest rate administered by the Intercontinental Exchange (ICE). The rate is derived from quotes received for short-term loans from major participating global private-sector banks. It is based on five currencies (U.S. dollar, euro, British pound, Japanese yen and Swiss franc) and seven maturities (overnight/spot, one week, and one, two, three, six and 12 months), all of which define a standard on which major global banks lend to one another.

This, in turn, serves as a benchmark for a variety of worldwide debt instruments including mortgages, corporate loans, government bonds, credit cards and student loans. LIBOR is also used for financial products like derivatives, including interest rate swaps or currency swaps.

In recent years, due to geopolitical and economic conditions, unsecured interbank lending has slowed, lowering the number of actual transactions across relevant currencies to provide a reliable estimate of LIBOR.

Additionally, there have been growing concerns regarding the manipulation of LIBOR by certain panel banks, further impacting its credibility. Consequently, the long-term sustainability of LIBOR as a benchmark has been questioned, and during the next two years, major economies around the world are working on transitioning largely, if not entirely, to alternate reference rates.

What it means

The cessation of LIBOR beyond 2021 will have an impact on both new and existing contractual arrangements. Several new benchmarks, known as risk-free reference rates, have been proposed as alternatives to interbank offered rates. The U.S. Federal Reserve Board and the Federal Reserve Bank of New York convened the Alternative Reference Rates Committee (ARRC) and recommended SOFR (secured overnight financing rate) as a preferred alternative to replace LIBOR.

Derived from a high volume of actual U.S. Treasury repo transactions (secured, repurchase agreements), rather than quotes from banks (as with LIBOR), SOFR is now being considered the most relevant and robust reference rate in the United States that can be further adaptive to market changes in the future.

That said, by its sheer nature (overnight), SOFR is volatile, and hence, determining the interest expense over a longer period is somewhat challenging. At present, users are referring to the average SOFR against the daily rate for their transactions to counter the unpredictability until such time that a term reference rate is available. While SOFR is evolving into an accepted benchmark rate for U.S. dollar-denominated derivatives and loans, other nations have sought their own alternative rates.

The impact on hotels

How does all this impact the lodging sector? Transitioning to SOFR (or similar reference rates being adopted by other major economies) has far-reaching implications for any organization that has loans, leases and other financial transactions benchmarked to LIBOR – particularly, public companies and investment funds.

To mitigate the adverse impacts of this shift, hotel companies and investors must assess their financial structure, business strategy and processes. For example, many credit agreements are indexed to LIBOR and while it is common to include a fallback provision for a replacement index if LIBOR is unavailable, the use of the replacement index for the remaining term of a deal may have a significant economic impact.

Overnight rates like SOFR are backward-looking; hence, the lack of a long-term forward-looking rate could result in the reference rate being changed multiple times over the term of an agreement.

Since the end of LIBOR is inevitable and nearing, market participants are preparing for the transition, and so should the lodging sector (if not already). Existing legacy financial instrument yields predicated on LIBOR to set variable rates most likely do not contain legal provisions that contemplate the cessation of LIBOR. Parties (lenders and borrowers) to such deals will need to negotiate mutually agreed upon amendments to provide for alternative rate setting mechanisms going forward. New debt originations tied to LIBOR are explicitly including a contract provision(s) for amending them when a replacement index is triggered.

Obviously, risks associated with an ultimate change in reference interest rates adds yet another uncertainty in today's fast-changing world. Financial and legal experts with significant experience in regulatory change will be in high demand to assist businesses across industries prepare to not only limit any impact the changes may have but also thrive from the change.

11/11/2019