Hotel Borrowers, Lenders Prepare for Transition of Debt Benchmark

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Floating-Interest Loans To Shift by Mid-2023

Hotel owners and financiers are confronting the phase-out of a longstanding interest rate benchmark as they address the impact the pandemic has had on borrowers' ability to repay loans.

Global financial regulators agreed to start phasing out the use of the London Interbank Offered Rate — commonly referred to as LIBOR — as the benchmark for short-term interest rates in favor of the Secured Overnight Funding Rate at the end of this year. Debtors and creditors who have reached agreements for floating-interest-rate hotel loans in recent years will be obligated to account for the switchover that's slated to be completed by mid-2023.

Daniel Lesser, president and CEO of New York-based consultant and hospitality-valuation firm LW Hospitality Advisors, said loan documents "vary dramatically" in how they address the change in the standard.

“The existing fallback is to either fix the interest rate to what the last [London Interbank Offered Rate] was or to revert to the prime rate. But there’s enough lead time to amend existing loan documents to reflect fallback provisions,” he said.

The "good news" is that the Secured Overnight Funding Rate — or SOFR — is almost always lower than its predecessor, he said.

Data shows the rates run almost parallel and about 0.1% apart. With the exception of a handful of spikes, Secured Overnight Funding Rates ranged from 1.6% to 2.5% between April 2018 and March 2020, when the rates plunged to less than 0.1% as a result of the pandemic, according to the Federal Reserve Bank of St. Louis. As of late January, the rate stood at about 0.06%. During the same time period, the three-month London Interbank Offered Rate ranged from 1.7% to 2.3% before dropping to about 0.4% when the pandemic hit and settling at approximately 0.2% late last month.

“There is a difference, but it’s not like it’s 50 basis points,” said Dan Peek, president of the hotel group at New York-based real estate adviser Hodges Ward Elliott. “It’s usually one-tenth of 1%.”

The change in the standard has been three years in the making. Adopted in the 1970s as a lending benchmark, the London Interbank Offered Rate is administered by the Intercontinental Exchange and is based on a survey of panel banks on what to charge for one-month, three-month, six-month and one-year loans — the longer the term, the higher the rate.

In 2008, reports began surfacing about banks colluding to manipulate the rates. In 2012, Barclays became the first bank to reach a settlement over allegations of manipulating rates, paying $453 million to U.S. and U.K. authorities, Reuters reported. Five years later, the Alternative Reference Rates Committee, which is a group of private-market participants working with the U.S. Federal Reserve Board and the Federal Reserve Bank of New York, announced the Secured Overnight Funding Rate would replace the new standard. In 2018, the Federal Reserve Bank of New York began publishing those rates, which reflect the cost of borrowing cash overnight collateralized by U.S. Treasury securities.

“The concept of [London Interbank Offered Rate] was experts predicting going forward what will happen. [Secured Overnight Funding Rate] is looking into the rear-view mirror of actual trades,” said Teague Hunter, president and CEO of Atlanta-based Hunter Hotel Advisors. “It’s a better model and more accurate.”

The timing is especially relevant because of the broad use of the London Interbank Offered Rate. As much as $300 trillion in mortgages, consumer loans, corporate debt or other financial instruments reference this standard for lending rates, Morgan Stanley estimated in

2019. Unlike office, industrial and residential properties that largely rely on fixed-rate financing, hotels are often financed with floating-rate loans that use the London Interbank Offered Rate as a rate benchmark.

“The average lease in an office building is eight years. That’s a perfect asset to be fixed,” Peek said. “Hotels have seasonality. It’s perishable. It lends itself to a floating rate as a business model.”

Larger Problems for Hoteliers

Hoteliers will face the changing standard at a time when hotel investment is expected to rebound after a year of being virtually frozen because of COVID-19.

“Nearly everyone who was an active seller before March pulled back,” Peek said. “During the first six to eight weeks [after the pandemic hit], there probably wasn’t a quote from a lender.”

Meanwhile, many lenders — who recognized that hotel operators weren’t to blame for the lack of cash flow — opted for flexibility in allowing payments to be delayed, reduced or added to the end of the loan term.

“The lenders have gotten very creative,” Hunter said. “The lenders don’t want to take the assets back, and as long as they don’t think the operator has done something material, they have no pressure to do anything.”

Lesser said that attitude from lenders is likely to be short-lived.

“We were seeing quite a bit of kicking the can down the road. Right when the pandemic hit, there was an undercurrent of, ‘Let’s play nicely in the sandbox,’” he said. “Come the middle of this year, the sharp elbows are going to be coming out.”

With that in mind, investors and lenders should expect the change in the loan rate standard to gain relevance as the travel industry gets a clearer picture of the rebound in demand.

“If we didn’t have anything else to worry about, this would be a massive deal,” Hunter said. “But we have an immense amount of uncertainty, so this is the least of people’s concerns. They’re too busy losing their hotels to their lender, or not getting hotel loans at all, to worry about the subtleties of pricing.”