Nothing Is as Easy as It Used to Be—LIBOR and Commercial Mortgage Loans

by Bob Marsico on March 6, 2012

If you have been involved in commercial mortgage financing during the past decade, whether as a borrower, lender, or legal counsel, you have likely been a witness to the changes that have taken place in the manner in which loan interest rates are set and adjusted. For most sophisticated institutional lenders, long gone are the days of long term, fixed interest rates, which remain unchanged throughout the life of the loan. Instead, many lenders now quote interest rates which either "float" with market conditions or, frequently, adjust to reflect the latest market trends.

The benchmark used by many lending sources to set loan interest rates is "LIBOR." "LIBOR," an acronym for the London InterBank Offered Rate, refers to an averaged rate, which is determined on a daily basis on behalf of the British Bankers' Association. It measures the cost at which a member bank can borrow from other member banks, on an unsecured basis, for a certain time period utilizing a given currency. The LIBOR rate is calculated for 10 currencies and for 15 maturities, ranging from overnight borrowing to a 12-month loan period.

It is common to see commercial mortgage lenders quote proposed interest rates based on a "spread" above a specific LIBOR rate, which rate is automatically readjusted at the end of each LIBOR period. For instance, the lender may quote an interest rate of 3.00% above one month LIBOR, which will adjust monthly at the end of each one-month LIBOR cycle.

Such variable rate loan pricing creates potential uncertainty as to the ultimate borrowing costs for a transaction. In order to bring some certainty and stability, many lenders offer their borrowers "interest swap" products, pursuant to which the borrower exchanges its variable rate loan obligation for a fixed rate obligation. The swapped, fixed rate is somewhat higher than the then current variable rate obligation.

Variable interest rate loan documentation, whether based on LIBOR or some other benchmark, requires careful drafting and negotiation to be certain that the details of the interest rate calculations, loan amortization, and swap features are properly covered. Therefore, it is important to consult with an experienced business and commercial financing lawyer.