Article

Negotiating Interest Rate Provisions As Libor Demise Looms

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On July 27, 2017, the Loan Syndications and Trading Association issued a statement that Andrew Bailey, chief executive of the U.K.'s Financial Conduct Authority, announced the FCA would not compel banks to submit to Libor after 2021, foretelling the demise of Libor. The ICE Benchmark Administration, currently responsible for administering and publishing Libor, may publish daily Libor rates after that date, although the submitting banks could be fewer, impacting the use of the rate. As a potential alternative to U.K. Libor, in April of 2018 the Bank of England will take over the Sterling Overnight Index Average, or SONIA, which tracks the rates for overnight funding transactions in wholesale money markets. Rather than relying on a group of submitting banks, this process is intended to minimize the risk of rate manipulation that was the subject of the 2012 Libor scandal, which resulted in large fines imposed by U.S. and British regulators. European Money Markets use a similar rate called the Euro OverNight Index Average, or Eonia, and it may be proposed as a replacement for Euro Libor, which is also known as Euribor.

The U.S. Federal Reserve established the Alternative Reference Rates Committee (ARRC) to select a replacement index for U.S. dollar Libor. The ARRC, which is composed of large U.S. banks and regulators, voted to use a rate tied to short-term loans backed by U.S. Treasury securities, called the Broad Treasury Financing Rate (BTFR). The Federal Reserve Bank of New York is expected to start publishing BTFR index rates in the first half of 2018. The BTFR index rates can be compared to Libor index rates over several years to determine if there is a spread between it and Libor. That comparison is crucial when and if the U.S. dollar Libor is no longer quoted, in order to determine if BFTR can meet the yield expectations of lenders and borrowers who use the U.S. dollar Libor to price their commercial loan transactions. Since 2001, except for periods in 2008 and 2009, the one-month Libor has been close to the U.S. federal funds rate, which is approximately 3 percent below the U.S. prime rate. Whether the BFTR rate, with or without an additional margin spread, will be seen as meeting the expectations of borrowers and lenders used to commercial lending based on Libor may depend in large part to that tracking experience over the next few years.

In the meantime, lawyers will grapple with the language in current and proposed commercial loan documents that provide for an alternative rate if Libor should become unavailable. Because that likelihood is more certain, it can be expected that borrowers will want to make sure that the replacement rate is more definite in tracking the interest rate they anticipated with Libor.

Typically, credit agreement or promissory note interest rate language simply provides for a "replacement rate determined by Lender," or "a comparable rate determined by Lender." When the issue of a replacement rate is raised, a lender may agree to add a "reasonable" qualifier, and in this author's experience, in the latter half of 2017, borrowers and lenders both appear to be satisfied with that result and move on to other negotiations.

Although some borrowers have requested a provision that the replacement rate be the same replacement rate offered to all of its borrowers, lenders resist such language because they are not sure they will have just one replacement rate. Borrowers with significant leverage may instead request a "most favored borrower" provision, such as:

Such replacement rate shall be the same as the replacement rate for LIBOR with the then lowest interest rate determined for its borrowers, and if the Lender thereafter agrees to a replacement rate that is, at such time, lower that the replacement rate determined by Lender for Borrower, then Lender thereafter apply such lower replacement rate to the Loan.

As the date for Libor's discontinuation comes closer, unless an industry standard has been understood and adopted as a replacement rate, the parties, particularly the borrower, may seek to obtain language that would provide a standard for determining "reasonableness," or a more mechanical test for the determination of a replacement rate. Based on the information available to date on proposals for Libor replacement rates, language for a replacement rate with one or more elements of the following might seem logical:

Such replacement rate shall be the replacement rate for LIBOR specified by the Alternative Reference Rates Committee of the U.S. Federal Reserve, or if not specified, the lower of (a) the replacement rate for LIBOR generally accepted in the banking industry as a substitute for LIBOR, or (b) a comparable rate determined by Lender by reference to "the replacement rate for the LIBOR Rate specified by the Alternative Reference Rates Committee of the U.S. Federal Reserve (AARC), or if not specified, the lower of (i) the replacement for the LIBOR Rate generally accepted in the banking industry as a substitute for the LIBOR Rate, or (ii) a comparable rate determined by Lender by reference to the Prime Rate as published daily in the WSJ under "U.S. Prime Rate" or, if unavailable such other comparable index as Lender may designate.

Since banks and their regulators make up the AARC, such replacement language might be thought to be noncontroversial. However, particularly as substitute rates are being tracked, lenders may have concerns that what is generally accepted in the banking industry or published by the AARC may be open to dispute, may not be applicable to their lending practices, or may not be available as an interest rate option that can be selected from the interest rates available on their loan servicing systems.

Lenders will likely also resist a comparable rate tied to the prime rate because Libor usually is lower than the prime rate, and they generally would not accept a rate quoted as a mechanical calculation of the prime rate "minus" a margin for a comparable rate going forward. However, specific language to that effect might be:

Such replacement rate shall be a replacement rate calculated by determining the average margin difference ("Prime Margin") between the daily LIBOR and the Prime Rate as published in the "Money Rates" section of the Wall Street Journal as the "U.S. Prime Rate" ("U.S. Prime Rate") for the prior 12 months, and subtracting the Prime Margin from the U.S. Prime Rate as of the date LIBOR would be determined after the date LIBOR is unavailable, or if the U.S. Prime Rate is unavailable, such other comparable index as Lender may reasonably designate.

or:

Such replacement rate shall be a replacement rate calculated by determining the average margin difference ("Prime Margin") between the daily LIBOR and the Prime Rate as published in the U.S. Federal Reserve Statistical Release (H15) (519) as the "Bank prime loan" rate ("U.S. Prime Rate") for the prior 12 months, and subtracting the Prime Margin from the U.S. Prime Rate as of the date LIBOR would be determined after the date LIBOR is unavailable, or if the U.S. Prime Rate is unavailable, such other comparable index as Lender may reasonably designate.

Each lender will have its own language to address the issues above, but the suggestions above may provide some guidance on reaching a compromise that will meet the parties' expectations, match industry practice and avoid disputes.

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