December 5, 2008

Changes in Loan Interest Rate Definitions

Areas of Interest

Leveraged Finance

United States

As a result of the recent credit market turmoil, some lenders are proposing significant changes to interest rate definitions in commercial loan agreements.

Examples include:

- The addition of a LIBOR floor to the Base or Prime Rate definition, and
- The linking of the borrower's credit default swap rate to determine the interest rate margin charged to the borrower over a benchmark LIBOR or Base or Prime Rate interest rate.

Other lenders should consider whether to propose similar changes, and borrowers should be aware of these changes when negotiating new or amended loan agreements.

Commercial loan agreements in the United States commonly define the interest rates paid by borrowers as the sum of a specified benchmark interest rate plus an interest rate margin. The two benchmark interest rates commonly used in US loan agreements are:

- LIBOR, a London interbank offered rate that is commonly defined in terms of a maturity or interest period (e.g., overnight, one, two or three months) and a published average of rates reported by a group of banks for each such maturity or interest period (e.g., Reuters), and
- The Base or Prime Rate, a rate that is commonly defined as the *greater* of:
  - the rate determined and publicly announced by the lender (or by the agent lender in a multilender deal) as its "base" or "prime" rate, or
  - the sum of 50 basis points plus the overnight Federal funds interest rate published by the Federal Reserve.

The interest rate margin typically varies based on the benchmark interest rate chosen by the borrower under the loan agreement. While it can sometimes be a fixed rate for the term of the loan agreement, the interest rate margin may also vary over the term of the loan agreement based on changes in the borrower's credit rating or performance under a financial measure.

Historically, before the recent credit market turmoil, LIBOR had been lower than the Base or Prime Rate. As a result, the interest rate margins added to the LIBOR benchmark interest rate had typically been greater by 100 basis points than the interest rate margins added to the Base or Prime Rate benchmark interest rate.

Currently, because of the credit market turmoil, LIBOR has sometimes exceeded the Base or Prime Rate. A lender may be concerned in such a scenario that its Base or Prime Rate may not adequately cover the lender's cost of funds. Although the lender may increase its Base or Prime Rate by publicly announcing an increase, the lender may be reluctant to do so given other consequences of such a change. As a result,

some lenders have proposed adding a LIBOR floor to the definition of the Base or Prime Rate. For example, as modified, the Base or Prime Rate may be defined to be the *greatest* of:

- The rate determined and announced by the lender as its Base or Prime Rate,
- The sum of 50 basis points plus the overnight federal funds interest rate charged by the Federal Reserve, or
- The sum of the LIBOR rate plus the applicable interest rate margin for LIBOR loans (the LIBOR floor). It is important to note that the LIBOR floor in a modified Base or Prime Rate definition will need to specify what LIBOR maturity or interest period (such as overnight, one month or other period) applies.

In addition to adding a LIBOR floor, some lenders have gone further and proposed that the Base or Prime Rate may not be less than the lender's cost of funds, as determined by such lender.

In terms of the LIBOR benchmark interest rate itself, consideration has also been given to other changes to its definition, including:

- To change the group of banks whose reported LIBOR rates are used in its determination (to address concerns that the reported LIBOR rates do not adequately reflect lenders' costs of funds generally), and
- To limit what maturities or interest periods a borrower may select (as longer maturities or interest periods may present more difficult funding issues for some lenders).

Another proposed change to loan agreement interest rate provisions, which is particularly relevant to borrowers that are the subject of credit default swaps, relates to increased volatility in market perception of certain borrowers' creditworthiness. As a consequence, some lenders have proposed linking the interest rate margin charged to the borrower (over the LIBOR or Base or Prime Rate benchmark interest rate) to the reported credit default swap rate for such borrower, as reported by a company such as Markit. In some deals, a cap and a floor may be set on the changes that may be made in the interest rate margin based on changes in the borrower's credit default swap rate.

As the commercial lending market continues to address liquidity, costs of funding and credit issues in the current challenging environment, it will be important to consider these and other proposed changes in preparing and negotiating and amending loan documents.

If you have any questions or require further information on any matter discussed in this publication, please contact your usual regular contact at Mayer Brown or Marshall C. Stoddard, Jr., at mstoddard@mayerbrown.com.

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