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Leveraged Finance Group Client Alert: Impending Changes to Federal Funds Rate Calculations & Credit Agreement Implications

Ever since the LIBOR fixing scandal attracted headlines in the wake of the financial crisis, financial benchmarks[1] of all stripes have come under increased scrutiny from financial regulators around the world. The concerns around governance, integrity of benchmark inputs and the calculation methodology that were raised regarding LIBOR have likewise been raised for other financial benchmarks beyond LIBOR and even beyond interest rate-related benchmarks. Key benchmarks in global foreign exchange and commodity markets, in addition to other interest rate-related benchmarks beyond LIBOR, have been placed under the regulatory microscope. Here in the U.S., the benchmark reform movement has recently swept up the key Federal Funds Effective Rate ("FFER"). As described below, recent announcements from the New York Federal Reserve portend changes in the way the FFER will be calculated going forward and, as a result, syndicated credit agreements and possibly other financial instruments that similarly use FFER as a reference benchmark, may be in for some modifications in the months ahead.

WHAT IS FFER AND HOW IS IT DETERMINED?

The FFER is the observed *per annum* rate at which depository institutions lend U.S dollar excess reserve balances, or "federal funds", to one another on an overnight, unsecured basis. Therefore, the FFER is one measure of bank borrowing costs and, in the corporate syndicated loan context, provides one possible "floor" against which the interest rate on corporate loans can be priced. More broadly, the FFER is a key

[1] Financial benchmarks are generally understood to include prices, rates, indices or figures that are (a) made available to market participants, (b) calculated periodically, entirely or partially by reference to one or more underlying assets, prices or certain other data and (c) used for reference for purposes including (x) determining interest payable or other sums due under loan agreements or other financial instruments, (y) determining the market price or value of a financial instrument and/or (z) measuring the performance of a financial instrument. See Consultation Report, Board of International Organization of Securities Commissions, "Financial Benchmarks", January 2013, at Annex A. The FFER is just one of innumerable examples of financial benchmarks used in global financial markets.

indicator and instrument for monetary policy – the Fed's Open Market Committee sets a target FFER (or FFER range) and instructs the New York Fed to trade in the Treasuries markets with member financial institutions in order to cause the FFER to approximate the target rate. While the New York Fed influences the FFER through the open-market activities of its trading desk, it also tracks the FFER based on data voluntarily submitted by major federal funds brokers, who are comprised of large banks that acting for their own or a customer's account to make a market in federal funds. While the majority of federal funds loans are non-brokered, and simply occur directly between financial institutions without an intermediary, the FFER has been historically calculated based on brokered transactions. Every business day, the New York Fed calculates and publishes the weighted-average rate of all overnight fed funds transactions arranged through brokers on the prior business day. This weighted average is the daily reported FFER.

BENCHMARK REVIEW & FED FUNDS

In line with the recent global regulatory review of financial benchmarks, the Fed internally examined the data collection methods underlying its calculation of FFER and, in April 2014, initiated a revised data collection method which incorporated data from *all* federal funds transactions instead of only data supplied by federal funds brokers (as had been past practice).[2] Under the revised method, the New York Fed gathers transaction-level data directly from depository institutions (which currently number over 160 depositary institutions) engaging in federal funds transactions. Such a broader data set will hopefully be more reflective of activity in the federal funds market and provide the New York Fed with better monitoring capabilities, thereby addressing some of the concerns that have been raised generally in recent years with financial benchmarks. While this new revised data collection process continues to undergo refinement, the New York Fed has announced that it expects to change the FFER calculation methodology based on the revised data collection sometime in 2016.

WHAT DOES THIS ALL MEAN FOR CREDIT AGREEMENTS?

U.S. Dollar-denominated syndicated credit facilities universally incorporate the FFER as one of several key benchmarks against which a borrower's interest rates (as well as rates on certain inter-lender obligations) are pegged. For their interest rates, corporate borrowers under these facilities are offered a choice between US Dollar LIBOR-based interest rate or a separate base rate (generally defined as "Base Rate" or "Alternative Base Rate"). Base Rate is widely defined as being the higher of (i) FFER plus ½ percent per annum, (ii) the Prime Rate (as determined by a reference financial

[2] See http://www.newyorkfed.org/markets/opolicy/operating_policy_150202.html.

institution or other publicly available quote of "prime rate") and (iii) one-month LIBOR applicable to dollars plus 1% per annum.

For decades, the inclusion of an FFER prong in the definition of Base Rate has been the market standard for U.S. syndicated credit agreements. Likewise, the definition of "Federal Funds Rate" has also become standardized over the years. Since the FFER has historically been calculated based on brokered fed funds transactions, the standardized definition of "Federal Funds Rate" under credit agreements has historically referred to this calculation basis. The authors have consulted dozens of credit agreements dating back to 2001 of all sizes, borrower types and capital structures, and these credit agreements almost uniformly define FFER by reference to overnight brokered federal funds transactions. The following is a typical example of how FFER is defined in a syndicated credit agreement:

> "**Federal Funds Effective Rate**" means for any day, the rate *per annum* equal to the weighted average of the rates on overnight Federal funds transactions with members of the Federal Reserve System *arranged by Federal funds brokers on such day*, as published by the Federal Reserve Bank of New York on the Business Day next succeeding such day.

Since the New York Fed has announced that it is moving away from relying wholly on data from brokered federal fund transactions to instead include data from both brokered and non-brokered transactions, the customary credit agreement definition for "Federal Funds Rate" will need to likewise be adjusted. This change could be as simple as striking "arranged by Federal funds brokers" from definitions similar to the above example. Another option is to refer generally to the rate calculated by the New York Fed from time to time based on fed funds transactions of relevant market participants (which, under Federal Reserve Regulation D, is generally limited to depository institutions). Here is one recent example that the authors have found of this second approach:

> **"Federal Funds Effective Rate"** means, for any day, the rate calculated by the NYFRB based on such day's federal funds transactions by depository institutions (as determined in such manner as the NYFRB shall set forth on its public website from time to time) and published on the next succeeding Business Day by the NYFRB as the federal funds effective rate.

WILL THIS RESULT IN CHANGE OF PRICING FOR BORROWERS?

It remains to be seen whether the data collection methods will yield a statistically significant change in the observed FFER. Based on Federal Reserve data collected since implementation of the new collection protocol, the broadened data pool does not seem to significantly impact FFER.[3]

CONCLUSION

The waves made by the recent LIBOR manipulation scandal have rocked boats outside the London interbank market. In the name of best practices for financial benchmarks, a growing range of financial markets and their important benchmarks have undergone recent review and reform and the above-described changes to the New York Fed's calculation basis for FFER are just one of the latest examples of this global reform movement. The financial contracts and other instruments that reference such benchmarks will of course need to keep pace with such reform movements. Just as syndicated credit agreements have undergone changes with respect to LIBOR definitions,[4] in the near future, such credit agreements may also need to undergo further review to ensure that references to FFER accurately reflect the New York Fed's most current practices.

[3] http://libertystreeteconomics.newyorkfed.org/2015/04/the-fr-2420-data-collection-a-new-base-for-the-fed-funds-rate.html

[4] See LSTA – LIBOR Market Advisory (January 29, 2014).

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