The market disruption clause

Banks are increasingly frustrated by the publicly quoted Libor being lower than the actual rates they pay for Eurodollar deposits. The market disruption clause is the main reason why

The most often cited reason is that banks on the British Bankers Association's (BBA's) panel do not want to report their true, higher costs of funds because it may be seen as reflecting a desperate need for cash. Another possible explanation derives from the fact that the market today is relatively thin, particularly for deposits with longer tenors, leading some to believe that rates quoted by the panel banks for longer-term deposits do not appropriately reflect such market conditions and may not be completely reliable.

Explanation

The possibility that publicly quoted Libor does not reflect a bank's cost of funds is contemplated by most credit documentation in a provision often referred to as the market disruption clause. This protects lenders against both: (i) quoted Libor rates being somehow tainted, as not reflecting actual market rates; and (ii) a tiering within the bank ranks resulting in some banks incurring higher funding costs than others. An example of a typical provision from a standard form Loan Markets Association (LMA) credit agreement reads as follows:

"If before close of business in London on the quotation day for the relevant interest period the agent receives notifications from a lender or lenders (whose participations in a loan exceed X% of that loan) (Required Lenders) that the cost to it of obtaining matching deposits in the (interbank market) would be in excess of Libor in relation to a loan for any interest period, then the rate of interest on each lender's share of that loan for the interest period shall be the percentage rate per annum that is the sum of the margin and the rate notified to the agent by that lender before interest is due to be paid in respect of that interest period to be that which expresses, as a percentage rate per annum, the cost to the lender of funding its participation in that loan from whatever source it may reasonably select."

A threshold of Required Lenders needed to invoke this clause is typical in both English-and US-style syndicated credit agreements, and refers to lenders holding a specified minimum percentage of all loans outstanding. In the London market, it is typically a simple majority or 30%, whereas in the US market it is usually the same percentage (simple majority or 66.66%) that would apply to decisions such as common amendments to the credit agreement and waivers. The aim of using a minimum percentage, and the challenge in determining an appropriate level at which the percentage is set, is to strike a balance between providing real protection to the lenders and subjecting the borrower to idiosyncratic conditions affecting only one or very few of the lenders.

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In the London market, the typical consequence of the clause being invoked is that each lender would be paid interest at a rate calculated by reference to that lender's cost of funding its participation in the loan from whatever source it may reasonably select. The consequence in the US market would typically be that interest on Libor-based loans would be converted to a rate calculated by reference to the base rate, a domestic US pricing option. Until recently, the base rate has consistently exceeded Libor and has therefore generally been regarded as a failsafe interest rate to protect banks against losses when Libor does not reflect the cost of funds.

Application

It is difficult to remember a time when this clause was invoked before the present period of market disruption. In the early nineties, when the Japanese economy slipped from its dominant position, many Japanese banks paid premiums in order to attract Eurodollar deposits, pushing their costs of funding above the rates paid by leading banks from other parts of the world. At that time, the prevailing practice was for Libor to be calculated under credit agreements as the average of the Eurodollar deposit rates quoted by several (usually from two to five) reference banks in the lending syndicate, rather than the practice of using a published rate. However, the number of affected banks was generally below the threshold of required lenders, and so relief under the market disruption clause was not pursued. Instead, where possible, Japanese banks were included as reference banks so that the Japanese premium would be taken into account in calculating Libor. Later, during the Asian financial crisis of the late nineties, the market again exacted a premium from certain banks. The number of affected banks was again generally insufficient to invoke the market disruption clause. This resulted in increased pressure on borrowers to reduce the threshold required to invoke the clause, but we are not aware of any cases where it was in fact successfully invoked.

During the present period of Libor market disruption, lenders and their leading industry groups have devoted countless hours to considering how to address the problem. Yet, despite the frustration expressed by many lenders, we are aware of only a relatively small number of cases where the market disruption clause has been successfully invoked. Several possible explanations have been proposed for the failure of the clause to be invoked, including the following.

Reputational risk
Banks might not wish to be seen as having higher than average cost of funds.

Cost of funds
In credit agreements where the market disruption clause would entitle each lender to charge its own cost of funds, some banks are quite sensitive about disclosing their cost of funds for competitive and reputational reasons. Also, even though credit agreements normally provide some level of exculpation for lenders in quoting these rates, the risk remains that a quote could be challenged.

Cure worse than the disease
Although US dollar Libor has always been higher than the base rate in the past, the relationship between these rates recently inverted. Accordingly, in the US market, where base rate pricing is the fallback when Libor does not reflect the cost of funds, invoking the market disruption clause could have the unintended effect of lowering returns.

Customer relationships
Lenders may be concerned about strong negative reactions from borrowers. Indeed, the British Association of Corporate Treasurers published a press release on September 28 2008 discouraging lenders from invoking the clause, except as a last resort.

Difficulty coordinating action
Some banks have expressed the view that it is difficult either to coordinate action or to achieve the threshold number of banks required to invoke the clause.

Prescriptions for change

The difficulties associated with invoking the market disruption clause have prompted suggestions for change, some of which have already been implemented on a piecemeal basis. Although the market has yet to settle upon a definitive approach, it is reasonable to expect that a resolution may include a combination of more than one of these suggestions. The suggestions fall into three categories: (i) changing the Libor calculation; (ii) changing the trigger event to invoke the market disruption clause; and (iii) changing the consequence of invoking the market disruption clause.

Changing the Libor calculation
Imposing a Libor floor has the advantages of increasing the yield under market conditions and being easy to apply. However, it is a blunt instrument, as a fixed floor does not adjust for changing market conditions.

“A spread set high enough to compensate for even more tumultuous conditions may encounter resistance from borrowers”

Using selected reference banks may provide the most flexible tool to diversify the source of Libor quotations for a particular transaction, but if banks are quoting inaccurate rates to Reuters it is unclear whether the rates quoted under a credit agreement would be more reliable. The proposal may also increase burdens on administrative agents.

At the beginning of September 2008, the BBA reportedly rejected many suggested changes to its calculation of Libor after considering them for almost two months. However, it left open the question of expanding its panel, said that it would consider introducing a new benchmark rate for borrowing US dollars in Europe and committed to proceed with plans to ensure accuracy in the rates obtained from panel members.

Changing the trigger event
Lowering the threshold for Required Lenders would make it easier to invoke the clause, both substantively (by lowering the percentage) and procedurally (by reducing the difficulty of taking coordinated action). However, it would subject borrowers to the increased risk of outliers (lenders with disproportionately large costs of funds).

An additional trigger event based upon an objective standard, for example a deviation between Libor and US Treasury rates or federal funds rates, has several advantages. By removing the subjective factor from the determination: (i) banks would not have to reveal their individual costs of funds; and (ii) borrowers would have greater confidence that they are being treated fairly. However, it may be difficult to identify an appropriate objective standard with broad market appeal, and some have argued that such a standard would add too much additional complexity to credit documentation.

Changing the consequences
For transactions in the US market, suggestions have been made to change the definition of base rate to being the highest of three benchmarks. These benchmarks would include the two that are prevalent today (the prime rate and the federal funds rate plus 50 basis points), as well as a third. That additional benchmark could be Libor for a defined period (one month, say), as determined on each day for which interest is payable. Though at first blush an additional benchmark may seem redundant – after all, it is only relevant if Libor does not reflect the cost of funds to begin with – it may provide an important benefit. Libor quotes are more likely to be problematic for longer tenors, where the different risk profiles of banks become more significant. Accordingly, if the tenor for the Libor quote used for defining the base rate is sufficiently short, it is less likely to present an issue. A disadvantage is that it will subject the administrative agent to the burden of monitoring another interest rate, albeit under limited circumstances.

In credit agreements that provide for the interest rate to be calculated by reference to cost of funds when the market disruption clause is invoked, changing this interest rate to a specific market-based benchmark would have the same advantage as described above for a trigger event based upon such a benchmark – objectivity. It would also face the same challenge of identifying an appropriate objective standard with broad market appeal, especially as the rate would primarily apply in cases where lenders are outside the US and have typically relied on deposits as their principal, if not exclusive, source of US dollars. However, following the rationale for adding short-term Libor as an additional component to calculate the base rate, one possibility might be to use a short-term (perhaps even overnight) Libor as the substitute interest rate basis.

The possibility of adding an incremental spread when the market disruption clause is invoked has some of the same advantages and disadvantages as those described above in connection with a Libor floor: though it would allow lenders to increase the yield under present market conditions, there is no assurance that the amount of the increase would be sufficient under other conditions. A spread set high enough to compensate for even more tumultuous conditions may encounter resistance from borrowers.

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