MILBANK, TWEED, HADLEY & MCCLOY LLP

Milbank

October 28, 2008

Global Finance

Client Alert

BEIJING FRANKFURT HONG KONG LONDON LOS ANGELES MUNICH NEW YORK SINGAPORE TOKYO WASHINGTON, DC

LIBOR MARKET DISRUPTION

by Richard M. Gray

Background

For more than 30 years, the London interbank market has been a major source of liquidity for banks seeking to fund U.S. dollar-denominated loans. The market has worked efficiently to enable banks in need of liquidity to obtain deposits of U.S. dollars, either on an overnight basis or for fixed terms (typically, one, two, three or six months), from other banks with excess liquidity.

Those deposits are sometimes referred to as "Eurodollar deposits"; and the interest rate on Eurodollar deposits is referred to as "LIBOR" or the "LIBO Rate", standing for the London interbank offered rate.[1] The British Bankers' Association (BBA) oversees the public quotation of LIBOR by designating a panel of 16 U.S. and non-U.S. banks[2] to furnish their rates to Reuters, which publishes the average after eliminating the highest and lowest rates.

Lenders in the bank loan market have expressed increasing frustration over the apparent fact that the publicly quoted LIBOR is lower than the actual rates they pay for Eurodollar deposits, if they are able to obtain those deposits at all. Unless a bank is willing to publicize the rate it pays for Eurodollar deposits in a manner that would allow its individual cost of funds to be specifically known, however, it can be difficult to prove with certainty that its rate is higher than the publicly quoted LIBOR. Nevertheless, this conclusion may be inferred for the market generally by noting the disparity between publicly quoted LIBOR and the rate available to banks under the Federal Reserve's term auction facility. As reported by the Wall Street Journal,[3] the rates payable under this facility should be lower than LIBOR because the borrowings under this facility are secured while Eurodollar deposits are unsecured. However, this report noted that on a recent day the rate payable under the Fed's 28-day term

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the attorneys whose names and contact information are provided herein.

In addition, if you would like copies of our other Client Alerts, please contact any of the attorneys listed. You can also obtain this and our other Client Alerts by visiting our website at http://www.milbank.com and choosing the "Client Alerts & Newsletters" link under "Newsroom/ Events".

This Client Alert is a source of general information for clients and friends of Milbank, Tweed, Hadley & McCloy LLP. Its content should not be construed as legal advice, and readers should not act upon the information in this Client Alert without consulting counsel.
© 2008, Milbank, Tweed, Hadley & McCloy LLP. All rights reserved.

[1] These rates are also sometimes referred to as "Eurodollar rates", which can be used interchangeably with "LIBOR".
[2] Bank of America, Bank of Tokyo-Mitsubishi, Barclays Bank, Citibank, Credit Suisse, Deutsche Bank, HBOS, HSBC, JP Morgan Chase, Lloyds TSB Bank, Rabobank, Royal Bank of Canada, The Norinchukin Bank, Royal Bank of Scotland, UBS, and West LB.
[3] "Libor's Accuracy Becomes Issue Again," WSJ.com, September 24, 2008.

auction facility was 3.75% while the publicly quoted one-month LIBOR was 3.19%. U.K. banks questioned the reliability of publicly quoted LIBOR at a meeting with the Bank of England in November 2007, and two economists at the Bank of International Settlements raised similar concerns in a report earlier this year.[4] As further evidence of this global phenomenon, the Asia Pacific Loan Market Association (APLMA) recently published results of its member survey showing that 19 out of 26 respondents reported a deviation in publicly reported LIBOR and their costs of funding U.S. dollars.

Several possible reasons have been proposed for the disparity between the publicly quoted LIBOR and the actual rates on Eurodollar deposits. The most often cited is that, for reputational reasons, banks on the BBA's panel do not want to report their true, higher cost of funds because it may be seen as reflecting a desperate need for cash. Another possible explanation derives from the fact that the Eurodollar market today is relatively thin, particularly for deposits with longer tenors. While banks may be willing to lend funds to each other overnight or for other short periods, it is difficult for some banks to obtain deposits for, say, three or six months. Rates quoted by the panel banks for longer term deposits therefore may contain some element of artificiality and not be completely reliable. Also, since U.S. banks are the principal source of U.S. dollars, the brunt of the illiquidity in the interbank market is borne by non-U.S. banks. It has been recently reported, for example, that rates paid by many European banks for overnight deposits are double the rates paid by U.S. banks.[5] The uneven impact of this illiquidity means that the actual LIBOR rates for some banks will be even further from the average, publicly announced LIBOR quotes.

In syndicated loan transactions, the assumption exists that banks are able to obtain Eurodollar deposits for specific periods and re-lend the amounts of those deposits to the borrowers. Based upon this assumption, it is common practice for borrowers to be able to elect that their loans bear interest at LIBOR for the corresponding period, plus a profit margin. Although it has not always been the case, credit agreements usually determine LIBOR for this purpose by reference to the rate publicly announced by Reuters rather than by reference to the actual rate paid on Eurodollar deposits by one or more of the lenders. Accordingly, the disparity referred to above between publicly quoted LIBOR and actual Eurodollar deposit rates means that a bank may lose money on a loan if its funding cost exceeds the interest it receives. This risk is especially high for loans to investment grade borrowers (where the slim profit margins are quickly eroded by the funding loss) than for leveraged loans (where the higher margins provide more cushion).

Explanation of the Market Disruption Clause

A concern has always existed that the fundamental assumption underlying the LIBOR interest rate option for syndicated loans – i.e. that banks can obtain Eurodollar deposits for specific periods at ascertainable rates and re-lend the amounts of those deposits to the borrowers and rely upon the margin as constituting their profit – might not always hold true. What if a tax, reserve requirement or other increased cost is imposed on such deposits by a change in law? What if it becomes illegal to accept Eurodollar deposits and/or to relend the proceeds? What if the administrative agent under a credit agreement is unable to ascertain the applicable rates? All of these contingencies are typically dealt with in customary credit documentation, either by allowing the lenders to pass through increased costs or by suspending their obligations to make or maintain loans bearing interest calculated by reference to LIBOR.

The problem described above, that the quoted LIBOR rate does not reflect the cost of funding to the lenders, is also generally contemplated by most credit documentation. The provision addressing this problem is often referred to as "the market disruption clause", "the alternative interest rate provision" or, more ominously, the "Eurodollar disaster clause". The original purpose of the clause was to protect lenders against exactly the circumstances experienced today, either (a) the quoted LIBOR rates are somehow "tainted", in that they do not reflect actual market rates, or (b) a tiering has occurred within the bank ranks resulting in some banks incurring higher costs than others to obtain Eurodollar deposits. An example of a typical provision reads in relevant part as follows:

[4] "Bankers Cast Doubt On Key Rate Amid Crisis," Wall Street Journal, April 16, 2008.
[5] "Dollar Surges Amid Hustle For Supplies Overseas", Wall Street Journal, October 7, 2008.

If prior to the commencement of any Interest Period for a LIBOR Borrowing . . . the Administrative Agent is advised by the Required Lenders that LIBOR for such Interest Period will not adequately and fairly reflect the cost to the Lenders of making or maintaining the Loans for such Interest Period, then the Administrative Agent shall give notice thereof to the Borrower and the Lenders as promptly as practicable thereafter and, until the Administrative Agent notifies the Borrower and the Lenders that the circumstances giving rise to such notice no longer exist, (i) any request to convert any Borrowing to, or continue any Borrowing as, a LIBOR Borrowing shall be ineffective and (ii) any requested LIBOR Borrowing shall be made as an ABR Borrowing.[6]

To better understand this provision, it is important to note its two principal components. The first component is the trigger event that entitles lenders to suspend making loans bearing interest at rates calculated by reference to LIBOR. In the sample clause above, the trigger event is a determination by "the Required Lenders that LIBOR for such Interest Period will not adequately and fairly reflect the cost to the Lenders of making or maintaining the Loans for such Interest Period". The use of the term "Required Lenders" is typical in U.S.-style syndicated credit agreements, and refers to the same percentage in interest (usually either a simple majority or 66-2/3%) that would apply to such matters as common amendments and waivers. Accordingly, it is usually necessary for lenders holding a very substantial portion of the loans to suffer funding losses in order for this clause to be invoked. In contrast, British-style syndicated credit agreements may require a lower percentage, perhaps as low as 30%. The importance of using a minimum percentage, and the level of the percentage used, 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.

The second component of this provision is the consequence of lenders having invoked their rights. In the sample clause above, the consequence is that all loans otherwise bearing interest calculated by reference to LIBOR instead would be Base Rate borrowings. "Base Rate", usually defined as the higher of the administrative agent's prime rate or 50 basis points above the federal funds rate, is an interest rate option that typically exists side-by-side with the LIBOR option in loan transactions syndicated in the United States for domestic borrowers. That is to say, a borrower generally has the option to elect from time to time whether all or a portion of its loans bear interest calculated by reference to the Base Rate (Base Rate borrowings) or LIBOR (LIBOR borrowings). The reason that Base Rate pricing is used as the fallback when LIBOR does not reflect the cost of funds is that the Base Rate has, until recently (as discussed more fully below), always exceeded LIBOR.[7] The prime rates of banks, one of the benchmarks used in the calculation of the Base Rate, are set unilaterally by banks and subject to change at any time based upon their cost of funds, competitive pressures and exhortation by governmental and bank regulatory authorities[8], and thus it has generally been regarded as a failsafe interest rate to protect banks against funding losses. Indeed, because the Base Rate has historically exceeded LIBOR by a significant spread, the profit margin charged on Base Rate borrowings is usually at least 100 basis points less than the profit margin charged on LIBOR borrowings; but, even taking into account the profit margin differential, the all-in interest rate on Base Rate borrowings has always been higher.

In many syndicated loan transactions where the borrower is not U.S.-based and syndication takes place primarily outside of the United States, which would include almost all transactions where British-style credit agreements are used, the Base Rate interest option is not available. In these cases, the consequence of lenders having invoked their rights under the market disruption clause is that each lender is entitled to charge interest on its loans equal to its cost of funds plus its profit margin. The cost of funds is generally not defined, but each lender is usually required to certify its cost to the borrower. In some non-U.S. transactions, the right of each bank to charge interest based on its own cost of funds is conditioned upon the failure of the borrower and the banks first to negotiate an alternative interest rate basis.

[6] Anatomy of a Syndicated Credit Agreement, Richard Wight, Warren Cooke, Richard Gray, (LSTA, forthcoming Fall 2008).
[7] Notwithstanding the fact that Base Rate has always been higher than LIBOR, borrowers may sometimes select the Base Rate option to take advantage of shorter notice requirements for borrowings of Base Rate loans and more flexibility for prepayments of Base Rate loans.
[8] Although the prime rate is theoretically subject to change at any time, such changes by major banks are generally regarded as a significant macroeconomic events and therefore do not take place frequently.

Application of the Market Disruption Clause

The market disruption clause is often regarded as mere legal boilerplate, and in fact it is difficult to remember whether it has ever been previously invoked. In the early 1990s, 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 current practice of using a published rate. However, the number of affected banks was generally below the threshold of "Required Lenders" and the market disruption clause was never invoked. Instead, where the opportunity arose, credit agreements were amended or new credit agreements were entered into providing for the Reference Banks to include Japanese banks so that the Japanese premium would be taken into account in calculating LIBOR.

Later, during the Asian financial crisis of the late 1990s, the market again imposed a premium on deposits in certain banks. At that time, affected banks frequently sought legal advice about their rights under their credit documentation. The number of affected banks was again generally insufficient to invoke the market disruption clause. This resulted in increased pressure on borrowers (which sometimes succeeded) to reduce the threshold required to invoke the clause in future transactions, but we are not aware of any cases where it was in fact successfully invoked.

During the current period of LIBOR market disruption, lenders and their leading industry groups have devoted countless hours considering how to address the problem. On October 7, 2008, for example, the Loan Syndications and Trading Association (LSTA), based in New York, hosted a conference call devoted solely to this subject in which almost 750 callers from around the world dialed in.[9] Yet, despite the frustration expressed by many lenders, we are aware of only a small number of cases – less than five – where the market disruption clause has been successfully invoked. Several possible explanations have been proposed for the failure of the clause to be invoked. In no particular order of priority, these possible explanations include:

- ***Reputational risk:*** Just as banks on the BBA's panel may not wish to report their true, higher cost of funds because it may be seen as reflecting the level of their need for cash, lenders in syndicates might not wish to be seen as having higher than average costs of funds.

- ***Cure worse than the disease:*** Although, as noted above, LIBOR has always been higher than the prime rate in the past, the relationship between these rates has recently inverted. (See the attached charts.) Accordingly, where a credit agreement contemplates Base Rate pricing as the fallback when LIBOR does not reflect the cost of funds (as is typical for transactions with U.S. borrowers), invoking the market disruption clause today would have the ironic effect of lowering returns. (Indeed, none of the cases we are aware of where the clause has been invoked have resulted in a conversion of LIBOR borrowings into Base Rate borrowings.) In credit agreements where the market disruption clause would entitle each lender to impose its own cost of funds, there are other drawbacks. First, banks are quite sensitive about disclosing their cost of funds for competitive and reputational reasons. Second, even though credit agreements normally provide some level of exculpation for lenders in quoting these rates[10], the risk remains that a quote could be challenged.

- ***Customer relationships:*** Because the market disruption clause has never been successfully invoked before this period of turmoil, and because even now it is seldom invoked, 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.

[9] The Loan Market Association (LMA), based in London, hosted a similar discussion for its members during the week of September 27, 2008, and the Asia Pacific Loan Market Association (APLMA), based in Hong Kong, hosted a meeting on the topic for its members on October 16, 2008.

[10] Typical exculpatory language might provide that a lender's quotation is to be conclusive in the absence of "manifest error" or "gross negligence or willful misconduct", or so long as it is provided "in good faith".

- ***Difficulty coordinating action:*** Even though the current Eurodollar market conditions appear to affect a larger number of banks than in the past, 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. Recently, an executive director of the British Bankers Association was quoted as saying "We are hoping people will return to their senses and not invoke these clauses."[11]

Prescriptions for Change

The difficulties associated with invoking the market disruption clause have prompted suggestions for change, some of which have been implemented on a piecemeal basis already. Not surprisingly, there are of course advantages and disadvantages to each suggestion. 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: changing the LIBOR calculation, changing the trigger event to invoke the market disruption clause and changing the consequence of invoking the market disruption clause.

Changing the LIBOR Calculation

Suggestions for changing the LIBOR calculation include (1) imposing a floor for purposes of calculating LIBOR under credit documentation, (2) abandoning the published rate announced by Reuters and reverting to the former practice of using an average of rates quoted by specified "Reference Banks" for purposes of calculating LIBOR under credit documentation and (3) prevailing upon the British Bankers' Association to modify its definition of LIBOR or to expand its panel of quoting banks.

- Imposing a LIBOR floor has the advantages of increasing the yield under current market conditions and being easy to apply. However, it is a somewhat blunt instrument, since a fixed floor does not adjust for changing market conditions. There is no assurance that the increased yield today would be sufficient under different market conditions and, conversely, it may be regarded as unfair to borrowers when the current disruption abates.

- 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.

- 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.[12] However, it left open the question of expanding its panel, said that it would consider introducing a new benchmark rate for borrowing U.S. dollars in Europe and committed to proceed with plans to ensure accuracy in the rates obtained from panel members.

Changing the Trigger Event

The principal suggestions for changing the trigger event in the market disruption clause have been (1) lowering the percentage of lenders in interest required to invoke the clause and (2) introducing an additional trigger event based upon an objective standard.

- Lowering the percentage of lenders in interest will make it easier to invoke the clause, both substantively (by lowering the threshold) and procedurally (by reducing the difficulty of taking coordinated action). However, it will subject borrowers to the increased risk of outliers. In addition, if this proposal also resulted in lenders having different interest rates in the same syndicated loan transaction, administrative agents would face the increased burden of monitoring the various rates.

[11] "Banks invoke right to pass on rising cost of funding," FT.com, September 30, 2008.
[12] "Changes to Libor Rejected," WSJ.com, September 6, 2008.

- An additional trigger event based upon an objective standard, for example a deviation between LIBOR and U.S. Treasury rates, federal funds rates or credit default swap (CDS) rates, has several advantages. By removing the subjective factor from the determination, (a) banks will not have to reveal their particular costs of funds, (b) borrowers will have greater confidence that they are being treated fairly and (c) the risk to borrowers of lowering the percentage of lenders in interest entitled to invoke the clause is less acute. On the other hand, it may be difficult to identify an appropriate objective standard with broad market appeal, and some have argued that drafting such a standard would add too much additional complexity to credit documentation.

Changing the Consequences

Possibilities for changing the consequences of invoking the market disruption clause include (1) modifying the definition of "Base Rate" to ensure that it is not below LIBOR, (2) where the consequences are to charge interest based on cost of funds, instead charging interest based upon an objective benchmark and (3) increasing the spread.

- Suggestions have been made to change the definition of "Base Rate" to be 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. The additional benchmark sometimes used is LIBOR for a defined period, say one month, as determined on each day for which interest is payable. While at first blush this 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 in fact provide an important benefit. LIBOR quotes are more likely to be problematic for longer tenors, where the different risk profiles of banks becomes more significant. Accordingly, if the tenor for the LIBOR quote used for purposes of the definition of "Base Rate" is sufficiently short, it is less likely to present an issue. An additional advantage of this change is that it would discourage borrowers from selecting Base Rate borrowings when the prime rate is less than LIBOR. A disadvantage is that it will subject the administrative agent to the burden of monitoring another interest rate, albeit under limited circumstances.

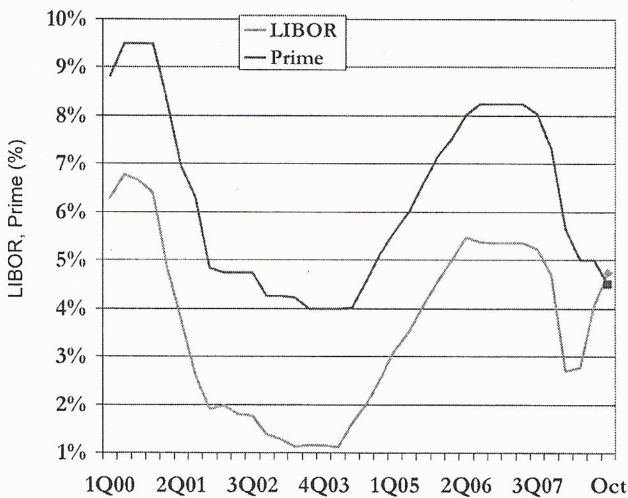
- In credit agreements that provide for the interest rate to be calculated by reference to cost of funds when the market disruption clause is invoked, changing this interest rate to a specific market-based benchmark would have the same advantages described above for a trigger event based upon such a benchmark – objectivity. It would also face the same challenge of identifying an appropriate objective standard with broad market appeal, especially since the rate would apply primarily in cases where lenders are outside the United States and have typically relied on Eurodollar deposits as their principal, if not exclusive, source of U.S. dollars. However, on the rationale set forth above 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.

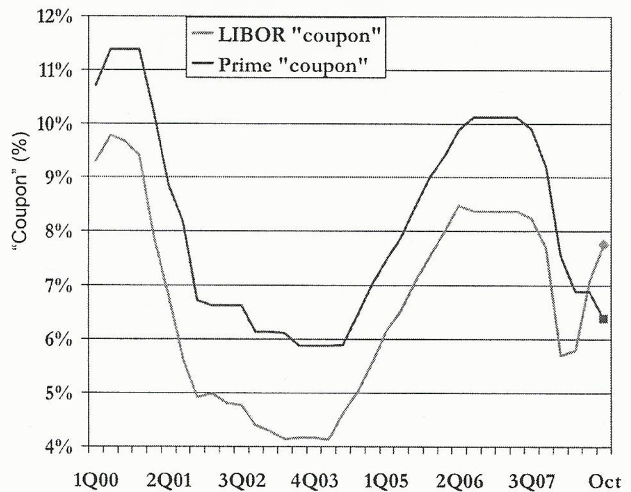
- The possibility of adding an incremental spread when the market disruption clause is invoked has the some of the same advantages and disadvantages as those described above in connection with a LIBOR floor: while it will increase the yield under current market conditions, there is no assurance that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

Further Information

If you have any questions about the foregoing analysis, please feel free to contact Rick Gray (212-530-5508; rgray@milbank.com), any of your regular Milbank contacts or any of the Milbank lawyers listed on the last page of this Client Alert.

Prime and LIBOR invert, impacting yields





- LIBOR-based margins often 100+ bps higher than Prime-based margins
- From 2000-2008
    - Average TLB LIBOR margin = 301 bps
    - Average TLB Prime margin = 189 bps
- As Prime fell and LIBOR rose, yields inverted at end of 3Q...

Source: LSTA/Reuters LPC

Reprinted from "Where do we go from here? Addressing a market turmoil," M. Coffey, T. Newberry, R. Stewart, G. Steockle, A. O'Brien. LSTA 13th Annual Conference, October 23, 2008.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the attorneys whose names and contact information are provided below.

Beijing
Units 05-06, 15th Floor, Tower 2
China Central Place, 79 Jianguo Road, Chaoyang District
Beijing 100025, China
Anthony Root
+86-10-5969-2777 aroot@milbank.com
Edward Sun
+86-10-5969-2772 esun@milbank.com

Frankfurt
Taunusanlage 15
60325 Frankfurt am Main, Germany
Thomas Ingenhoven
+49-69-7194-3436 tingenhoven@milbank.com
Rainer Magold
+49-69-7194-3430 rmagold@milbank.com

Hong Kong
3007 Alexandra House, 18 Chater Road
Central, Hong Kong
Young Joon Kim
+852-2971-4802 ykim@milbank.com

London
10 Gresham Street
London EC2V 7JD, England
John Dewar
+44-20-7615-3004 jdewar@milbank.com
Patrick Holmes
+44-20-7615-3022 pholmes@milbank.com
Catherine Marsh
+44-20-7615-3010 cmarsh@milbank.com
Suhrud Mehta
+44-20-7615-3046 smehta@milbank.com

Los Angeles
601 South Figueroa Street
Los Angeles, CA 90017
Edwin Feo
+1-213-892-4417 efeo@milbank.com
Edward Kayukov
+1-213-892-4682 ekayukov@milbank.com
Allan Marks
+1-213-892-4376 atmarks@milbank.com
Karen Wong
+1-213-892-4419 kwong@milbank.com

Munich
Maximilianstrasse 15 (Maximilianhoefe)
80539 Munich, Germany
Norbert Rieger
+49-89-25559-3620 nrieger@milbank.com

New York
One Chase Manhattan Plaza
New York, NY 10005
Daniel Bartfeld
+1-212-530-5185 dbartfeld@milbank.com
Michael Bellucci
+1-212-530-5410 mbellucci@milbank.com
William Bice
+1-212-530-5622 wbice@milbank.com
Richard Brach
+1-212-530-5350 rbrach@milbank.com
John Cobb
+1-212-530-5451 jcobb@milbank.com
Warren Cooke
+1-212-530-5220 wcooke@milbank.com
Richard Gray
+1-212-530-5508 rgray@milbank.com
Jonathan Green
+1-212-530-5056 jgreen@milbank.com
L. Douglas Harris
+1-212-530-5144 lharris@milbank.com
William Mahoney
+1-212-530-5286 wmahoney@milbank.com
Elihu Robertson
+1-212-530-5187 erobertson@milbank.com
Eric Silverman
+1-212-530-5648 esilverman@milbank.com
Blair Tyson
+1-212-530-5233 btyson@milbank.com
Caroline Walter-Meade
+1-212-530-5238 cwalter-meade@milbank.com

Singapore
30 Raffles Place, #14-00 Chevron House
Singapore 048622
James Murray
+65-6428-2422 jmurray@milbank.com
David Zemans
+65-6428-2555 dzemans@milbank.com

Tokyo
21F Midtown Tower, 9-7-1 Akasaka, Minato-ku
Tokyo 107-6221 Japan
Gary Wigmore
+813-5410-2840 gwigmore@milbank.com

Washington, DC
International Square Building, 1850 K Street
Washington, DC 20006
Glenn Gerstell
+202-835-7585 gerstell@milbank.com
Jonathan Maizel
+202-835-7565 jmaizel@milbank.com