Simply Speaking

Obscure legal concepts or terms in a loan document explained in plain English

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LIBOR Fallback Language

Example

Notwithstanding anything to the contrary herein or in any other Loan Document, upon the occurrence of a Benchmark Transition Event or an Early Opt-in Election, as applicable, the Administrative Agent and the Borrower may amend this Agreement to replace LIBOR with a Benchmark Replacement. Any such amendment with respect to a Benchmark Transition Event will become effective at 5:00 p.m. on the fifth (5th) Business Day after the Administrative Agent has posted such proposed amendment to all Lenders and the Borrower so long as the Administrative Agent has not received, by such time, written notice of objection to such amendment from Lenders comprising the Required Lenders. Any such amendment with respect to an Early Opt-in Election will become effective on the date that Lenders comprising the Required Lenders have delivered to the Administrative Agent written notice that such Required Lenders accept such amendment.[1]

What is it and what does it do?

The LIBOR fallback language allows the lender and the borrower to replace LIBOR with another reference rate. While there are variations, conceptually it provides a framework for the replacement of LIBOR either by hardwiring into the loan agreement a specified alternate reference rate or allowing the parties to amend the loan agreement within certain parameters.

[1] A complete version of the ARRC-recommended fallback language for syndicated loans may be found at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/Syndicated_Loan_Fallback_Language.pdf

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Why is it there?

Financial institutions submitting sample interest rate quotes to LIBOR's administrator to calculate LIBOR are expected to stop doing so after 2021, likely resulting in the end of LIBOR. Loans charging interest based on LIBOR need a replacement reference rate, and loan agreements must provide for a way to make such replacement.

Why is it important (or not so important) to Lender?

The rate of interest being charged on a commercial loan (including most shipping loans) often has two components: a reference rate (which is used as a proxy for the lender's cost of funding) and a margin (which represents the lender's profit). By far the most common reference rate used for this purpose (especially in shipping loans) is LIBOR, and without it, the lender will not be able to calculate the interest rate.

A lender underwrites a loan with set profit expectations by way of interest. Needless to say, if the formula for calculating interest changes (e.g. by replacing LIBOR with another reference rate, which may not be economically equivalent to LIBOR), the lender's profit margin may change (potentially to the lender's detriment). Hence, the lender needs to ensure that a well-drafted LIBOR fallback provision is included in the loan agreement to maintain its yield.

While many existing loan agreements already contain some forms of so-called "market disruption" provisions, which at least partially address the issue of LIBOR's unavailability, these protections are intended as a short-term fix, and are not an ideal way to deal with a permanent event like LIBOR's disappearance.

How does it affect a Borrower in practical terms?

The borrower has the opposite of the lender's concern. The borrower signed up to pay interest determined by an agreed formula, but if the formula changes before the loan matures, the borrower may end up paying higher interest. While imperfect, many existing loan agreements do contain various protective provisions for lenders, which may be invoked upon LIBOR's disappearance. The borrower may be in a precarious position without a specific, agreed approach on LIBOR's replacement.

How is it relevant to shipping?

The replacement of LIBOR presents several unique issues for ship finance lenders and owners.

First, many shipping loans are bilateral or "club" deals, which on one hand may make the amendment process efficient (given the small number of lenders), but on the other hand, because some of these loans are documented on legacy form documents on a relationship basis, they may not fully protect the lenders when it comes to an unexpected event like LIBOR's disappearance.

Second, given that a small number of shipping banks capture the large percentage of the market share, amending each and every existing loan all at the same time (or in a very short window of time) will be very difficult, which warrants early preparation.

Third, if the loan agreement is amended to provide for a replacement reference rate, ship mortgages will need to be amended, as the change in the interest calculation method is a substantive matter material to the interests of third party creditors. This prospect, especially in the context of a credit facility collateralized by a large fleet of vessels, makes early preparation even more important.

Fourth, many sale-leaseback transactions (which are prevalent in ship finance) have a LIBOR component in calculating the charter hire. Because these transactions are often documented on a BIMCO-form bareboat charter with additional clauses, they don't always contain the boilerplate protective language that one would typically find in a loan agreement. These bareboat charters will need to be amended to provide for a different method of interest calculation.

Fifth, interest rate hedges are prevalent in shipping. Many shipping companies have entered into derivative instruments to fix their interest rate exposure. Like loan agreements, these derivative instruments (which are based on LIBOR) will need to be amended to provide for an alternate reference rate to replace LIBOR, and shipping companies need to ensure harmonization between amendments to the underlying loan and the hedging instrument, so that there is no gap in derivative coverage.

Sixth, for public companies, LIBOR's likely disappearance warrants disclosure, given the risks involved in amending the loan agreement and other related transaction documents. Many public companies (shipping or otherwise) have started to include such disclosure in the form of a risk factor in their periodic filings.

How is it negotiated?

The Alternative Reference Rates Committee (ARRC) is a group of market participants convened by the Federal Reserve Board to help with this issue (as related to U.S. dollar-based LIBOR). They have developed and published (after a public comment period) recommended fallback language for various financial products, including syndicated loans, to be inserted into loan agreements and have also identified the Secured Overnight Financing Rate (SOFR) as a potential alternative to LIBOR. However, these recommendations are slow to gaining broad market acceptance. Many banks (and their law firms) still use their own "house" language to deal with this issue, and many market participants are generally waiting for some sort of market consensus without being proactive.

ARRC's recommended language itself employs two separate approaches: an "amendment approach" and a "hard-wired approach". Both approaches start with pre-determined triggers for the replacement of LIBOR, which include LIBOR's actual or impending disappearance or the lenders' election for early transition.

Upon the occurrence of any such trigger, the "amendment approach" provides for a mechanism by which the lenders and the borrower can amend the loan agreement to replace LIBOR and to adjust the profit margin within certain parameters (and with a set level of lender approval right, or a negative approval right where the amendment becomes effective if a required number of lenders do not object).

The "hard-wired approach", as the name suggests, takes all discretion away from the parties. It spells out exactly what will happen upon a trigger event. It pre-bakes into the contract which rate will replace LIBOR and how the margin will adjust.

The replacement of LIBOR is an important but fluid issue fraught with uncertainty. Seward & Kissel will continue to provide regular updates along the way.

Questions?

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