

# Passing on the distress

Paul Ng, Global Head of Aviation at Stephenson Harwood, investigates how lenders facing liquidity issues are invoking market disruption clauses to the detriment of borrowers



## Introduction

These are interesting times in credit markets, both for borrowers and lenders. Too interesting for most. Difficulties experienced by many of the premier banks in raising liquidity for their operations are having a significant effect on financing transactions. To appreciate the true effect on lenders of this liquidity scarcity, we need to understand that most lenders' ability to do business (i.e. lend money) is premised on being able to borrow in the interbank market at a specific base rate and then re-lend funds to borrowers at such base rate plus a margin or profit.

When this approach was first introduced in the 1970s, provisions were created to protect a bank's profit or margin if certain pre-defined circumstances arose which could increase its cost of borrowing. These provisions are commonly called *margin protection* clauses, and were largely neglected by borrowers and lenders alike when negotiating financing documentation as they were viewed as covering circumstances which were theoretical and at best, speculative.

It is hardly surprising therefore, that since the onset of the liquidity crisis and seizure of credit markets last year, margin protection clauses have found new prominence for banks, borrowers and facility agents alike.

In this article, we will discuss one of the least negotiated

and previously, rarely invoked, margin protection clauses found in syndicated loan agreements, the *market disruption* clause, which has been causing much distress to market players (in particular borrowers) in the past months.

## Discrepancies between lenders' base rate and the documentation base rate

As alluded to above, lenders' income derived from interest earned on most loan agreements is determined by adding (a) the base rate, usually the London Interbank Offered Rate (LIBOR) or some other base rate, which is the assumed rate at which the lender borrows in the interbank market to fund itself for re-lending to the borrower, and (b) the margin (or profit).

Current practice is to define the base rate objectively as a rate which can be read off a computer screen which records the interest rate levied on funds lent to and/or borrowed by financial institutions, generally as calculated by a banking association (in the case of LIBOR it is usually the

British Bankers Association (BBA)).

Taking BBA as an example, the rates which the association announces are in turn derived from rates quoted to them by a panel of leading banks of the rates which those banks could borrow funds in the interbank market. Herein lies the problem. Rates being quoted do not appear to

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reflect reality for many banks who are trying to borrow monies in the interbank market because credit is in short supply and banks are very wary of lending to each other. Therefore many banks are in fact paying significantly more than such base rate for monies borrowed in the interbank markets in order to maintain their commitments to borrowers, and this eats into the margin (profits) of their existing deals.

Most loan agreements contain a market disruption clause which allows lenders to deal with such circumstances by passing on any additional cost of funding to the borrower. Generally, if a sufficient number of lenders (typically in Asia, lenders with a combined debt participation interest of 30 - 60 percent in the relevant loan) are unable to obtain funds at the documented base rate, then the interest rate for the affected lender(s) are reset to the rate which the affected lender(s) can fund the loan (ie, the relevant lender's cost of funds).

## Invoking Market Disruption

Despite having the right to invoke market disruption clauses, such action can have serious reputational consequences for a lender, including an admission that the lender is unable to fund itself at the agreed base rate and therefore prompting the suggestion that they are less credit-worthy than other banks in the interbank market who are able to fund themselves at the base rate.

Furthermore, many Asian borrowers who have signed binding loan agreements with their relationship banks have become accustomed to relying on their relationship banks to deliver committed funding at an agreed price, and may feel a sense of betrayal if now asked to fork out additional sums in order to prevent these banks from suffering a loss in their profit margin as a result of market conditions caused by the turmoil in the banking industry, and not by them.

Unfortunately the repercussions for the borrower are not limited to higher costs of funds - they could run deeper in certain circumstances to include a breach by the borrower of its financial covenants under existing debt facilities

(such as under certain cash flow and interest cover financial covenants where the borrower agrees with lenders that its interest payment commitments will not exceed a certain percentage of its revenues) as a result of the higher interest payments they are expected to pay.

Under usual market disruption provisions, once invoked, a lender is able to charge its cost of funds (as determined by the lender) as the actual cost of funds from any source it may 'reasonably' select. The borrower has very limited ability to investigate, query or verify the lender's cost of funds which the borrower is being asked to pay (other than where the cost is considered wholly unreasonable).

## Developments

Despite the fact that credit markets are starting to thaw at the time of writing, in most instances borrowers are still struggling to dictate terms and consequently, many of the developments in relation to the market disruption clause in recent financing documentation have not improved but rather worsened borrowers' positions by transferring greater risk from lenders to borrowers of increased costs of funding. Developments include lowering the threshold for triggering such market disruption clauses from the usual 30 - 60 percent of debt participation to, in some cases, less than 10 percent of debt participation; a shift away from an objective determination of interest to one that is based on a more subjective rate determined by certain reference banks (who oftentimes are the majority lenders in the syndicate); the requirement to pay an additional liquidity premium if an objective LIBOR (screen rate) is used to determine interest, and; the appearance of market disruption clauses, even in fixed rate loans, where the method for determining interest is not by reference to a base (floating) rate.

The introduction of the market disruption clause was only ever for use in extraordinary circumstances and as one banker recently said, "those extraordinary times are here and now".

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## NEWS in brief

### Clyde & Co form Saudi affiliation

Clyde & Co has announced the expansion of its Middle East presence with an affiliation with the law office of Abdulaziz A Al-Bosaily in Riyadh, Saudi Arabia. Al-Bosaily has advised on some of the Kingdom's largest ground-breaking Islamic

finance structures and major project finance deals with clients ranging from petrochemical companies to banks. Clyde & Co has over 160 specialist lawyers and support staff in the GCC operating from offices in Dubai, Abu Dhabi and Doha. The firm will be making several secondments to Riyadh over the coming months.