ACT

LEADING TREASURY PROFESSIONALS

The ACT Borrower's Guide to LMA Loan Documentation for Investment Grade Borrowers

Produced by

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BENCHMARKS SUPPLEMENT

NOVEMBER 2014

Introduction

Since March 2013 the LMA has made numerous adjustments to the definitions of LIBOR and Euribor and related provisions in its recommended forms of facility agreement for investment grade borrowers (the "**Investment Grade Agreements**"). These adjustments were due, in the main, to changes in the administration of those benchmarks and the discontinuation of certain maturities.

The LMA has now completed a more comprehensive review of the benchmark provisions, prompted by the global regulatory focus on the use of benchmarks in the financial markets and the bank community's reaction to that process. On 12 November 2014, the results of the LMA's review (the "**Benchmark Changes**") were incorporated into all of the LMA's recommended forms of facility agreement including, following discussions with the ACT, the Investment Grade Agreements.

In summary, the Benchmark Changes, most of which are presented as optional provisions:

- cater for the use of benchmarks other than LIBOR or Euribor;
- address contractually the possibility of intra-day rate re-fixing;
- ensure that Reference Bank Rates, where applicable, are quoted on the same basis as the Screen Rates they are intended to replace;
- provide the option to minimise significantly the circumstances in which Reference Bank Rates will be used as a fallback should the chosen Screen Rate be unavailable;
- move away from any assumption, arguably implicit in the Investment Grade Agreements since inception, that inter-bank lending costs are an accurate representation of Lenders' funding costs; and
- limit the liability of those banks who agree to act as Reference Banks and protect the confidentiality of Reference Bank Rates and Lenders' individual funding rates.

This supplement to the ACT Borrower's Guide to LMA Loan Documentation for Investment Grade Borrowers (the "**ACT Guide**")[1], summarises the key features of the Benchmark Changes and comments on their implications for investment grade Borrowers.

Clause references are to the latest version of the LMA's multicurrency term and revolving facilities agreement for investment grade borrowers and capitalised terms have the meanings given in that agreement, in each case, unless otherwise indicated.

Slaughter and May, 14 November 2014

1 Available from www.treasurers.org or www.slaughterandmay.com.

1. NEW FRAMEWORK FOR NON-LIBOR CURRENCIES

Non-standard benchmark provisions have become more common over the last eighteen months due to the contraction in the number of currencies for which LIBOR is quoted. LIBOR rates for Australian dollars, Canadian dollars, New Zealand dollars, Danish kroner and Swedish kronor were all discontinued during 2013.

The Benchmark Changes include provisions catering for Loans in "Non-LIBOR Currencies" priced off a benchmark to be agreed. These are an optional framework for the insertion of details of the applicable benchmark and related market conventions. To accompany this framework, the LMA has produced separately some "slot in" drafting for certain of the more commonly used interest rate benchmarks namely, BBSY (BID), BBSW, BKBM (MID), CDOR, CIBOR and STIBOR[2].

New optional Clause 35.4 (Replacement of Screen Rate) enables the incorporation of replacement benchmarks and related market conventions into the agreement with Majority Lender consent, subject to a "you-snooze-you-lose" clause[3]. This provision is part of the LMA's aim to "future-proof" the benchmark provisions far as possible. It could be used, for example, to effect the replacement of an agreed Screen Rate should it be discontinued during the term of the facilities.

Borrower Notes

The LMA's framework for non-LIBOR currencies and the slot-in drafting for certain benchmarks are useful additions to the LMA's drafting resources. For further information on non-LIBOR benchmarks, readers are referred to the ACT's guide to alternative rate sources[4].

[2] See "Domestic interest rate benchmark schedules for use in conjunction with the recommended form of Primary Documents", November 2014, available to LMA members from www.lma.eu.com.

[3] Which requires the relevant Lenders to respond within a certain number of days to the request for consent or lose their right to participate in the vote.

[4] Published in January 2013 and available from www.treasurers.org.

2. SCREEN RATES AND RATE RE-FIXING

ICE Benchmark Administration Limited ("**IBA**"), the administrator responsible for LIBOR currently has in place an error policy which provides for the intra-day re-fixing and re-publication of LIBOR rates where there has been an error in the calculation or submission process[5]. According to the policy, rates will be re-fixed or re-calculated if there is an error which exceeds the IBA's chosen materiality threshold (3bps) and that error is reported to IBA by 15.00 London time on the relevant day. Any re-fixed rates will be published by no later than 16.00 London time the same day. It is possible that similar policies may be adopted in relation to other benchmarks.

The LMA has amended the definition of Screen Rate in the latest versions of the Investment Grade Agreements, giving parties the option, in relation to any chosen benchmark, to use either the relevant rate as originally published, before any correction, re-calculation or re-publication by the relevant administrator, or the eventual rate for that day, as the same may be corrected, re-calculated or re-published.

Borrower Notes

The LMA explains the implications of IBA's error policy in relation to LIBOR under LMA facility documentation in a note to members, published in conjunction with the Benchmark Changes[6]. The note explains that whether or not parties choose to exclude the effects of a re-fixing and re-calculation of LIBOR is a commercial matter.

The revised rate may not arrive in the market until fairly late in the day (although as noted above, IBA's error policy includes a cut-off of 16.00 London time for the publication of any corrected rate). As a result, Agents (and possibly Lenders) may prefer to exclude the effects of rate re-fixing/re-calculation for operational reasons. Borrowers may take the same pragmatic view or may prefer to use the corrected rate.

For both Lenders and Borrowers, the operation of any interest rate hedging in the event of any correction to the first published rate may be a factor to consider. As the LMA mentions in its note, according to the 2006 ISDA Definitions, interest rate hedging will take account of re-fixed/re-published rates only if they are re-published within an hour of the publication of the original rate, so LIBOR re-fixes may not qualify.

5 See "Error Policy", available from www.theice.com/iba.

6 Note to members November 2014: LIBOR Error Policy and revised LMA facility documentation, available from www.treasurers.org or to LMA members from www.lma.eu.com.

3. REFERENCE BANKS AND REFERENCE BANK RATES

The Investment Grade Agreements have provided since inception for the use of Reference Bank Rates, should the agreed Screen Rate be unavailable. A group of around three Reference Banks are normally appointed by the Agent in consultation with the Borrower to provide quotes, which are averaged to produce a Reference Bank Rate.

Over the past year, it has become clear that many institutions are reluctant, or even unwilling, to act as Reference Banks. This is the result of a number of factors, including:

- for banks which participate in benchmark contributor panels, the potential for conflict with their new regulatory obligations to keep benchmark submissions confidential;

- concerns about whether it is possible to provide a proxy rate in circumstances where the Screen Rate is unavailable. If the Screen Rate is unavailable due to insufficient contributor quotes, for example, it is likely that the market is dislocated in some way which could also affect the ability of Reference Banks to quote; and

- whether it is appropriate for the Reference Bank role to involve unlimited responsibility to the other parties to the facility, in particular compared to the very limited exposure accepted by other administrative parties such as the Agent.

Acknowledging these difficulties, in the latest versions of the Investment Grade Agreements all Reference Bank provisions have been marked with square brackets as optional provisions and the role of the Reference Banks, where Reference Bank Rates are used, has been narrowed quite considerably (see sections 4 to 6 below).

Given that the process of benchmark reform remains ongoing, the definition of "Reference Bank Rate" has also been updated to ensure that it will operate as a proxy for the chosen benchmark, notwithstanding any future changes to the definition of the rate in question.

For example, pursuant to the latest versions of the Investment Grade Agreements, in relation to LIBOR, each Reference Bank is asked for the rate (rounded upwards to four decimal places) at which it could "*borrow funds in the London interbank market in the relevant currency for the relevant period were it to do so by asking for, then accepting, interbank offers for deposits in reasonable market size in that currency and for that period*" unless the rate LIBOR contributors are asked for is different, in which case, that rate definition should be used.

Borrower Notes

As noted in the June 2014 Supplement to the ACT Guide[7], a number of banks have determined as a policy matter that they will not act as Reference Banks either at all, or in relation to certain currencies. However, we are not aware of any English law syndicated transactions to date where the parties have agreed to dispense with the use of Reference Bank Rates altogether.

In some transactions, where there have been no Lenders willing to be Reference Banks on the date of the agreement the parties have generally agreed that the Reference Banks will be appointed by the Agent (in consultation with the Borrower) as and when required. The option to dispense with named Reference Banks is not reflected in the latest versions of the Investment Grade Agreements. It will be interesting to see whether any banks change their view on whether they are willing to act as Reference Banks in light of the Benchmark Changes outlined in sections 4 to 6 below.

[7] Available from www.treasurers.org or www.slaughterandmay.com.

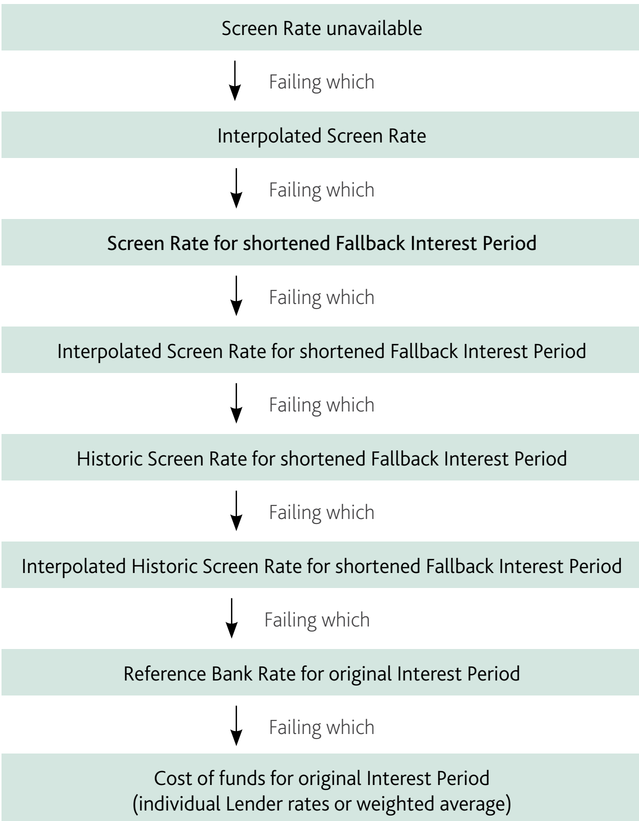
4. SCREEN RATE FALLBACK OPTIONS

Clause 11.1 (Unavailability of Screen Rate) in the latest version of the Investment Grade Agreements has been comprehensively redrafted, to provide for a greater range of fallback options in the event that the chosen Screen Rate is unavailable.

The Clause is now presented in two alternatives.

First alternative: the new benchmark waterfall

The first alternative, illustrated in the diagram below, is a complex waterfall of fallback options which, should the Screen Rate be unavailable and interpolation impossible, provides for the use of rates for a shortened "Fallback Interest Period" and "Historic Screen Rates" before moving to Reference Bank Rates and Lenders' cost of funds.



The length of the Fallback Interest Period is left blank to be agreed, but the intention is that it will be as short as possible. The Historic Screen Rate is defined as the most recently available rate for the relevant Interest Period, as of a day which is no more than a specified number of days ago.

Second alternative: Reference Banks and cost of funds

The second alternative is simpler and reflects the waterfall of fallback options that applied in previous versions of the Investment Grade Agreement. If the Screen Rate is unavailable and an interpolated rate cannot be calculated, the Loan is priced using:

- a Reference Bank Rate, or, if a Reference Bank Rate cannot be calculated (because none, or only one, of the Reference Banks provides a quote),

- Lenders' costs of funds.

The Reference Bank Rate level of each of the two alternatives is presented in square brackets to indicate that the parties may choose to dispense with Reference Bank Rates as a fallback.

Cost of funds

Certain changes have also been made to the basis on which Lenders' cost of funds will be charged. Previous LMA terms contemplated a different interest rate being paid to each Lender. Interest on the relevant Loan was calculated based on the rates notified by each Lender to the Agent as its cost of funds from a source reasonably selected by that Lender.

Under the new drafting scheme, the rate notified by each Lender for this purpose is defined as its "Funding Rate". New Clause 11.4 (Cost of funds) provides two options for calculating cost of funds. Either, the parties can choose to pay the individual Funding Rate of each Lender as previously. Alternatively, the parties may use the Funding Rates notified by each Lender to calculate a single weighted average rate, which is applied to payments to all Lenders. If this new weighted average option is used, if any Lenders do not notify the Agent of their Funding Rate, the weighted average of the remainder will apply.

Borrower Notes

Which alternative to choose?

We have noted a general trend in syndicated facilities towards more complex benchmark fallback arrangements which minimise the likelihood that Reference Bank Rates will apply. Provisions along the broad lines of the new first alternative version of Clause 11.1 started to appear in loan documentation some time ago.

Certain Lenders may be nervous about using Historic Screen Rates other than for a very short period, especially in circumstances where the Screen Rate is unavailable due to disruption in the market. However, the LMA definition of "Historic Screen Rate" specifies the most recently available rate, which is in any event no older than a specified number of days (for example, between three to five Business Days). The Fallback Interest Period concept is also intended to address concerns about the advisability of longer-term reliance on a Historic Screen Rate.

It is therefore anticipated that the first alternative version of Clause 11.1, the more complex benchmark waterfall will be attractive to Agents, especially those managing larger syndicated facilities. It offers a mechanism for overcoming the short-term unavailability of the Screen Rate without the need to provide Reference Bank Rates, cost of funds quotations or engage Lenders in a discussion with regard to alternative rates.

Borrowers might also prefer the first alternative to stave off the application of Reference Bank Rates and/or Lenders' cost of funds as far as possible.

Impact on interest rate hedging

Borrowers who rely on interest rate hedging may wish to bear in mind that the use of fallbacks based on Historic Screen Rates is not reflected in current ISDA terms, which generally provide only for a fallback to Reference Bank rates. However, to date many interest rate hedging arrangements have been unlikely to cater precisely for the more remote contingencies of the pre-existing position. For example, if sufficient Reference Bank quotes are unavailable, the rate according to the ISDA 2006 Definitions is the mean of the rates quoted by major banks selected by the Calculation Agent. Hedging by reference to Lenders' cost of funds would require bespoke drafting.

When is a Screen Rate "unavailable"?

Contingency measures put in place by benchmark administrators more recently may decrease the likelihood of contractual fallback options being triggered in any event.

IBA currently has in place a contingency plan which specifies that if inputs are received from fewer than 4 banks (or no inputs are received), a new rate for that day will not be calculated. Instead, the LIBOR rate for the previous day will be re-published and treated as the LIBOR rate for that day. The Euribor Code of Conduct makes similar provision.

These contingency plans potentially narrow the circumstances in which fallback provisions might be invoked, although there remains some possibility of disputes as to whether contractually, a previous day's rate should be treated as the current day's rate.

Individual Funding Rates or weighted average?

The impact on the Borrower of the new option to measure cost of funds as a single weighted average of the Lenders' individual Funding Rates is difficult to judge. We understand it has been introduced for operational reasons, so it might be anticipated that the average rate will be preferred by Agents. If we have understood correctly how the weighted average will be calculated (based on the participations of each Lender in the Loan), it would not seem to affect the overall amount of interest paid by the Borrower on the relevant Loan. However, whether it has any impact on the longevity of the application of cost of funds and Lenders' appetite to notify the Agent pursuant to the market disruption provisions may depend on the particular dynamics of the syndicate in question.

5. MARKET DISRUPTION

The Borrower may become obliged to pay interest based on Lenders' cost of funds as a result of the operation of the benchmark fallback provisions described in section 4. Cost of funds may also apply as a result of the market disruption clause.

Clause 11 (Changes to the Calculation of Interest) has been comprehensively redrafted to incorporate the Benchmark Changes. The market disruption provisions have moved to Clause 11.3 (Market Disruption).

Clause 11.3 provides that interest will be calculated either on the basis of Lenders' individual Funding Rates or a weighted average of those rates (see section 4 above) if the specified proportion of Lenders notify the Agent that the cost to them of funding their participation in the Loan *"[from whatever source [the relevant Lender] may reasonably select]/[from the wholesale market for the relevant currency]"* would be in excess of the agreed benchmark.

Under previous LMA terms, the market disruption trigger for a move to cost of funds was different. It required the specified proportion of Lenders to notify the Agent that the cost to them *"of obtaining matching deposits in the [relevant inter-bank market] would be in excess of [LIBOR/Euribor]"*.

Borrower Notes

Market disruption trigger

The LMA's decision to alter the market disruption trigger for a move to cost of funds is understood to be an updating measure. For a number of reasons, loan participations may not be funded in the inter-bank market[8]

This change, of itself, may have a limited impact on Borrowers in practice. It may even operate in the Borrower's favour as Lenders may be able to fund at a rate closer to the agreed benchmark rate outside the inter-bank market. If the first option provided in the revised drafting is chosen and Lenders are free to select their funding source, they are required to act reasonably which provides some safeguard against the choice of an expensive funding source if the relevant Lender has access to cheaper alternatives.

Nonetheless, the change may prompt users to refocus on the operation of this Clause in light of changes in funding conditions since the Investment Grade Agreements were first published around 15 years ago. It has long been the case that some banks are unable to fund themselves at LIBOR or Euribor, at least in the inter-bank market. Further, non-bank lenders who cannot fund themselves at LIBOR in any circumstances are participating in syndicated loans, although perhaps not on a widespread basis in the investment grade market.

As a result, the market disruption clause in many syndicated facilities may, in theory at least, be capable of operation regardless of any disruption in any market. That may have been the case under both the previous and the current versions of the Investment Grade Agreements. However, while attention is focussed on benchmarks, Borrowers may wish to think about whether that is a reasonable position for Lenders, who have agreed to participate in the facilities based on an agreed benchmark, to take. The heading of the Clause, "market disruption", arguably suggests it to contain provisions to cater for the consequences of an adverse change in funding conditions. That is likely no longer to be the case.

The market disruption provisions also seem out of step with other cost-plus mechanics in the Investment Grade Agreements. For example, the tax gross-up and the increased costs clause are both primarily focussed on entitling Lenders to be reimbursed costs incurred in the event of an adverse change vis-à-vis that Lender's day 1 position. .

8 In its 20 October 2014 "Position Paper on the Evolution of ICE LIBOR", IBA notes the reduction in unsecured inter-bank lending and outlines a number of the driving factors.

Clause 11.3 could be adjusted to incorporate an adverse change concept. For example, the Clause could provide that a move to cost of funds may only be triggered as a result of individual Lenders' funding costs if those costs have increased materially or as a result of a material and adverse change in funding conditions generally.

It remains to be seen whether Lenders would react favourably to any proposals along those lines. Lenders may point out that the Clause as drafted requires Lenders representing a material proportion of the Loan in question to notify the Agent that they are unable to fund as the agreed benchmark, which in many cases should protect the Borrower from the Clause being invoked by a minority of Lenders. However, although historically the agreed threshold here was often Lenders whose participations represent 50% of the Loan, there has been some downward pressure on this figure in recent years, with many deals at 35%. It is suggested that this is an important point for Borrowers to negotiate, at least pending any more wide-ranging adjustment to this Clause.

In addition, Borrowers should consider the suggestions in the new footnotes to Clause 11, which were added at the request of the ACT. They remind users to consider whether the Borrower should have rights to replace any Lender that notifies Agent it cannot fund at the agreed benchmark or to revoke a Utilisation Request relating to a Loan which subsequently needs to be priced on a cost of funds basis.

Alternative market disruption provisions

The alternative market disruption provisions which form part of the LMA's Finance Party Default and Market Disruption provisions (the "**Market Conditions Provisions**") have also been amended. The basic architecture remains, but the detail has been updated in line with the Benchmark Changes. The alternative provisions are described in the ACT Guide in the commentary on Clause 11. They are not widely used in investment grade loan agreements. As they require the appointment of two sets of Reference Banks it is anticipated that they might be used even less often going forward.

6. PROTECTION OF REFERENCE BANKS AND CONFIDENTIALITY

A number of new protections for Reference Banks have been introduced as part of the Benchmark Changes.

These include new optional Clause 26.18 (Role of Reference Banks), which provides that no Reference Bank is obliged to quote and excludes the Reference Banks' liability save for gross negligence and wilful default. It also provides that no party may take action against the officers and employees of a Reference Bank.

New Clause 37 imposes obligations on the Agent to keep Reference Bank quotes confidential and obligations on both the Agent and the Obligors to keep Funding Rates confidential.

Borrower Notes

The Reference Bank role is an administrative role, similar to that of the Agent. As such, the Borrower might accept that is reasonable for Reference Banks to limit their liability along similar lines to the Agent.

The new confidentiality provisions in Clause 37 have been adopted in light of LIBOR contributors' obligations under the LIBOR Code of Conduct for Contributing Banks to keep their funding rates confidential, which is in turn designed to implement IBA's obligations under the Financial Conduct Authority regulatory regime applicable to benchmark administrators[9]. Paragraph 4.12 of the Code permits the disclosure by contributing banks of submitted rates to individuals who have a commercially reasonable business need to know and/or to certain customers, so long as "appropriate arrangements for preserving confidentiality" are in place. Reference Bank quotes (which, as noted in section 3 above, are designed to be a proxy for the relevant benchmark) and "Funding Rates" are treated as subject to the same confidentiality requirements as LIBOR rate submissions for this purpose.

[9] MAR 8.3.3 and MAR 8.3.4 of the FCA Handbook require benchmark administrators to maintain arrangements designed to ensure the confidentiality of benchmark submissions.

7. BENCHMARKS IN SWINGLINE FACILITIES

One aspect of the Benchmark Changes affects only the Investment Grade Agreements that incorporate swingline facilities. The Reference Bank benchmark applicable to the LMA's euro swinglines has been replaced with the screen rates for either EONIA or the overnight euro LIBOR rate ("**Overnight LIBOR**").

If EONIA/Overnight LIBOR is unavailable on screen, a variety of options are offered as the possible fallback: a historic screen rate, a Reference Bank Rate or cost of funds (determined in the same way as outlined in section 5 above in relation to other benchmarks).

No specific changes have been made to the benchmark provisions applicable to dollar swinglines. The applicable interest rate remains the higher of the prime commercial lending rate in dollars announced by Agent and in force on that day and a specified percentage above the Federal Funds Rate published by the Federal Reserve Bank of New York for that day.

Borrower Notes

Most current euro swinglines are priced off Reference Bank rates in our experience. We understand that the LMA's preference for published screen rates is the result of the concerns about the availability of Reference Bank quotes and the reluctance of certain institutions to act as Reference Banks outlined in section 3 above.

Treasurers will be aware that EONIA and Overnight LIBOR have dipped in and out of negative figures since August 2014. Payments based on these rates (and any other benchmark rates) under current LMA terms are subject to a zero floor, with the effect that if LIBOR is negative, it will be deemed to be zero for the purposes of the agreement.

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Copies of the ACT Guide (April 2013) and the June 2014 Supplement are available via the Slaughter and May website (www.slaughterandmay.com) and the ACT's website (www.treasurers.org).