



# Managing Risk in a Volatile Landscape

## Also in this issue

- FIRST INTERVIEW WITH ADAM FARKAS
- LOAN REFERENCE RATES: LENDER OR BORROWER – DO I OR SHOULD I CARE
- CREDIT RISK: MAKING THE “RIGHT” DECISION
- SIGNIFICANTLY ENHANCING RISK MANAGEMENT IN THE INSURANCE INDUSTRY
- AUDITING SOLVENCY II – ORSAs FOR CORSAs
- WHEN THEY CALL YOU – WHO ARE YOU GONNA CALL?
- THE FUTURE OF GLOBAL FINANCE

# LOAN REFERENCE RATES: LENDER OR BORROWER – DO I AND SHOULD I CARE?

*Simon Ling-Locke is a bank credit risk specialist and a regular contributor to the Global Risk Update.*

When we consider lending by way of loan facilities to most borrowers from the mid-sized corporates to the largest multinationals around the world (whether on a bi-lateral, club or syndicated basis) we know that it will have been documented through a facility agreement and that a number of those provisions in the agreement will have been heavily negotiated between lender and borrower, particularly around margins, fees, covenants and borrower undertakings. These are known as soft provisions which will tend to be tailored to each deal as against the hard provisions where one would expect the legal wording in agreements to be mostly standard from one agreement to another (such as the definition for interest periods). Historically the definitions for LIBOR or EURIBOR<sup>1</sup> and those for market disruption<sup>2</sup> were considered to be hard provisions which did not require heavy negotiation and were accepted by lenders and borrowers alike without question. That perception changed it seemed for a period of time during 2008, particularly after the collapse of the Icelandic banks and Lehmans, but has since drifted back into obscurity. Is that right and should we be concerned if there is another bout of severe market disruption in the interbank markets?

Firstly we must define what LIBOR means since it is used as a proxy for each lender's cost of funds. LIBOR (or EURIBOR in the case of lending in Euros) is meant to be the rate at which large soundly rated banks (A and AA type rated institutions) offer money into the market whilst LIBID is the rate at which these banks bid for and accept deposits from the market. The premise that LIBOR 'is the cost of funds' for a bank or financial institution has though been accepted as the appropriate reference index for many years but in reality it is not! Particularly in 2008 many of the major banks of the world were technically quoting LIBOR rates which were significantly below their own money market cost of funds (let alone those of other smaller banks and financial institutions) but they were not actually willing to lend out to other institutions at their quoted LIBOR rates. This, I think, reflected both the fear factor of whether the requesting institution might be the next Lehmans to fail reflecting the opaqueness of business activities in the financial markets and hence with whom the risks actually lie since so much of the business is handled on an OTC<sup>3</sup> basis, but also a desire to pretend that their own funding base had not, so to speak, shot through the roof for fear of what such messages could have conveyed to the wider retail deposit market. Imagine the perception from the ordinary man or woman in the street if



they had heard after some sensationalism by elements of the press that their bank could only fund itself at excessive rates in the money markets whilst Base, Fed and ECB rates had come down to such low levels, especially after the very public failures of Northern Rock, the Icelandic banking system and Lehmans which had already shaken their faith in the banking system to its very foundations.

In reality almost all lenders do not match-fund loans but instead fund from available liquidity and intra-day treasury activity with more of their hardcore asset base funded by a combination of deposits, longer term debt issuances, share and quasi share capital and retained earnings. Clearly therefore LIBOR does not reflect a lender's cost of funds. Indeed the lender also has to consider requirements of the Basel accords on cost of capital and the commercial return it requires for the risk of lending to a particular counterparty. These elements are reflected in the margin which is added to LIBOR but if LIBOR is not a true reflection of 'funding cost' how will the lender know if it is achieving an overall return which is commensurate of its funding costs and desired return for the risk level accepted?

One way is for the bank to charge its own 'LIBOR' rate. Indeed in the 1980s it was not so unusual to find a bank on a bi-lateral facility offering its customer a LIBOR rate determined by its own treasury department rather than from an aggregated screen rate. However, this effectively switched the bank's own funding risk onto the borrower and hence the borrower could find that it was paying not just for its own risk in the margin but also for the risk perceived by the market of that lender who had to fund itself above LIBOR. This was particularly evident during a period in the 1990's, after a number of the major Japanese banks had suffered heavy losses from previous poor property lending decisions and prior to the Japanese government having introduced bank support programmes. During this time some of the Japanese banks might have had to pay perhaps 50-100bp over LIBOR to fund themselves from the market.

If LIBOR is determined by the lender itself then there is potentially the risk of forcing a borrower to effectively pay three elements: the market rate for LIBOR, a margin to cover the lender's individual risk of funding itself and a margin to cover the borrower's risk and profit margin sought by the

## LOAN REFERENCE RATES: LENDER OR BORROWER – DO I AND SHOULD I CARE?

lender! For example a bi-lateral loan at LIBOR plus a margin of 50bp from one bank could effectively have been say LIBOR+50bp plus a margin of 50bp from a Japanese bank. Conversely, if LIBOR is determined collectively by a few large market players as displayed in a screen rate or a reference rate, then it may well not reflect the true funding cost of many of the other players in the market. Indeed during the 2000s it was well known in the syndicated loan market that more and more of the small and medium sized players were being squeezed out of the corporate market because the LIBOR and margins on offer were insufficient to cover their true cost of funds and desired profit targets, leading some of these institutions into higher risk areas such as leverage financing and securitised deals with even more sorry consequences!

The problem for a number of lenders was compounded in 2008 and into 2009 when quoted LIBOR rates did not reflect even the cost of funds of those institutions providing the quotes. In syndicated loans across the world during this period some lenders, usually small domestic and regional banks, tried to invoke market disruption clauses which, if successful, would have allowed them to have charged more realistic market funding rates. However, invariably these lenders did not form a sufficient quorum to actually be able to invoke the clause and were thus frustrated in their actions and as a consequence suffered losses as they were forced to continue to lend at rates below their own cost of funds. This dilemma has subsequently diminished somewhat as liquidity has come back into the interbank market. Nevertheless markets are still quite fragile and significant risks remain which could once again lead to a drying up of liquidity and false LIBOR rates being quoted.

Is there an answer? Clearly allowing lenders to quote their own LIBOR only switches the risk onto the borrower and should a borrower necessarily be penalised just because a lender's own credit standing has diminished since the loan was first provided? One answer which was considered in the syndicated loan market in the 1980s was the concept of committed revolving back-up loan facilities with uncommitted tender panels incorporated within them, known as MOFs<sup>4</sup>. Under these structures a borrower would ask its lenders to bid for short term loans. Each lender had the choice whether to bid at whatever rate they chose, or not to bid at all, on the uncommitted tender panel whilst the borrower had the choice of either accepting some or all of

those bids or reverting to a draw-down on the committed loan facility. Under these structures some lenders would sign-up to both the committed and uncommitted facilities while others just participated in the uncommitted lines. This structure allowed the borrower to undertake best price discovery and provided market discipline amongst lenders in terms of their treasury activities. However, it also had perverse consequences which became apparent during the recessionary period of the early 1990s. On a number of these deals a previously investment grade corporate rapidly fell into difficulties resulting in breaches of covenants and an inability to drawdown under the committed facility. At this point it was often found that the lenders who had drawn exposure were those participating in the uncommitted lines and were expected, as they had drawn exposure, to work through long-term restructuring plans whilst committed but undrawn lenders tried to walk away relying on the fact that covenant breaches prevented new committed drawings! For the borrowers as well it proved more complicated because lenders with drawn exposure were not necessarily their 'core banks' so increasing the difficulty of undertaking a workout.

Another option is to use a wider representative group of banks within each syndicated deal to quote each of their cost of funds to represent their average cost of funds which is then applied for all the lenders. Again, though this does require each reference bank to quote its true cost of funds. Furthermore, in the cyclical field of syndicated lending, competition amongst arrangers increases all too quickly and after the crash of 2008 has already resulted in more and more give-aways to borrowers including the use of screen reference rates rather than a reference rate from a group of quoting banks within the actual syndicate.

Alternatively, the use of prices quoted for government securities, such as UK Gilts or US Treasuries, as an index could be used. This still does not resolve the fact that lenders fund the loans at their own cost of funds. It might, however, overcome the problem of miss-priced quotes from major banks being used for screen LIBOR/EURIBOR rates. In reality though, the chances of changing a whole market would seem to be very low, so for lenders the truth is that the margin should reflect not just risk, opportunity cost, capital adequacy implications and profit margin but also needs to price in liquidity risk of funding.

Simon Ling-Locke can be reached at [SLL@riskrewardlimited.com](mailto:SLL@riskrewardlimited.com)

<sup>1</sup> IBOR = London Interbank Offered Rate

<sup>2</sup> EURIBOR = European Interbank Offered Rate

A market disruption event means one of the following events:

(a) if on the quotation day for the relevant interest period the screen rate (by the British Bankers Association, or the Banking Federation of the European Union if for Euros) is not available and none or only one of the Reference Banks supplies a rate to the agent to determine LIBOR (or EURIBOR); or  
(b) before close of business on the quotation day for the relevant interest period, the agent receives notifications from a lender or lenders (whose participations in the loan exceeds a certain percentage of that loan) that the cost to it of obtaining matching deposits in the relevant interbank market would be in excess of LIBOR (or EURIBOR).

<sup>3</sup> OTC = Over the Counter, a private trade made directly between two parties which means that there is counterparty risk. This is different to trading through a regulated exchange where that risk is removed through the use of a CCH (Centralised Clearing House)

<sup>4</sup> Multiple Option Facilities

For further information please contact:

**Dennis Cox – CEO**  
telephone: +44 (0)20 7638 5558  
email: [DWC@riskrewardlimited.com](mailto:DWC@riskrewardlimited.com)

**Lisette Mermod – New York**  
telephone: 1-914-619-5410  
email: [LM@riskrewardlimited.com](mailto:LM@riskrewardlimited.com)

**Joanna Kraska – Public Relations**  
telephone: +44 (0)20 7638 5558  
email: [JK@riskrewardlimited.com](mailto:JK@riskrewardlimited.com)