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Who Said the Rules of the Game Could Change Because LIBOR's Going Away?

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There's been a lot of discussion in the fixed income world about the end of the London Interbank Offered Rate (LIBOR) and what might replace it. But what hasn't been as widely discussed is an important consequence for investors in this space: changes to LIBOR language in new-issue and amended credit agreements—particularly how these changes are implemented. Mark Boyadjian, director of our Floating Rate Debt Group, and Reema Agarwal, vice president and director of research, explain.

Background

For decades, lenders worldwide have used the London Interbank Offered Rate (LIBOR) to set interest rates for a variety of financial products, including interest rate swaps, student loans, mortgages, collateralized loan obligations (CLOs) and syndicated floating rate loans in which a group of lenders known as "the syndicate" work together to provide funds for a single borrower at a variable interest rate.

A panel of leading banks active in London set the LIBOR rate, which represents the level they have determined they can borrow short-term, unsecured funds in the interbank market. Put simply, LIBOR represents the average interest rate they (banks) would charge each other for a loan, and its widespread use by so many market participants was based on its construction and availability.

Hundreds of trillions of dollars' worth of interest rate exposure is tied to LIBOR,[1] which until recently was seen as a standard and accurate rate by a wide swath of market participants.

LIBOR has been beset with multiple pricing scandals over the past few years, casting doubt on the pricing process and its validity as a reference rate. The result is that LIBOR will eventually be discontinued. The Financial Conduct Authority has confirmed that the future sustainability of LIBOR can't be guaranteed, but 20 of the LIBOR panel banks will continue to support it until 2021.

Why LIBOR's Fate Matters to Us

It remains unclear what benchmark will replace LIBOR in the syndicated floating rate market. Notwithstanding the recent rise in LIBOR (roughly 100 basis points in the last six months) a change would require amendments to the contracts and credit agreements underlying trillions in global assets. The interest rates on many of these financial instruments are currently set based on LIBOR. If an alternative benchmark does not reflect the risk and return signatures provided by LIBOR, such a change will likely result in a resetting of the credit spreads syndicated lenders charge and borrowers are willing to pay for these assets.

In situations where there is a syndicate, the lenders participating in this group agree to fund the loan together which enables them to spread the risk of default across other entities. These loans are typically larger than a single lender could handle so the role of the syndicate is important. The terms of the loan agreement must be agreeable to all of the lenders, regardless of whether they are known to each other or not.

Typically, if a borrower wishes to make a change to a loan agreement, he or she would contact the group of lenders in the syndicate (usually through the agent) to communicate and explain the reason for the proposed change. Amendments to existing credit agreements can represent complex or simple requests. For example, there could be a request for an extension of the deadline to file quarterly financial statements, or to push out the maturity date of a loan.

Generally, a borrower would need the affirmative approval of a clear majority of the lenders of record prior to the amendment's changes taking effect. [Changes to more material terms of a loan (e.g., interest rate and maturity) would require the approval of all lenders.] The lenders collectively decide whether to grant, withhold or renegotiate any proposed amendment to the terms of the credit agreement. This would include a change to the interest rate being paid on the loan.

Getting back to LIBOR, in most credit agreements, there is backup or contingency language for the temporary replacement of LIBOR. For example, the prime rate is frequently referenced as a substitute, in the event LIBOR is unavailable. However, the prime rate is typically higher than LIBOR, and naturally, the borrower's goal is to minimize their interest payments on the loan. Therefore, the borrower would only be obligated to use a substitute rate, if the LIBOR is unavailable and could revert back to LIBOR upon its being available.

Now, faced with the likelihood of LIBOR going away permanently, instead of treating the LIBOR change as a typical affirmative amendment—which should require the consent and approval of the clear majority of the group of lenders—some borrowers are issuing new or amended credit agreements with a reference rate of their choosing, and if a certain number of lenders don't reject (or "opt out" of) this replacement choice, they are automatically accepted.

This is a disturbing and unfortunate market dynamic that concerns us as investors. Historically, in the syndicated floating rate leveraged-loan market, LIBOR has been a primary component of the income generated for investors. So, adding new terms to a loan agreement that require lenders not to participate, if they don't like the new interest rate could negatively impact our investors and jeopardize these traditional sources of income.

A Slippery Slope

Essentially, the most offensive examples of the LIBOR replacement language allow administrative agents and companies (borrowers) to amend the credit agreements in the future without a lender's affirmative consent, which then changes the future risk profile of the investment. In our view, it's a fundamental rule of lending that each affected lender should affirmatively consent to any proposed reduction or change in the interest rate or benchmark of a loan.

In some cases, these new and amended credit agreements state that the changes will become effective unless 50% of lenders object within five business days of notice. This is a significant change from the way these types of changes were traditionally handled. We believe it is not realistic or likely to expect lenders to respond negatively (i.e., to opt out) within five business days, particularly given lenders as part of this syndicate group often are unknown to each other and therefore have no way to engage each other to discuss such a change or what an acceptable alternative would be. We are seeing very little transparency with these changes and it appears intentional—as though the borrower or agent bank is seeking the option to unilaterally negotiate better terms in a way that will minimize the lenders taking notice, including their ability to be in a position to constructively negotiate an acceptable alternative.

Investor Rights Being Diluted

If lenders allow changes to be made to credit agreements that permit the agent or borrower to select a LIBOR replacement without their affirmative acceptance, they are all accepting an erosion of lender protections—protections which we think are critical to our asset class and our investors—while simultaneously receiving no commensurate compensation for giving this option away.

As troubling as this new practice of negative consent for credit-agreement amendments on LIBOR replacement is, the language and substance of some are egregious. We have seen provisions in new and modified credit agreements that permit the borrower to change the reference rate from LIBOR, without ANY lender approval. Furthermore, in some cases, this language was not in draft documentation sent to investors. It was added to final executed versions of the credit agreements, which raises questions of ethical business practices.

The legality and underhandedness of inserting such a provision are debatable, but we are taking a proactive approach in responding to this development. We are watching for this type of language in draft credit agreements of any new-issue transactions and in amended credit agreements of repricings we are considering investing in.

As an investor, we do not believe these new or amended forms of credit agreements are in the best interests of our clients. We are seeking to require prior consent and approval of any changes made to the LIBOR or reference benchmark rate in the final credit agreement as a condition of investing. We have also seen several repricing transactions recently with unfavorable replacement language added, and have taken an active decision in some cases to eliminate or dramatically reduce our exposure to those borrowers.

We encourage our peers and competitors to seek to protect their clients' investments by negotiating unfavorable LIBOR replacement language out of new or amended credit agreements. We believe that any change to the usage of LIBOR should require an affirmative amendment process with >50% consenting lenders approving any replacement index. In other words, a majority of lenders would need to collectively opt in, rather than be pressured to organize quickly to opt out.

In our view, there is a simple solution to the issue of determining what will replace the LIBOR benchmark in credit agreements—treat this change like a regular amendment that seeks outright majority approval, and let us have a voice in the matter.

What Are the Risks?

Franklin Floating Rate Daily Access Fund

All investments involve risks, including possible loss of principal. Investors should be aware that the fund's share price and yield will fluctuate with market conditions. The fund should not be considered an alternative to money market funds or certificates of deposit (CDs). The floating-rate loans and debt securities in which the fund invests tend to be rated below investment grade. Investing in higher-yielding, lower-rated, floating-rate loans and debt securities involves greater risk of default, which could result in loss of principal—a risk that may be heightened in a slowing economy. Interest earned on floating-rate loans varies with changes in prevailing interest rates. Therefore, while floating-rate loans offer higher interest income when interest rates rise, they will also generate less income when interest rates decline. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value. The fund is actively managed but there is no guarantee that the manager's investment decisions will produce the desired results. These and other risks are discussed in the fund's prospectus.

Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN/342-5236 or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.

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1. Source: ICE Benchmark Administration.