

DRAFTING NOTES

THE "INTEREST" AND "MARKET DISRUPTION" CLAUSES

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INTRODUCTION

Under a loan agreement, a lender, in many cases a bank, agrees to make a loan available to a borrower. The lender advances an amount of money and the borrower commits to repay it at the specified time or times and to pay the interest accrued on the principal.

The parties can document a loan in a relatively simple agreement providing only the essential terms, such as the amount borrowed, the maturity and the interest rate. Most loan agreements, however, are more elaborate documents whose terms depend on, among other things, the purpose of the loan, the amounts borrowed, the creditworthiness of the borrower and the existence or not of collateral.

In this paper we review the "interest" and "market disruption" clauses of a typical international commercial loan agreement, in particular the rules for calculating interest, the distinction between fixed and floating rates and the way reference rates are formed and determined. We also discuss the market disruption clause as a protective mechanism for situations in which the reference rate cannot be determined.¹

¹ The main loan models now used in international markets are the Loan Market Association ("LMA") model, widely adopted in the European syndicated loan market, and the Loan Syndications and Trading Association ("LSTA") model, which is extensively employed in the United States. For commentary and further reference see *The ACT Borrower's Guide to the LMA's Investment Grade Agreements* (KATHRINE MELONI, Slaughter and May, 6th edition) and *The LSTA Complete Credit Agreement Guide* (BELLUCCI AND MCCLUSKEY, Milbank, 2nd edition, McGraw-Hill, 2017).

This is the second of a series of articles reviewing the key terms of international loan agreements. Subsequent papers will cover:

- utilisation of the loan and conditions precedent;
- representations and warranties;
- positive and negative covenants;
- financial covenants;
- events of default and acceleration;
- assignment and transfer;
- remedies and waivers; and
- governing law and dispute resolution.

1. THE "INTEREST" CLAUSE

1.1. Fixed and Variable Interest Rates; Formation of the Interest Rate

Interest is the amount the lender charges the borrower as consideration for making the loan, generally calculated as a percentage of the amount lent. It compensates the lender for the risks inherent in lending money and for its cost of capital, and it provides the lender's profit from the loan.

Interest is typically calculated on the principal amount alone. In some cases, the parties add accrued interest to the principal, so that interest runs on a higher total. Some jurisdictions prohibit compound interest or restrict it to default interest.

Most international loan agreements set out rules concerning the calculation of interest that broadly follow these guidelines:

- (a) interest accrues daily, adding each day a further amount to the total owed, because this reflects the actual time the borrower has held the funds;

- (b) interest runs from the day the money is borrowed until full repayment, excluding the day of payment. It begins to accrue when the lender advances the money and continues until the borrower has repaid everything owed, including accumulated interest; and
- (c) interest is calculated on the actual number of days elapsed, on a 365-day or 360-day year basis. Rates are expressed as annual rates, so the calculation apportions the rate to the time elapsed in the relevant period. Another time reference would create unnecessary differences in the calculation of interest.

The interest rate can be fixed, remaining unchanged during the term of the loan, or floating, in which case the lender charges a margin over a reference rate that accounts for its cost of obtaining money in the interbank market.

The more commonly used reference rates in international finance are:

- (a) Euribor (Euro InterBank Offered Rate);
- (b) SOFR (Secured Overnight Financing Rate);
- (c) SONIA (Sterling Overnight Index Average); and
- (d) TONA (Tokyo Overnight Average Rate).

The loan agreement must also specify the interest payment dates. Interest is generally paid monthly, quarterly, half-yearly, or yearly.

For commercial and bank loans in the Eurozone countries, Euribor is the reference interest rate of the euro interbank market for the relevant period, administered by the European Money Markets Institute in association with the ACI Financial Markets Association and published on the EURIBOR01 page of Thomson Reuters. The agreement usually defines "Euribor" broadly enough to cover the replacement of the administrator or a change in the method of publication of the rate.

In theory, Euribor reflects banks' cost of refinancing in the interbank market, although this is not an actual cost, since banks may access various sources of capital to finance the loans they grant to their clients. Even so, Euribor approximately tracks those costs: if most banks can access more funds than those available in the interbank market, they can charge rates lower than those of banks operating in that market, and Euribor should decrease. Euribor is in turn set by reference to another rate, the European Central Bank (ECB) discount rate, at which banks may deposit funds with the ECB. The two

rates are related because banks may deposit available funds with the ECB and receive remuneration or lend them in the interbank market, and they will only do the latter if the remuneration is higher, since depositing with the ECB carries less risk than lending to other banks. Euribor and its equivalents for sterling, the US dollar or the yen (or any other currency) are therefore higher than the discount rates of the respective central banks.

Banks view this value as a cost because, when they do not have funds available, they must resort to the market to finance their activity, although, as noted above, this is not absolutely precise. The cost will tend to be lower if the bank has resources at a lower cost, and higher if it cannot obtain funds at costs equal to Euribor, which is the case of undercapitalised banks. For this reason, in times of economic crisis interest rates tend to increase, reflecting the difficulties banking activity faces, even though the ECB and other central banks may lower the refinancing rate to encourage financing of the economy. The margins (spreads) between the ECB discount rate and Euribor, and between the latter and bank rates, will tend to widen.

The rate agreed by the parties is the sum of the reference rate (of which Euribor is an example) and the margin, which defines the return the lender expects to obtain. In addition to the margin, the lender may require payment of the costs of maintaining own funds, i.e. the costs (expressed as a percentage) of complying with the capital reserve obligations that European Union Regulation 575/2013 and Directive 2013/36/EU, which implement the Basel III guidelines, impose on banks. Loans with higher risk or weaker collateral require larger capital reserves and yield less, which leads banks to seek a wider margin over Euribor.

Reference rates can turn negative, as Euribor did between 2015 and 2022. Lenders responded with the zero floor: if the reference rate falls below zero, the agreement deems it to be zero, so that a negative rate does not erode the margin. Some jurisdictions restrict these floors in consumer credit and personal mortgages; in commercial loans the floor is a matter for negotiation.

The rate set by the lender reflects the risks associated with the loan, but the banking and credit markets are competitive, and the lender the borrower has chosen can be expected to offer the most competitive rate possible, taking into account the legal and economic terms of the agreement, the collateral offered by the borrower and the conditions of the financial markets at the date the loan is contracted.

1.2. Interest Periods

In floating rate loans, the parties divide the life of the loan into successive interest periods, usually of one, three or six months. The reference rate is set for each period on the quotation date and interest is paid on the last day of the period. For term benchmarks such as Euribor, the applicable rate is generally fixed by reference to a quotation date before the start of the period; for compounded overnight rates such as SOFR or SONIA, the rate is generally calculated in arrears from daily observations during the period. Interest is paid on the relevant interest payment date.

If a period would end on a day that is not a business day, it is extended to the next business day or, if that day falls in the following month, shortened to the preceding business day. The final period ends on the repayment date. Shorter periods track market movements more closely; longer periods give the borrower certainty of cost within each period.

1.3. Modification of the Interest Rate by Unilateral Decision of the Lender

Loan contracts may include clauses allowing the lender to adjust the interest rate when the risk weighting or other circumstances affecting the profitability of the loan change, typically in the following situations:

- (a) the imposition of new taxes or an increase in taxes payable by the lender as a result of entering into the contract or granting the loan, namely income taxes or withholding tax on interest;
- (b) additional costs arising from compliance with legal obligations relating to the creation of provisions and capital reserves in respect of the loan; and
- (c) changes in legal rules that result in a reduction in the value of payments due to the lender or in the effective profitability of the loan.

These clauses are widely used but some have been stricken down in European countries, particularly where they are contained in standard terms and confer an unrestricted or insufficiently controlled power to alter the rate. These issues must be taken into account when drafting market disruption clauses so that they are less open to attack.

Modification of the interest rate by unilateral decision of the lender is equivalent to a right to modify the price or other economic terms of the contract. In principle, if the parties have agreed to grant this right to one of them, what has been agreed prevails.

Numerous contracts, namely lease and distribution contracts, contain clauses for automatic price adjustment or adjustment after notice, which permit an increase in the price or remuneration due for goods not yet delivered or services not yet rendered but already owed under the contract. Price alteration by unilateral decision of one party also occurs in the provision of services. The alteration of the price of a good sold, whether delivered or not, is less common.

In loan and financing contracts, the alteration of interest alters the "price" or consideration due for the loaned capital, which is at the borrower's disposal. The borrower will hardly be able to repay the loan at that point, leaving no alternative but to pay the additional cost if the contract so provides. The closest situation is an increase in the rent the landlord charges the tenant, but that modification generally follows clear rules and reflects the loss of value of money as a result of inflation and is therefore regular. The contract provides for the amount of the increase, at a constant rate or by reference to inflation or another index. Interest, itself established as an annual percentage of the loaned amount, resolves this problem.

1.4. Default interest and break costs

If the borrower fails to pay any sum on its due date, the lender charges default interest on the overdue amount: a surcharge, typically of one to two percentage points per annum over the rate otherwise applicable, from the due date until actual payment. The surcharge reflects the higher credit risk of an overdue exposure and gives the borrower an incentive to pay on time. Many jurisdictions cap it or allow courts to reduce it when it operates as a penalty.

Where voluntary early repayment is allowed, the borrower may repay the loan before the maturity date by giving the lender prior notice that it complies with the formalities and notification deadlines set out in the contract. As a rule, the amount of early repayment must be equal to the minimum amount indicated in the contract or a multiple of that amount. In some cases, voluntary early repayment may involve the payment of compensation for early repayment, "break costs", which typically compensate the lender for losses or costs arising from repayment other than on the last day of an interest period. Separate prepayment fees, where agreed, may address the broader economics of early repayment.

If the borrower repays the loan in the course of an interest period, the lender loses the difference between the interest it would have earned until the end of that period and the return it can obtain by redeploying the funds in the interbank market. Loan agreements usually require the borrower to compensate the lender for that difference. Break costs lose relevance where the loan is priced over a

daily compounded rate, such as SOFR or SONIA, because the lender does not fund itself for a fixed period.

SUGGESTED CLAUSE

Interest

The Borrower shall pay interest on the outstanding principal amount in respect of each Interest Period relating thereto, on each Interest Payment Date, at the rate to be the aggregate of Euribor [Interest Period] months published on the Quotation Date plus a margin of [Margin] per cent per annum.

The Interest Periods in respect of the Loan shall have a duration of [Interest Period] months and the first Interest Period shall commence on the Utilisation Date. If in respect of an Interest Period Euribor is not published, the substitute rate applicable shall be the rate determined by the Lender corresponding to the interpolation of the Euribor rates published for the immediately smaller and higher periods in relation to the relevant interest period.

In the event an Interest Period ends on a day which is not a Business Day, such Interest Period shall terminate on the following Business Day of that month or, if such day falls in the following month, on the Business Day immediately preceding that date.

In case an Interest Period ends after the Repayment Date that Interest Period shall terminate on the Repayment Date.

Interest rate

The rate of interest payable on a Loan is [Loan Interest Rate] per cent per annum.

Accrued interest

Interest shall accrue daily (calculated on the basis of a 360-day year) and shall be payable on the Interest Payment Date and on any date the Loan or a portion thereof is repaid or prepaid (but only in respect of the interest that has accrued on the amount of such Loan paid or repaid).

Interest rate limitation

Notwithstanding anything in this Agreement to the contrary, if [at any time | on the date hereof] the interest rate applicable to the Loan, together with all fees, charges and other amounts which are treated as interest on such Utilisation under applicable law (collectively the "Charges"), shall exceed the maximum lawful rate (the "Maximum Rate") which may be contracted for, charged, taken, received or reserved by the Lender holding such Utilisation in accordance with applicable law, the rate of interest payable in respect of the Loan, together with all Charges payable in respect thereof, shall be limited to the Maximum Rate.

2. THE "MARKET DISRUPTION" CLAUSE

The market disruption clause is a safety mechanism for situations where the interest reference rate cannot be determined, for instance when the screen rate becomes unavailable because none or only a few reference banks can provide the benchmark. Market disruption clauses may also cover situations where one or more lenders cannot fund the loan at the benchmark rate, that is, where the lender's cost of funds is higher than the agreed benchmark.

Inability to fund the loan for excessive costs can be more controversial because it assumes that the lender cannot obtain funding at the agreed reference rate when, in most situations, that rate does not represent the actual cost of funding but an agreed reference for determining it. When only one of the lenders is unable to fund the loan, the cause may lie in its own problems; for instance, a downgrade left the bank unable to access financing at the cost assumed by the loan agreement, or a new lender cannot access funding at the same cost as the original lenders. Syndicated loan agreements commonly mitigate this issue by requiring notifications from lenders representing a specified minimum proportion of the relevant loan before the market disruption clause is triggered.

Where no screen rate is available, the parties must agree a substitute rate. Finding that rate or agreeing the calculation of the lenders' cost of funding, may be difficult: the reference chosen determines the final interest rate applicable to the loan, and the borrower and the lenders have opposing economic interests in it.

The temporary disruption of a benchmark differs from its permanent cessation or loss of representativeness. After the phasing out of Libor, loan agreements increasingly include benchmark replacement provisions, such as the LMA rate switch mechanics, which provide for the original benchmark to be replaced by a successor rate upon the occurrence of specified trigger events.

SUGGESTED CLAUSE

Market disruption

If, at or about [Euribor Time: 10:00 CET | GMT] on the Quotation Date for an Interest Period in respect of the Loan, Euribor cannot be determined, the Lender and the Borrower shall enter into negotiations, within [Time to Agree Substitute Rate: 10 | 15 | 20] Business Days of such notification, with a view to agreeing a substitute basis for determining the rates of interest applicable to the Loan therefrom.

3. CONCLUSION

The interest and market disruption clauses are central mechanisms of a loan agreement. Through them the parties allocate the economic cost of funding, the risk of movements in financial markets and the consequences of a temporary or structural failure of the agreed benchmark rate.

The interest clause makes the agreed economics of the loan operational. It translates the parties' pricing agreement into a working mechanism that determines what the borrower must pay and when. The market disruption clause addresses a related concern: what happens if that mechanism stops functioning properly.

The governing law rules on usury, compound interest, unilateral changes to the contract and unfair standard terms should be taken into account when drafting or reviewing these clauses.

In practice, the parties should review these provisions together. An agreement without an effective mechanism for benchmark replacement or temporary market disruption may undermine even a well-drafted interest clause.

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