**Loan Agreement Provisions –**

**Interest, Margin Protection Provisions and Subordination**

This element explains how interest is calculated is a loan agreement and the purpose of margin protection provisions. It then goes on to consider the concept of subordination.

Note: Clause references throughout this element are to the LMA Agreement. Unless specifically indicated, you are only required to familiarise yourself with the structure of the LMA Agreement. You are **not** required to read the clauses in the LMA Agreement in full.

**Interest and Interest Periods (clauses 15 and 16)**

**Interest**

In addition to the repayment of the initial amount of the loan itself, a lender will charge interest on the loan during its term. The interest rate is key here and we will look at this later in this element.

**Interest Period**

Before we look at the different rates of interest, we must clarify what we mean by an interest period:

**Term Loan:** The loan is drawn down by a borrower in the ‘Availability Period’ and the loan remains outstanding until the ‘Maturity Date’. Interest is then calculated under successive interest periods, the first of which starts on the drawdown date with the remaining interest periods beginning on the last date of the preceding period.

**Revolving Credit Facilities:** The loan is available for drawdown at any time and monies can be repaid and redrawn over the period of the loan. Each advance of the loan has its own interest period, with the advance being either repaid or rolled over on the last day of that interest period.

**Interest Rate**

• A **fixed rate** is a rate of interest that is unchanging for the life of the loan. It will provide the lender (and the borrower) with certainty. However, this certainty comes at a cost. If the base rate of interest rises, the lender may find that its own cost of funds increases meaning the cost to the lender exceeds the amount of interest it is receiving from the borrower. To offset this risk, a fixed rate of interest tends to be higher than the floating rate available to the borrower at the time the loan agreement is entered into and is therefore, less attractive to the borrower. Therefore, **fixed rate interest is rare in corporate lending**.

• Most corporate loans will bear interest at a **floating rate.** At the simplest level, banks, like any other business, make their profit on the difference between the price of the product they sell and the cost of making that product available. Applying this concept to loans, the “cost” of the loan is the lender’s cost of borrowing the money (known as its 'cost of funds').

• The interest rate charged by a lender on a loan will generally be a benchmark rate plus the 'margin' as will be discussed below. This means the interest rate will vary throughout the life of the loan to broadly reflect the fluctuating cost to the lender of providing the finance to the borrower. Benchmarks are calculated by independent bodies, so create an element of standardisation and transparency in the market.

**Floating rate interest benchmark: LIBOR - RFRs**

• Until recently, LIBOR (which stands for the London Interbank Offered Rate) was the main interest benchmark rate used around the world for corporate lending.

• Set in London, LIBOR is a screen rate derived by the LIBOR administrator (ICE Benchmark Association, which is supervised by the FCA) from panel banks submitting daily their own internal rates for lending in one of the five LIBOR currencies (sterling, US dollars, the euro, the Swiss franc and the Japanese yen) for each of seven interest periods (overnight, one week, one month, two months, three months, six months and twelve months).

• As a result of the LIBOR manipulation scandal, and the fact that changes in the interbank market have meant that many LIBOR settings are not grounded in sufficient transactional data (because there is so little trading for certain currencies), confidence in the reliability and robustness of existing interbank benchmark interest rates was undermined. As a result, the Financial Stability Board recommended in 2014 that stakeholders around the world should identify Risk Free Rates ('**RFR**s') that might be used as alternative benchmark interest rates to LIBOR.

**Floating rate interest benchmark: relevant RFR – SONIA**

• The replacement to LIBOR is the relevant risk-free rate (‘**RFR**’).

• The relevant RFR for sterling loans is the Sterling Overnight Index Average ('**SONIA**'). This is what we will use for the purposes of this Workstream. Other currencies have different RFRs (e.g. US dollar loans have the Secured Overnight Financing Rate (‘**SOFR**’), while Euro loans have the Euro Short-Term Rate (‘**€STR**’), though EURIBOR continues to be used as an alternative benchmark to LIBOR for euro loans).

• The dates for the discontinuation of LIBOR differs depending on the currency, but sterling LIBOR ceased to be published from 31 December 2021 on its original basis.

• SONIA is administered by the Bank of England and broadly reflects the average of the actual interest rates the banks have paid to borrow sterling overnight, on an unsecured basis, from other financial institutions in circumstances where credit, liquidity and other risks are minimal.

• Unlike LIBOR, the RFRs are only produced as overnight backward-looking rates. SONIA for a given London business day is published by the Bank of England at 9 am on the following London business day.

**Floating rate interest benchmark: relevant RFR**

• At a very basic level, the lender (or agent in a syndicated loan) will work out the relevant RFR at the end of each interest period and will notify the borrower of the amount of interest to be paid (which will be the RFR plus margin (see below)).

• A lender may use its own base rate as the cost of funds as an alternative to the relevant RFR. The lender’s base rate will vary as it will usually track whatever the Bank of England’s base interest rate is. The borrower will still have to pay a specified margin above this (see below). However, it is rare for base rates to be used in corporate lending.

**Interest rate components**

**Floating Rate** This is the rate that we will use in this knowledge stream and is made up of:

**RFR**

• The costs of funding by a lender fluctuate and so an element of the interest that is to be paid will float (in that it will be calculated for a set interest period).

• The lender (or the agent in a syndicated loan) will work out the relevant RFR at the end of each interest period and notify the borrower of the amount of interest to be paid.

• The amount of interest will be the RFR combined with the margin.

[AND]

**Margin**

• This is broadly the profit made by the lenders. The margin will usually be a fixed rate on top of the relevant RFR (or the base rate). The level of the margin will depend on the risk associated with the particular borrower/transaction as well as general market conditions.

• The margin is usually expressed as a percentage per annum based on the lender’s quote which is usually in basis points per annum. You need to be able to translate between the two (100 basis points = 1%, so a margin rate of 1.9% per cent per annum = 190 basis points).

**Default Interest**

• Default interest is a specific rate of interest which protects the lender against any late or non-payment of interest (or, as applicable, capital).

• The default rate is usually expressed as a fixed rate above the normal contractual rate: e.g., 1% above the interest rate payable on the loan. This is a higher rate of interest as - upon late or non-payment - a borrower becomes a higher credit risk and so the lender requires **compensation**.

• Default interest covers any additional borrowing costs of a lender and reflects the change in the credit risk of the borrower.

• A concern for the lender is, if the default interest clause is challenged, the court may judge it to be unenforceable as a penalty. Whether a clause is held by a court to be unenforceable would depend on whether the level of interest would be out of all proportion to any ‘legitimate interest’ of the lender. When setting the level of default interest, therefore, the lender has to be careful not to set it too high.

**Margin protection provisions: Overview**

• As seen the interest rate charged by a lender is usually calculated by adding a margin to the floating rate element. If the cost of lending rises, the lender needs to be able to pass that increase onto the borrower to protect its profit.

• The main 'threats' to a lenders margin include **withholding tax** and **increased costs**.

• Margin protection provisions within a loan agreement are those which aim to protect a lender against such events which could erode their margin and thereby ensure the lender is not out of pocket.

• This will be achieved by including in the loan agreement margin protection provisions, namely a '**tax gross-up**' clause to deal with the imposition of withholding tax and an '**increased costs**' clause to deal with the imposition of increased costs. These will be considered below.

• Such clauses are potentially disadvantageous to a borrower. However, the loan agreement also provides some protections for the borrower.

• Any interest that a lender will receive from a borrower will comprise income for the lender. This income will fall within the lender’s computation for UK corporation tax.

• A payment of UK source interest is subject to UK ‘withholding tax’ unless the lender falls within one of a number of exceptions.

• ‘**Withholding tax**’ is a mechanism for tax authorities to collect tax at source, so the corporation tax liability of the lender will be deducted (or withheld) at source by the borrower and paid directly to HMRC.

• The lender would then receive its interest payment net of (i.e. reduced by) the withholding tax.

• Subject to specific conditions being met, an exemption may be available where the lender is a UK bank, or where the lender is a UK corporate. If an exemption applies, the lender will be able to receive interest from the borrower **gross** of any tax (i.e. the borrower will not have to withhold tax).

**Withholding tax and banks**

• The LMA Agreement refers to a '**Qualifying Lender**', which includes UK banks and UK corporates subject to the exemption mentioned above, and lenders in jurisdictions with which the UK has a double tax treaty, referred to as a '**Treaty Lender'.**

**Purpose of a tax gross-up clause (clause 19.2(a)-(d))**

• The commercial terms agreed between a UK bank lender and borrower will usually assume that the full amount of interest will be paid to the bank (without any withholding).

• However, the ‘**Tax Gross Up**’ clause protects the lender in a scenario whereby tax is deducted, for example if the **borrower ceases to be exempt from its withholding tax obligation**, or if **there is a change in law.**

• The 'Tax Gross Up' clause usually makes the borrower responsible for the cost of any withholding tax, by requiring the borrower to ‘gross up’ (i.e. increase) the amount of any interest paid so that, after tax has been deducted, the lender receives the original amount which it would have received if the deduction had not been made. Therefore, the lender is not out of pocket.

**Purpose of increased costs clause (clause 20)**

• This clause protects a lender in a situation where its underlying costs relating to a loan facility increase **as a result of a change in law**. In such a scenario, the borrower will be required under the increased costs clause to compensate the lender for the increase.

• Where any costs associated with the loans do rise unexpectedly, this will have a knock-on effect on margin. This, in turn, could lead to the profits of the lender suffering.

**Increased costs and banks**

**What kinds of cost are envisaged?**

• Costs arising from changes in rules relating to maintaining regulatory capital in accordance with capital adequacy rules. Broadly, these rules require lenders to maintain a sufficient proportion of capital compared to loans, to protect depositors in case those loans are not repaid.

• Costs arising from any other changes in law or regulation to which the lender is subject.

**What kind of costs would not be recoverable from the borrower?**

• Costs arising from non-compliance/breach of any law or regulation the bank is subject to.

• Costs arising from changes in tax law. The lender would be protected by the tax gross-up provisions.

**Protections for the borrower**

• If the borrower is obliged to pay additional amounts under either the gross-up clause or the increased costs clause, there may be certain protections available to it in the loan agreement.

• The Borrower may have the right to prepay the affected lender if withholding tax would be required to be paid in respect of that lender and the borrower would have to gross-up its interest payment to that lender or if increased costs were payable by the borrower (clause 12.6(a)). Note, under clause 2.3 a borrower can request that another lender takes on the amounts that would otherwise be cancelled under clause 12.6(a).

• For gross-up only, the borrower may be entitled to receive from the lender the amount paid to HMRC if the lender receives an equivalent amount in the form of a tax credit and can attribute that tax credit to the amount the borrower paid (clause 19.4).

• There are certain circumstances where loans are transferred between lenders in which the tax gross-up clause or increased costs clause will not be triggered.

• Finally, clause 22 (‘**Mitigation**’) sets out a duty on the lender to act so as to minimise any application of the tax gross up and increased costs clauses. This is designed to give a borrower some comfort that a lender will not rely on the open-ended protection which those clauses afford and make no attempt to minimise or avoid the increased tax or other costs.

**Subordination**

• We have now considered the key clauses in a loan agreement.

• The remaining slides focus on a problem that arises when there is a group of companies and there are loans at different levels of the group.

• This is known as **structural subordination.**

**Structural Subordination**

• It is very common for companies to operate under a group structure where a holding company has 100% shareholdings in subsidiaries. These subsidiaries may be operating companies, running businesses and owning assets or themselves intermediate holding companies of operating companies. Lenders may lend to the holding company which then filters the money down to the subsidiary(y/ies).

• This can cause problems for the lender which lends to the holding company if the subsidiaries have existing loans or later take out loans. This is because of the statutory order of repayment of creditors on the winding-up of a company.

**The repayment of creditors on a winding-up is made in the following order (note: this is a deliberately simplified list):**

• fixed chargeholders;

• preferential creditors;

• payments out of the ring-fenced fund;

• floating chargeholders;

• unsecured creditors; and finally

• shareholders.

**Subordination**

**Example:**

*[Diagram: Bank X arrow under box “Lends” to Hold Co ; line from Hold Co to Company A and line from Hold Co Company B (under box “100% subsidiaries”) ; Arrow from Bank Y to Company B under box “Lends 18 months later”].*

**Structural Subordination**

**Example:**

• Companies A and B are wholly-owned subsidiaries of HoldCo. Companies A and B are the operating companies owning the majority of the group’s assets and generating the income for the group. HoldCo’s only assets of value are the shares in its subsidiaries and it does not generate any of its own income.

• Bank X lends money to HoldCo. 18 months later, Bank Y lends money to Company B.

• On a winding up of the group, the assets of Company B will not be available to satisfy the debt owed by HoldCo to Bank X until Bank Y (and any other creditors of Company B) has been paid in full. This is because HoldCo only has a claim to the assets of Companies A and B as a shareholder – and, as can be seen from the above list, shareholders are the last to be paid on a winding up.

• Note that the issue is the existence of the **loan** to Bank Y. **It does not matter if this loan between Company B and Bank Y is secured or not** because Bank Y, whether as a fixed chargeholder (if the loan is secured) or an unsecured creditor (if the loan is unsecured), will still rank above Holdco as shareholder.

• Because of the group structure, and the order of claims imposed by the statutory order of payments on a winding up, **Bank X is said to be ‘structurally subordinated’ to Bank Y**.

**Structural Subordination- solutions**

**Unsurprisingly, this situation is unsatisfactory to Bank X. To reduce the effect of a situation like the one in the example, Bank X can:**

• Insist on HoldCo giving (1) no financial indebtedness, (2) negative pledge and (3) no disposals undertakings to Bank X in the loan agreement. These would restrict HoldCo and HoldCo’s subsidiaries from (1) creating more than a certain amount of debt; (2) granting security over their assets; and (3) selling any of their assets. The aim is to limit the amount owed to creditors that would rank ahead of Bank X on a winding up of the group and to retain as many assets as possible in the group which are unsecured and available to pay off creditors. These would also ensure that no further debt could be taken on at Company B level, meaning that Bank X is not further structurally subordinated in respect of additional lenders to Company B.

• Take a guarantee and/or take security from Company B so Bank X has a direct claim against Company B or its assets.

• Require a subordination agreement between the respective lenders (i.e., contractual subordination) (see slides below).

**Contractual Subordination**

• Where there are different lenders either in a group structure (as above) or within a transaction (e.g. there may be a loan from a syndicate as well as a separate loan being given by a shareholder or the directors) then these lenders can decide amongst themselves the order in which they will be paid by a defaulting borrower.

• The document which governs this arrangement is invariably either called a subordination agreement, an intercreditor deed or a deed of priorities.

• There are various ways that contractual subordination can be structured but the most common is when the junior lender agrees that it will not demand the junior debt from the borrower until such time as the senior lender has been paid in full.

• This might be drafted to include all monies owed to the junior lender or just the amount of principal owed (so the junior lender is able to receive any fees or interest owed to it).

• Only when the senior lender has been paid in full will all amounts outstanding to the junior lender be paid in the agreed contractual order of priority.

• If the junior lender receives money from the borrower before the senior lender has been paid in full the agreement usually provides that the junior lender will hold this money on trust for the senior lender.

• It is sometimes the case that all of the lenders who have entered into a contractual subordination agreement have taken security for their loans. In this instance, the senior lender will not want a junior lender being able to enforce its security (and thereby forcing the senior lender’s hand) so the agreement will also include a provision restricting when the junior lender can enforce its security.

• Enforcement of security is often only allowed with the consent of the senior lender.

• The agreement should also provide that all parties are restricted from amending the loan agreement in specified ways without the other lenders’ consent. This will primarily relate to changes such as increasing amounts due under the respective loan agreement (interest and principal) or making the terms of the loan agreement materially more onerous for the borrower.

• This will help to maintain the level of indebtedness due to any party and the terms with which the borrower has to comply.

• You might be wondering why a junior lender would agree to these terms which, in effect, means they are more exposed to potentially not having their debt repaid in full or even at all. However, to reflect this increased risk of non-payment a junior lender will be able to charge the borrower higher fees and/or margin.

• The order of priority under a subordination agreement will only be relevant if the borrower becomes insolvent or enters into financial difficulty. Most of the time, the borrower will be able to pay both the senior and junior lenders in accordance with the repayment schedule in their respective loan agreements.

• Another reason why a junior lender might agree to entering into a subordination agreement is if there is a need for a cash injection into the borrower/group. Agreeing to be subordinated to another lender might be the only way to attract a new lender. This is one of the reasons why a lender to a subsidiary might agree to give up their priority in a structural subordination situation (as in the example above).

**Summary**

• The interest clause will set out the interest rate a lender will charge on the loan. This will be made up of a floating rate (based on a benchmark rate) with a margin added.

• A lender will want to protect itself from anything which may erode its margin, as this would mean the lender not getting the full amount of interest it is expecting.

• Events such as imposition of withholding tax or an increase in underlying costs could threaten a lender's margin.

• **Tax gross-up and increased costs** provisions in the loan agreement help to **protect a lender** against erosion of the margin, by effectively allocating the risk of imposition of withholding tax to the borrower and passing on any increased underlying costs to the borrower.

• This is counter-balanced with certain protections for the borrower, which will also be included in the loan agreement.

• A lender will be concerned about structural subordination, which may arise where there is a group of companies and separate lending at different levels of the group. Contractual subordination may be used as one of the possible solutions to this problem.