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Recent developments in U.S. leveraged finance – November 2017

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The fourth quarter of 2017 has given rise to at least three developments of interest to the U.S. leveraged lending community: (1) the taking of steps now to address the expected discontinuation of the London interbank offered rate (LIBOR) after 2021; (2) the Republican House tax plan proposal to limit the deductibility of interest on debt; and (3) the temporary procedural invalidation (and possible permanent rejection) of the U.S. Leveraged Lending Guidance.

Discontinuation of LIBOR after 2021

LIBOR is an interest rate at which banks in London are able to obtain unsecured funding for an agreed period and currency. LIBOR underpins trillions of dollars of financial contracts, including bonds, loans and derivatives. Past scandals associated with the setting of LIBOR prompted the administration of LIBOR to be moved from the British Bankers Association to its current administrator, Intercontinental Exchange, operating through ICE Benchmark Administration Limited – hence the current moniker, "ICE" LIBOR. In July of 2017, the U.K.'s Financial Conduct Authority announced that it will no longer support LIBOR after 2021, and directed the finance industry to come up with an alternative to LIBOR. Although working groups have proposed various alternatives to LIBOR – such as, for U.S. dollars, SOFR or Secured Overnight Funding Rate (also known as the "broad Treasuries repo financing rate" or BTFR) – it will be some time before industry and regulatory stakeholders coalesce around a viable LIBOR replacement. Of course, in the current hotly oversubscribed U.S. leveraged loan market, it is common for the tenor of loans made now to extend well past 2021. Late October 2017 saw the first widely known instances of arrangers including language in credit agreements allowing administrative agents to select a LIBOR replacement.[1] In some cases, administrative agents have been given the right to make this selection without lender consent; while in others, a so-called "negative consent" approach (giving lenders a short period of time to object to the administrative agent's selection) has been adopted. Market participants will want to continue to stay tuned in this area – both for the emergence of an ultimate successor to LIBOR by 2021, and in the interim, for the development of market standard credit agreement language dealing with LIBOR's expected discontinuation.

Republican tax plan proposal to limit the deductibility of interest on debt

The Republican House tax plan released on Thursday, November 1, included a proposal to cap the deductibility of interest on debt at 30% of a company's earnings before interest, taxes, depreciation and amortization (EBITDA). Needless to say, this could seriously impact highly levered financings such as those used in leveraged buyouts. Private equity firms have already objected to the House tax plan as upending their entire business model (or at least, decreasing return on equity)[2]. With a wide array of other lobbyists lining up to oppose other aspects of the House tax plan, the Senate expected to propose its own tax plan, and President Trump's approval rating seemingly reaching new lows on a daily basis, it remains

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to be seen whether U.S. tax reform will pass at all, let alone whether specific areas of reform (such as caps on interest deductibility) will be enacted. Developments in this area too will be of keen interest to U.S. leveraged loan market participants.

Leveraged Lending Guidance

Regular readers of Osler Updates will be familiar with the Leveraged Lending Guidance (LLG) published in 2013 by U.S. regulators (See here for a reminder.) Among other things, the LLG provided that a leverage level after planned asset sales (that is, the amount of debt that must be serviced from operating cash flow) in excess of six times EBITDA will raise supervisory concerns for most industries – subjecting regulated lenders who make such loans to regulatory scrutiny and even sanction. Not surprisingly (in retrospect at least), the LLG has resulted in the origination of highly levered loans moving away from regulated lenders (such as banks) toward unregulated lenders. Recall that the LLG was issued as a "guidance" rather than a formal "rule." As recently noted by the Loan Syndication and Trading Association[3], on October 19, the U.S. Government Accountability Office (GAO) issued an opinion that the LLG was in fact a "rule" subject to review by the U.S. Congress. The submission of the GAO opinion to Congress on October 20 started the running of a 60-day clock, during which Congress and President Trump can reject the LLG. What's more, pending the regulators' submission of the LLG itself to Congress, the LLG is technically not in force. This too will be a key area of focus for U.S. leveraged loan market participants, given that rejection of the LLG by Congress and President Trump (if this occurs) could re-level the playing field among regulated and unregulated lenders.

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[1] Debtwire, October 25, 2017, "Banks take upper hand over lenders in crafting Libor replacement plans."

[2] Wall Street Journal, November 3, 2017, "Private-Equity Firms Have a Beef with Tax Bill—but Things Could Be Worse."

[3] LSTA "Week in Review", October 27, 2017: "GOA on LLG: What Now?"